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THE INSTITUTIONAL INVESTOR'S GUIDE TO SECURITIES CLASS ACTION LITIGATION

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Barrack, Rodos & Bacine

Stock Option Backdating: The Ultimate in Greed

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On March 18, 2006, *The Wall Street Journal* published an article, "The Perfect Payday: Some CEOs reap millions by landing stock options when they are most valuable. Luck – or something else?" The article was the result of an extensive investigation into an apparent pattern at certain companies to grant stock options to senior executives on dates when a company's stock reached its low points. The article reported that the Securities and Exchange Commission was examining questionable stock option practices at many companies.

Since the article's publication, brokerage firms, business publications, consulting firms and law firms have uncovered what appears to have been a widespread practice in corporate America to backdate stock option grants. The SEC has confirmed that it is investigating over 120 companies. Other companies have revealed that they are under investigation by the U.S. Department of Justice. Dozens of companies have announced internal investigations into their options practices and many have also disclosed that they will be issuing restatements of previously issued financial statements, to correct improper

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Does Sarbanes-Oxley Make U.S. Markets Less Competitive?

Jeffrey A. Barrack

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The massive corporate scandals at WorldCom and other large corporation led President Bush to call for "truthful books, honest people and well enforced laws against fraud and corruption," and Senator Paul Sarbanes (D-Md.) to warn that "unless we come to grips with the crisis in accounting and corporate governance, we run the risk of seriously undermining our long-term world economic leadership." In response, Congress enacted and President Bush signed into law the Sarbanes-Oxley Act of 2002, which contained important corporate governance reforms designed to deter corruption and to hold corporate managers accountable for harm to investors. Signing the bill into law on July 30, 2002, President Bush hailed it as one of the "most far-reaching reforms of American business practice since the time of Franklin Delano Roosevelt."

Now, when Enron, WorldCom and other scandals have fallen out of the news, influential industry groups are hoping to swing the regulatory pendulum in the opposite direction. For example, in September 2006, academic, financial and corporate leaders formed the Committee on Capital Markets Regulation (CMR), whose goal was "to provide carefully considered recommendations for adjustments to the current regulatory and liability framework." CMR Committee co-chairmen R. Glenn Hubbard and John L. Thornton claimed that these "adjustments" – including changes to Sarbanes-Oxley – are needed to improve the competitiveness of American capital markets.

The CMR Committee is not alone in its negative view of Sarbanes-Oxley. In an interview with CNBC, Vice President Cheney said: "I think you can make a case that Sarbanes-Oxley went too far. The fact of the matter is – when we had, for example, Enron and WorldCom, the problems that developed from the standpoint of those companies, those activities were illegal before there was any additional regulation put in place." Securities and

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Stock Option Backdating

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accounting for backdated stock option grants. Indeed, one analysis estimates that *the stock options backdating scandal has cost companies nationwide approximately \$10.3 billion.*

Stock Options: A Primer

Companies typically grant stock options to their executives and directors as equity-based compensation. When compensation is tied to stock price, members of company management have a great incentive to improve the company's performance, which in turn raises the company's stock price. An increased stock price increases both the value of the options granted and shareholder returns.

Several reasons account for the popularity of stock options as compensation for executives and non-executives. Beginning in 1972, employee stock options were not shown as an expense on a company's income statement, so long as the option's terms were fixed when the option was granted, and so long as the exercise price was equal to the market price on that day. Options became more popular after 1993, with the enactment of section 162(m) of the Internal Revenue Code, which limited to \$1 million the deductibility of cash compensation awarded to certain top executives except under certain circumstances.

This change tilted compensation practices away from salary and toward performance-based compensation to which the cap did not apply. Unfortunately, as the use of options compensation has increased, so has the abusive practice of backdating.

But how does it work? A stock option granted by a corporation allows the grantee to purchase the corporation's stock for a specified period at a specific price, called the "exercise" or "strike" price. Under most stock option plans, the exercise price of the option is based on the price of the stock on the grant date. When the holder of a stock option exercises that option, he or she purchases the stock from the company at the exercise price, regardless of the stock's current market price on the exercise date. Typically, the recipient cannot exercise the option until it has "vested," usually after passage of a set period of time.

Options with a strike price equal to the current trading price of the underlying stock are referred to as being "at the money" and options with a strike price below the current trading price of the stock are "in the money."

What is Backdating?

The improper practice of "backdating" stock options occurs when the exercise price for a stock option is based on a date before the grant date of the option, when the stock price was below what it was on the grant date. Thus, the holder pays less – and the company receives less – money for the stock when the option is exercised. This practice unfairly enhances the option grant as compensation and undermines the incentive value of the option grant.

Backdated options allow company executives and directors to prosper without building long-term shareholder value. By creating an instant paper profit, backdating undermines the goal of motivating those who lead the company to act in ways that improve the business and enhance the stock price. Indeed, backdating is a lot like betting on a poker hand after all the cards are displayed.

While stock options generally qualify for favorable tax treatment, options issued at a discount to the market price do not qualify for that treatment. For example, for performance-based stock options (generally granted to the five highest-paid executives), a company is allowed to take a tax deduction of the full value of the stock option, *provided that the options were granted at the market price.* Backdating, however, automatically disqualifies those options from receiving the tax break and can result in significant adverse tax consequences for the company.

Under IRC section 162(m), at-the-money options are usually considered performance-based compensation deductible from corporate tax returns, even if an executive earns more than \$1 million a year. If these performance-based options were actually in-the-money options, the options are not deductible. Instead, a company's tax deduction is capped at \$1 million for each of the five highest-paid executives. The problem with backdating is that it allows in-the-money options to appear in regulatory filings as if they were ordinary at-the-money grants. Adjustments to correct the backdated options can eliminate the effects of tax breaks the company had received. In light of these serious tax ramifications, the IRS is examining many companies for backdating stock options to determine whether they owe millions of dollars in unpaid taxes.



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The instant paper profit received by executives and directors through the use of backdated stock options also raises serious accounting issues. Under generally accepted accounting principles (“GAAP”), the instant paper profit was extra compensation and should have been reflected as a cost to the company in its financial statements. But because companies failed to record the costs as extra compensation in their financial statements, their profits were overstated during the fiscal periods in which the options were granted.

Stock option backdating “represents the ultimate in greed... It is stealing, in effect. It is ripping off shareholders in an unconscionable way.”

Former SEC Chairman Arthur Levitt

Alarming, in many instances executive officers and directors have repeatedly awarded themselves and their associates options backdated to dates just prior to a large increase in the company’s stock price. As a result, these officers and directors were unjustly enriched to the detriment of the company and its shareholders. Backdating the options also breached these individuals’ fiduciary duties of care, loyalty, and good faith.

The March 18, 2006 article, “The Perfect Payday,” in *The Wall Street Journal* gave some background on the issuance of stock option grants and when company insiders would benefit from the backdating of those grants:

The use of stock options surged in the late 1990s as young firms that had bright prospects but little revenue used them to attract and pay executives. As dot-com and telecom shares exploded, stock options became a source of vast wealth.

They also grew controversial. Critics worried that big options grants tempted executives to do whatever it took to get the stock price up, at least long enough to cash in their options. At the same time, during a general bull market, the options sometimes richly rewarded executives for stock buoyancy that had little to do with their own efforts.

On May 22, 2006, *The Wall Street Journal* quoted former chairman of the SEC Arthur Levitt, who stated that

stock option backdating “represents the ultimate in greed.” Further, Levitt stated, “***It is stealing, in effect. It is ripping off shareholders in an unconscionable way.***” And, during recent Senate hearings on the backdating scandal, Senator Chuck Grassley stated:

It is behavior that, to put it bluntly, is disgusting and repulsive. It is behavior that ignores the concept of an “honest day’s work for an honest day’s pay” and replaces it with a phrase that we hear all too often today, “I’m going to get mine.” Even worse in this situation, most of the perpetrators had already gotten “theirs” in the form of six-and seven-figure compensation packages of which most working Americans can only dream. But apparently that was not enough for some. Instead, ***shareholders and rank-and-file employees were ripped off by senior executives who rigged stock option programs – through a process called “back-dating” – to further enrich themselves.*** And as we have found far too often in corporate scandals of recent years, boards of directors were either asleep at the switch, or in some cases, willing accomplices themselves.

(Emphasis added).

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DOES YOUR PENSION PLAN MISS OUT ON CLASS ACTION SETTLEMENTS?

According to a 2006 study by James Cox, a professor at the Duke University School of Law and Randall S. Thomas, a professor at Vanderbilt University Law School, only 28% of institutional investors eligible to file proofs of claim in securities class action settlements actually do file claims. Is your fund one of the 72% of institutional investors missing out?

If your fund believes it may be losing out on recovering its share, BR&B can advise you on a remedy. Please contact us to see how BR&B can help. ❖



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Barrack, Rodos & Bacine's Involvement in Stock Option Backdating Cases

Barrack Rodos & Bacine is currently representing institutional investors in a number of derivative actions (*see* "Stock Option Backdating and Derivative Actions" below) brought on behalf of companies that appear to have engaged in the manipulative practice of issuing backdated stock option grants. As is our overall practice philosophy, we have not rushed to file every case that could possibly be filed. Rather, it has only been after sufficient due diligence and consultation with our clients that we have become involved in cases that merit our client's involvement. The cases have been brought as shareholder derivative actions for the benefit of the subject company, a nominal defendant, typically against the members of the board of directors of the company and certain of its executive officers, seeking to remedy defendants' breaches of fiduciary duties, unjust enrichment, and related violations of federal and state law, as appropriate.

The complaints in these cases target the period of time, often from the mid-1990's until and often going beyond passage of the Sarbanes-Oxley Act in mid-2002, during which management-level employees committed gross breaches of their fiduciary duties by:

- √ improperly backdating grants of stock options to senior executives, and sometimes other executives and board members, in violation of the company's stock option plans;
- √ improperly recording and accounting for the backdated stock options, in violation of GAAP;
- √ improperly taking tax deductions based on the backdated stock options, in violation of IRC section 162(m);
- √ disseminating to shareholders and the market false financial statements and other SEC filings that improperly recorded and accounted for the backdated option grants and concealed the improper backdating of stock options; and
- √ improperly exercising or permitting the exercise of previously backdated options.

In each of these cases, we have alleged that the defendants caused their companies to file false and misleading statements with the SEC, including proxy state-

ments, that the options granted carried an exercise price that was not less than the fair market value of the stock on the date of the grant. The lawsuits against the individual defendants include claims for: (a) breaches of fiduciary duties (both in overseeing the granting of stock options in violation of the companies' stock option plans and for filing false proxy and financial statements); (b) unjust enrichment; (c) violations of applicable state laws; (d) abuse of control; (e) gross mismanagement; and (f) constructive fraud. When appropriate in the federal court actions, the lawsuits include claims for (a) violations of the antifraud provisions of the federal securities laws; (b) violations of the proxy provisions of the federal securities laws; (c) violations of the Sarbanes-Oxley Act; and (d) violations of insider selling prohibitions.

The facts of each case vary. Generally, however, it appears that the defendants in each of these cases, despite the real risks involved, have engaged in and abetted improper and illegal activities involving backdating of stock options, false and misleading accounting of those options, and false and misleading disclosures about the options.

We believe that these cases have substantial merit. The individuals who failed their own companies and their shareholders in such ways should be held accountable for their actions. They should be called upon to disgorge the profits on their stock sales to which they were not entitled and otherwise compensate their companies for the company's exposure to federal investigations, payments of back taxes, penalties and interest, and restatements of financial statements. Unfortunately, with new revelations every week, there is no apparent end in sight to the backdating scandal. BR&B will continue to seek redress for shareholders and the corporations "ripped off by senior executives who rigged stock option programs." ❖

Stock Option Backdating and Derivative Actions

Regina M. Calcaterra, Esquire
Partner, Barrack, Rodos & Bacine

Much of the litigation that has arisen from the stock option backdating scandal has been in the form of shareholder derivative actions, rather than class actions for violations of the federal securities laws. Securities and derivative actions serve two different purposes. In securities class actions, investors seek to recover their own losses caused by misleading public disclosures. In a derivative action, by contrast, the lawsuit is filed by a

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shareholder *on behalf of* the corporation, to recover for harm done to the corporation, typically caused by its officers and directors.

What is a Derivative Action?

A derivative action is a lawsuit brought by a current shareholder of a corporation in the name of the corporation typically against corporate officers or directors who allegedly caused harm to the corporation. Most often the claims are for breaches of the officers' and directors' fiduciary or other duties to the company. Derivative actions are appropriate in situations when the harm is suffered by the corporation rather than by its shareholders. In derivative actions, the corporation is usually named as a "nominal" party to the lawsuit because, although no relief is sought *from* the corporation, relief is sought *for* the corporation's benefit. Recoveries in derivative actions are paid to the corporation itself, and not to those shareholders who bring these derivative actions.

Corporate officers and directors will find themselves as defendants in a derivative action when they have violated rules governing proxy statements or stock option plans, when they have breached their fiduciary duties to the corporation and its shareholders, or when they have misappropriated the corporation's business opportunities and have wasted corporate assets.

Where the corporation's management and board of directors are controlled by the wrongdoers, the derivative litigation mechanism is an effective means to protect the corporation.



Regina M. Calcaterra

The Duties of Officers and Directors

Officers and directors of a publicly-owned company, because of their positions of control and authority at the company, are required to exercise reasonable and prudent supervision over the company's management, policies and practices. By virtue of such duties, the officers and

directors of the companies involved in the stock option backdating scandal were required to but did not:

- √ exercise good faith in ensuring that the affairs of the company were conducted in an efficient, business-like manner so as to make it possible to provide the highest quality performance of their business;
- √ exercise good faith in ensuring that the company was operated in a diligent, honest and prudent manner and complied with all applicable federal and state laws, rules, regulations and requirements, including acting only within the scope of its legal authority;

We believe that the misconduct relating to the backdating of stock option grants should not be protected by the "business judgment" rule.

- √ exercise good faith in supervising the preparation, filing and dissemination of financial statements, press releases, audits, reports or other information required by law, and in examining and evaluating any reports or examinations, audits, or other financial information concerning the financial condition of the company;
- √ exercise good faith in ensuring that the company's financial statements were prepared in accordance with generally accepted accounting principles ("GAAP"); and
- √ refrain from unduly benefiting themselves and other company insiders at the expense of the company and its shareholders.

They were also responsible for maintaining and establishing adequate internal accounting controls for the company and to ensure that the company's financial statements were based on accurate financial information. According to GAAP, to accomplish the objectives of accurately recording, processing, summarizing, and reporting financial data, a corporation must establish an internal accounting control system. Many of the companies had audit committee and/or compensation committee charters that required these committee members to undertake certain additional responsibilities to the board and shareholders.

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Exchange Commission Chairman Christopher Cox said in a recent Congressional hearing that section 404 of Sarbanes-Oxley, which requires certifications by management and opinions by auditors on the adequacy of internal controls, “has been too expensive for investors.” Paul Sharman, president of the Institute of Management Accountants, says that Sarbanes-Oxley is responsible for “nothing less than a massive erosion of U.S. global competitiveness. The clock is ticking and the global stage is watching – now is the time to be bold and decisive to restore U.S. global competitiveness.” In his first major speech as U.S. Treasury secretary, Henry Paulson, Jr. told a Columbia University audience: “Often the pendulum swings too far, and we need to go through a period of readjustment. The challenge before us now is how to achieve the right regulatory balance to allow us to become competitive in today’s world while guarding against the re-occurrence of past abuses.”

Supporters of Sarbanes-Oxley are just as vocal. “This is an escalation of the culture war on regulation,” Duke Law School professor James D. Cox told *The New York Times*. Ben Stein suggested in his column *Everybody’s Business* that when one talks about a “corporation” one should always keep in mind “the widows and orphans who actually own the stock and the company.” Stein asks: “Is it really right for prominent American executives, amid a host of scandals involving other executives looting their shareholders blind, to have the best and the brightest of academe and the Street lobbying for *less* accountability to shareholders?”

Do We Need Sarbanes-Oxley?

Investors depend on the accuracy and reliability of financial statements and internal corporate controls when making their investment decisions. The anti-Sarbanes-Oxley forces emphasize that this work is being done by “professionals who have been educated specifically on how to design, implement and manage internal control systems.” But are well-trained professionals enough to prevent corporate fraud? As federal district court Judge Thomas W. Thrash, Jr., has noted: “corporate insiders and upper management always have the opportunity to lie and manipulate.” And the federal court in Enron characterized that fraud as involving “a combination of arrogance, greed, deceit and financial chicanery.” Elsewhere, Judge Abner J. Mikva of the United States Court of the Appeals observed that “greed paired with sloth can subvert the legal system.”

The question of who has responsibility for accounting and financial reporting is fairly simple under generally accepting accounting principles (“GAAP”). GAAP states unequivocally that the responsibility for the reliability of an enterprise’s financial statements rests with its management. Kirsten L. Flanagan, a shareholder of the Philadelphia accounting firm Shechtman Marks Devor, explains that: “GAAP describes objectives and concepts underlying standards and practices existing in the financial markets. APB Statement No. 4, issued in 1970, provides that management of a company, including its CEO, CFO, directors, and audit committee members, are ultimately responsible for maintaining effective systems of accounts and internal control, and preparing adequate financial statements.”

Transparency and reliability is precisely what has enabled the U.S. to enjoy its long-term economic leadership in global markets.

Typically, a company’s accounting department prepares financial statements and the company’s controller, chief financial officer, and ultimately the chief executive officer, supervise the process. Oversight of management’s performance of these tasks is the responsibility of the company’s board of directors, which oversight is generally delegated to the board’s audit committee. These layers of corporate oversight are crucial to a company’s control over its accounting and financial reporting. A company’s internal control structure is designed to provide reasonable assurance that the company’s financial reporting is reliable, its operations are effective and efficient, and it is complying with applicable laws and regulations.

Recent announcements demonstrate that Sarbanes-Oxley has improved corporate accounting and reporting. In July 2006, the U.S. Government Accountability Office (GAO) issued a report to Senator Sarbanes concerning financial restatements. The GAO identified over 1,750 financial restatement announcements between July 1, 2002, and June 30, 2006 and found that the number of public companies announcing financial statement restatements rose by about 67 percent since passage of Sarbanes-Oxley. The GAO concluded that many factors contributed to the rise in restatements, including “increased accountability requirements on the part of company executives; increased focus on ensuring internal controls for financial reporting; increased auditor and regulatory scrutiny (including clarifying guidance); and a general unwillingness on the part of public companies to risk failing to restate.” The GAO

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found that the primary reasons given for the restatements were to correct errors made in accounting and in reporting revenue, costs or expenses.

Commenting on the GAO report, Charles D. Niemeier, a member of the Public Company Accounting Oversight Board created by Sarbanes-Oxley, explained:

Many of these restatements are attributed to errors identified in companies' and auditors' examination of the effectiveness of internal controls.... Indeed, the number of restatements by U.S. companies in 2005 reached a record level.... While troubling that this number of material errors in U.S. companies' financial statements still exist, it is, at the same time, a positive sign that, working with their auditors, U.S. companies are getting their accounting on the right path.

In a speech in Sao Paulo, Brazil, Mr. Niemeier recounted that by the late 1990s, audits were perceived to be “compliance obligations as opposed to the linchpin of reliable financial reporting” and that weaknesses in controls over corporate accounting and financial reporting allowed managers “to manipulate results as reported to investors.” Mr. Niemeier concluded that Sarbanes-Oxley was designed to restore the transparency and reliability to financial statements and disclosures, giving investors the information they needed to make informed



Jeffrey A. Barrack

investment decisions. Reliable financial statements and disclosures would restore investor confidence in the integrity of financial and accounting information available in the capital markets.

Mr. Niemeier dismissed the contention that Sarbanes-Oxley has discouraged companies from tapping U.S. capital markets, explaining that the “greatest costs companies listing in the U.S. face are not compliance costs but rather are underwriting fees.... The facts appear to confirm the continued attraction of U.S. markets to companies, because of the significant valuation premium for companies that can meet the requirements of U.S. listings.” Niemeier says that New York Stock Exchange estimates peg the valuation premium at 30 percent. Similarly, a December 2005 study

found that companies from countries with more extensive disclosure requirements, stronger securities regulation, and stricter enforcement mechanisms, have a significantly lower cost of capital. Christianna Wood, senior investment officer at the California Public Employees' Retirement System, told Reuters that the cost of capital for companies listing in the U.S. is 7 percent less than abroad, and valuations are at a 13 percent premium. As a result, “the U.S. share of worldwide IPOs actually has increased since 2001,” S.E.C. Commissioner Annette L. Nazareth told *Newsweek*, adding: “[Sarbanes-Oxley] has not harmed our ability to compete but rather is viewed by other countries as providing valuable investor protections.”

The transparency and reliability of corporate governance systems, accounting and financial reporting standards, and related requirements for internal control structures lead to the kind of growth in value that is desired by long-term investors, who depend on clear and reliable financial reporting. That transparency and reliability is precisely what has enabled the U.S. to enjoy its long-term economic leadership in global markets. Transparency through reasonably accurate disclosure – as embedded in the federal securities laws and in Sarbanes-Oxley – is the key to ensuring that U.S. capital markets continue that leadership for years to come. ❖

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About the Publisher...



Barrack, Rodos & Bacine is a boutique law firm that has been extensively involved in class and derivative actions alleging violations of securities laws since 1976. The firm, with attorneys in offices located in Philadelphia, San Diego, New York, and New Jersey, has been appointed by federal judges throughout the country as lead counsel in many cases since the passage of the PSLRA and represents a number of institutional investors in securities class actions. The *Barrack Bulletin* is edited by Leslie Bornstein Molder, Esquire.

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BR&B Welcomes...

A. Arnold Gershon and Gloria Kui

Barrack, Rodos & Bacine recently welcomed two new lawyers to its New York office, in its new location in midtown Manhattan.

A. Arnold Gershon

Alexander Arnold Gershon joined Barrack, Rodos & Bacine as a partner in 2006 in the firm's New York office. Since 1969, Arnold has represented plaintiffs in cases arising under the federal securities laws, the corporation laws, and similar matters in class actions, individual actions, and stockholders' derivative actions in the state and federal courts throughout the country. He has contributed to the jurisprudence of class action settlements in cases such as *National Super Spuds, Inc. v. New York Mercantile Exchange*, 660 F.2d 9 (2d Cir. 1981) and has helped to establish important standards in shareholder derivative actions such as *Seinfeld v. Barrett*, 2006 WL 890909 (D.Del. 2006), and *Vides v. Amelio*, 265 F.Supp.2d 273 (S.D.N.Y. 2003) (exceptions to the demand requirement in stockholders' derivative actions); *Lewis v. Vogelstein*, 699 A.2d 327 (Del.Ch. 1997), and *Kaufman v. Beal*, 1983 WL 20295 (Del.Ch. 1983) (standards for executive compensation). Arnold has also contributed to the establishment of the standards of required disclosure under the federal securities laws when corporate stockholders are solicited to approve executive bonus plans seeking tax benefits under the Internal Revenue Code. See *Shaev v. Saper*, 320 F.3d 373 (3d Cir. 2003).



A. Arnold Gershon

Arnold graduated from the Georgia Institute of Technology in 1962 with a Bachelor of Science in Chemistry, from Emory University in 1964 with a Bachelor of Laws,

Claims Filing Deadlines

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for detailed claims filing deadline information.

and from New York University in 1966 with a Master of Laws (in Taxation). Arnold is a member of the Georgia bar (inactive), the New York bar, and the bars of various federal courts, including the United States Supreme Court the circuit courts of appeal for the District of Columbia Circuit and the Second, Third and Ninth Circuits, as well as a number of federal district courts.

Gloria Kui



Gloria Kui

Gloria Kui joined the New York office of Barrack, Rodos & Bacine in 2006. She graduated from New York University in 2000, with a degree in Piano Performance. Gloria attended Cardozo School of Law and received her J.D. in 2005. While at Cardozo, she was a Notes Editor of the *Cardozo Public Law, Policy & Ethics Journal*. Before joining BR&B, Gloria represented plaintiffs in stockholder derivative cases in state and federal court. ♦

Derivative Actions

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The Defendants' "Good Faith Business Judgment" Defense

Among the defenses being raised in these derivative cases, many corporate managers seek to have the complaints filed against them dismissed on the basis of the "business judgment" rule. The "business judgment" rule states that when a director undertakes an action in good faith, and without conflict between himself and the company, the decision is protected. We believe, however, that the misconduct relating to the backdating of stock option grants – and the filing of false financial proxy statements – should not be protected by the "business judgment" rule. Our reason is simple: good faith business judgment should never protect corporate managers from liability for causing a company to violate its own stock option plans; issue false financial statements; issue false proxy statements; cause the company to file false tax returns; subject the company to owe back taxes and penalties to the IRS; subject the company to potential federal securities law prosecutions; and pay extra compensation to its officers and directors through manipulative schemes like stock option back-dating. ♦