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Investors, Reeling from Financial Collapse, Look to Obama Administration with a Hopeful Eye

By John Rizio-Hamilton

As President Barack Obama takes office in the wake of a string of financial scandals, investors are considering a number of reforms to a legal and regulatory system that has allowed fraud to flourish and thrown the country into its worst recession in decades.

Over the past several years, Congress, the Supreme Court, and the Securities and Exchange Commission ("SEC") have, through action or inaction, curtailed investor rights in a number of important ways. These rollbacks have included the elimination of a private right of action against "secondary actors" who assist in securities fraud, the withering of enforcement actions by the SEC, the imposition of regulations that prevent investors from electing independent directors, and the proliferation of executive pay structures that incentivize fraudulent conduct. As a direct consequence of these and other developments, corporate wrongdoers have run amok, enriching themselves while destroying trillions in shareholder value.

President Obama has given investors reason to hope he might level the playing field by reversing some or all of these rollbacks of the past eight years. On December 18, 2008, while introducing Mary Schapiro, his nominee for Chairwoman of the SEC, he clearly stated that "financial regulatory reform will be one of the top legislative priorities of my administration....And if the financial crisis has taught us anything, it's that this failure of oversight and accountability doesn't just harm the individuals involved, it has the potential to devastate our entire economy. That's a failure we cannot afford."

One initiative that investor advocates will likely pursue is the legislative reversal of two Supreme Court rulings that have eliminated private securities fraud liability for so-called "secondary actors" — i.e., people or entities that actively participate in a fraudulent scheme but make no public statements. In the first of these

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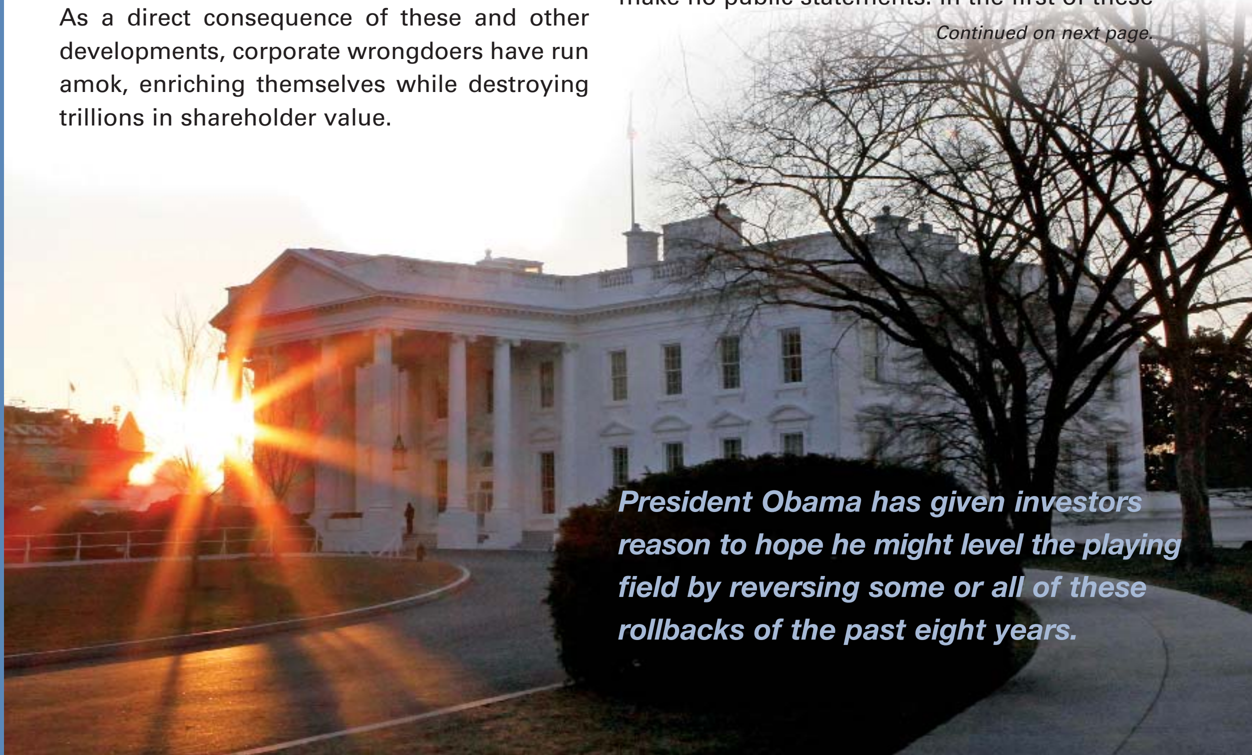

President Obama has given investors reason to hope he might level the playing field by reversing some or all of these rollbacks of the past eight years.

AP Images / Charles Dharapak

HOPEFUL EYE

Continued from page 1.

decisions, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the Supreme Court held by a narrow 5-4 margin that defrauded investors could not bring suit under Section 10(b) of the Securities Exchange Act of 1934 against those who "aided or abetted" the fraud.

In *Central Bank*, investors in defaulted bonds sought to sue the Central Bank of Denver, which was the indenture trustee of the bonds. The plaintiff claimed that Central Bank was liable as an aider and abettor of the fraud because it knew that the collateral securing the bonds was inadequate, in plain violation of the terms of the bond covenants, but let the bond issue proceed anyway. The SEC supported the plaintiff's position. Nevertheless, the Supreme Court rejected this theory of liability. Expressly disregarding the question of "whether imposing civil liability on aiders and

One initiative that investor advocates will likely pursue is the legislative reversal of two Supreme Court rulings that have eliminated private securities fraud liability for so-called "secondary actors."

abettors is good policy," the Supreme Court held that defrauded investors could not bring a private right of action against entities that had aided and abetted a fraud, but had made no public statement themselves. Although the Court substantially limited the claims that investors could pursue against so-called "secondary actors," such as lawyers, accountants, or banks, that assist in a fraud, it did indicate that those claims could survive in narrow circumstances. Specifically, the Court wrote that those claims could proceed when the secondary actor either employs a "manipulative device," such as engaging in sham transactions that allow a company to falsify its financial results, or when the secondary actor makes a statement in connection with the fraud, such as when an auditor certifies financial statements that are false.

Then, in 2008, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta,* 128 S. Ct. 761 (2008), the Supreme Court further limited the circumstances under which investors could pursue fraud claims against secondary actors. In *Stoneridge*, the Court held, again by a narrow 5-3 margin (with one Justice recusing himself), that defrauded investors in Charter Communications could not bring a securities fraud action against Scientific-Atlanta (one of Charter's vendors), even though Scientific-Atlanta had agreed to engage in sham transactions with Charter so that Charter could artificially inflate its financial results.

Inside Look

Max Berger

As a new administration takes office, we are hopeful that the recent erosion of investor protections will come to an end. The relaxation of accountability in corporate boardrooms and by auditors, and deregulation of the financial industry in general, allowed investors to become victims of financial fraud. These trends also spawned a financial meltdown, the depths of which still remain unknown.

Firm associate John Rizio-Hamilton discusses the legal and regulatory unwinding of investor protections over the past few years, and outlines the critical oversight and accountability measures that need to take place in order to restore investor confidence and prevent similar scandals in the future in "Investors, Reeling from Financial Collapse, Look to Obama Administration with a Hopeful Eye" (page 1).

In "Executive Compensation: A 'New Ethic of Responsibility' to Cure an Old Problem" (page 6), firm associate Ian Berg confronts the ongoing problem of excessive executive pay — highlighted recently by news that executives at the center of the financial collapse walked away with huge payouts — and details the steps the federal government and certain states are taking to curtail unrestrained compensation.

I also direct your attention to the regular "Eye on the Issues" column, beginning on page 4. Firm associate Takeo Kellar provides a perceptive compilation of the most significant recent developments in securities litigation, regulation and corporate governance.

We trust that you will find this issue of the *Advocate* both informative and insightful. As always, we welcome your comments, questions and input and wish you all a healthy and happy New Year.

Max W. Berger

Quarterly Quote...

"In today's regulatory environment, it's virtually impossible to violate rules...it's impossible for a violation to go undetected, and certainly not for a considerable period of time."

Well-known investment guru Bernard Madoff on Oct. 27, 2007; Madoff was arrested in December 2008 and is awaiting indictment on charges related to his orchestration of what appears to be the largest Ponzi scheme in history.

The Court reasoned that, because Scientific-Atlanta had not made any false statements on which Charter investors relied, then it could not be held responsible for the fraud. Instead, the only source of recovery for the defrauded investors was against Charter itself. For a fuller description of the *Stoneridge* decision, see "Silence is Golden: *Stoneridge* Decision Deals a Blow to Investors' Scheme Liability Claims," in the *Advocate* for the fourth quarter of 2007.

Those two decisions have made it next to impossible for wronged investors to sue a variety of "secondary actors" for their active, culpable participation in fraudulent schemes-including "gatekeepers" who are supposed to protect investors from misconduct, such as lawyers who structure fraudulent transactions, accountants who conceal wrongdoing, and rating agencies that knowingly give pristine ratings to junk debt. Further, the prohibition on aiding and abetting liability is unique in the context of civil securities fraud; indeed, aiding and abetting liability is routinely recognized in the criminal context and a variety of other civil contexts. Indeed, the SEC is explicitly permitted to bring such securities fraud claims — an authority it has inadequately utilized. Given the manner in which this unique prohibition has allowed active participants in fraud to escape the consequences of their conduct, investor rights advocates are likely to urge the next Congress to legislatively overrule both *Central Bank* and *Stoneridge* by expressly authorizing a private right of action against aiders and abettors.

Investor advocates also will push for President Obama to reinvigorate the SEC. Under the stewardship of current Chairman Christopher Cox, the SEC has decreased exponentially its number of enforcement actions.

Investor advocates also will push for President Obama to reinvigorate the SEC. Under the stewardship of current Chairman Christopher Cox, the SEC has decreased exponentially its number of enforcement actions. This inaction had led to a severe decline in investor protection, a result that has recently become very clear with the SEC's failure to properly regulate either Bear Stearns or Lehman Brothers before their collapse. The agency's failing became even more apparent in its utter failure to effectively investigate the largest financial fraud in history-the estimated $50 billion Ponzi scheme run by Bernard L. Madoff — even after numerous sophisticated investors and members of the SEC warned of Madoff's Ponzi scheme. Indeed, under Cox's watch, the SEC sharply decreased the number of securities fraud prosecutions it pursued. In 2000, the SEC prosecuted 437 fraud cases. Through the first 11 months of 2008, the agency's fraud prosecutions had plummeted to 133.

Against that backdrop, President Obama recently nominated Mary Schapiro to replace Chairman Cox. Schapiro, who formerly headed the Financial Industry Regulatory Authority ("FINRA"), the National Association of Securities Dealers, and the Commodity Futures Trading Commission, is an experienced regulator. Nevertheless, early reaction to her nomination has been mixed. While New York Senator Charles Schumer has praised her as "the kind of strong and experienced regulator we need in these times," Robert Banks, a director of the Public Investors Arbitration Bar Association, said that under Schapiro, FINRA had "not put much of a dent in fraud."

Investors also will look to the Obama administration to overturn recently-enacted SEC rules that significantly limit investors' ability to hold corporations accountable. One particular problem facing investors is that boards of directors, which management largely selects, do not effectively supervise executives. Nominating independent directors is especially difficult because the current proxy rules require any nomination to occur by way of a full, formal, and prohibitively expensive proxy solicitation. In response, investor advocates likely will propose new legislation or regulatory rules that allow shareholders to nominate independent directors without incurring the expense of launching a full proxy solicitation, perhaps by placing the names of independently-nominated directors on the company's own proxy card.

The current rules governing voting by brokers also unfairly constrain investors' ability to elect independent directors. Under the current regime, brokers who

Continued on page 8.

Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Takeo Kellar

SEC To Increase Oversight Of Credit Rating Agencies. The SEC approved a series of measures aimed at increasing "transparency and accountability" at credit rating agencies. The new measures impose additional requirements on the credit rating firms, such as Moody's, Standard & Poor's and Fitch, "whose ratings of residential mortgage-backed securities backed by subprime mortgage loans and of collateralized debt obligations linked to subprime loans contributed to the recent turmoil in the credit markets" according to a SEC press release. The new rules include prohibiting any firms from rating debt they helped structure and barring credit analysts from accepting gifts or entertainment exceeding $25 in value from the issuers of debt they rate. The new rules will also require ratings firms "to provide transition statistics for each asset class of credit ratings for which it is registered or is seeking registration, broken out over 1, 3, and 10 year periods." According to *The Wall Street Journal,* the SEC did not implement "more controversial changes that would designate different ratings for structured products, such as mortgage bonds and corporate debt, and that would reduce agency rules' reliance on the use of credit ratings for such things as investments by money-market mutual funds." The SEC also did not implement a proposal that would have required rating firms to disclose all their ratings publicly. Instead, the credit ratings firms must publicly disclose a random sample of 10% of their credit ratings on their web sites six months after they were issued. According to the SEC, the new rules were informed by the agency's 10-month examination of three major credit rating agencies that found "significant weaknesses in ratings practices" which contributed to the subprime market collapse. *SEC Press Release 2008-284, Dec. 3, 2008 (http://www.sec.gov/news/press/2008/2008-284.htm); The Wall Street Journal, Dec. 4, 2008*

Auditor Watchdog Issues Alert On Potential Fraud Due To The Current Economic Environment. The Public Company Accounting Oversight Board ("PCAOB") recently issued a Staff Audit Practice Alert warning auditors to take special care in their audits of companies in the current market downturn, highlighting the riskier areas created by the credit crisis, including the increased risk of corporate fraud. The alert discusses potential risk areas including the review of companies' fair value measurements, their ability to remain a going concern (the resources to continue to operate), and the adequacy of disclosures and accounting estimates. The PCAOB also notes the increased pressure to misstate financial results in order to meet expectations during a market downturn. *http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/ 2008/12-05_APA_3.pdf (Dec. 5, 2008)*

Report Reviews Audit Deficiencies In Inspections Of The 8 Largest U.S. Audit Firms. The Public Company Accounting Oversight Board ("PCAOB") recently released a report summarizing the results of its four year inspection of the eight largest U.S. accounting firms as mandated by the Sarbanes-Oxley Act of 2002. The report noted that inspectors continue to find deficiencies in important and high risk audit areas. The report states that the deficiencies were caused, in part, by "the failure [of auditors] to apply an appropriate level of professional skepticism" when conducting audit procedures and evaluating audit results. "In some instances, firms did not sufficiently test or challenge management's forecasts, views, or representations that constituted critical support for amounts recorded in the financial statements [and] in many of these instances, they limited their audit procedures to obtaining management's oral representations," according to the 28-page report. The report also blames the firms' audit deficiencies on weaknesses in training, supervision, methodologies, monitoring, and enforcement. The report was based on annual PCAOB inspections from 2004 to 2007, which included, among other things, partial reviews of more than 1,600 audits. *http://www.pcaobus.org/Inspections/Other/2008/1205_Release_2008-008.pdf (Dec. 5, 2008)*

SEC's Manual Reveals View On Its Waiver Of The Attorney-Client Privilege. The Securities and Exchange Commission ("SEC") recently released its "Enforcement Manual" which, for the first time, publicly discloses the internal policies and procedures that guide its investigation of potential violations of the securities laws. The SEC published the manual in an effort to counter criticism of a lack of transparency and consistency regarding its policies and procedures. Among other topics, the manual provides guidance on the SEC Enforcement Staff's Wells Process pursuant to which individuals or entities against whom the staff is considering recommending an enforcement action are given an opportunity to respond, protection of the attorney-client privilege during investigations, and cooperative investigative efforts. The provisions regarding the waiver of attorney-client privileges have received much attention by defense practitioners and corporations. A coalition of business, civil rights and legal organizations have pushed for legislation prohibiting all federal agencies from seeking privilege waivers as evidence of cooperation in corporate investigations. In an apparent effort to address these concerns, the manual directs SEC staff not to ask a party to waive the attorney-client or work-product privileges, but to refer all potential waiver issues to supervisory staff. The manual also states that a privilege waiver is not necessary for a party to obtain credit for cooperation with the SEC staff. *http://www.sec.gov/divisions/enforce/enforcementmanual.pdf (Oct. 6, 2008); The National Law Journal, Oct. 20, 2008*

Executives' Margin Calls On The Rise. Mandatory stock sales resulting from massive margin calls may further weaken the declining markets. As the crisis in the financial market has recently revealed, executives who appeared to own large shares of stock in their companies actually pledged those shares as collateral for cash loans, and are now being forced to sell those shares to repay borrowings. In October alone, there were approximately $1 billion in sales by company insiders selling stock to meet margin calls. Under SEC rules, executives are typically required to disclose insider sales within two days of the sale and indicate why they were sold, including whether they were sold as a result of a margin call. However, there are no SEC rules requiring that the public be told ahead of time that an executive has pledged stock in a margin loan or how the borrowed money is being used. Because margin loans are private transactions between banks and borrowers, it is difficult to know how many executives may face margin calls. Margin calls force executives to sell their shares at times when stock prices are already falling and can flood the markets with sell orders, which can push the stock down quickly and drastically, adversely affecting the public investors who are not informed of the executives' encumbered shares. *The New York Times, Oct. 14 and 20, 2008; The Wall Street Journal, Oct. 13, 2008*

Recent Regulation Regarding Director Independence. The NASDAQ Exchange and the New York Stock Exchange ("NYSE") recently implemented amendments modifying slightly the definition and tests for director independence under their respective rules. First, the SEC approved amendments to the definition of "independent director" under the NASDAQ Stock Market Rules. Prior to the amendment, the rule provided that a director would not be considered independent if the director or an immediate family member accepted any compensation from the listed company in excess of $100,000 during any twelve month period within the preceding three years (with certain exceptions). The amendment increased the dollar threshold from $100,000 to $120,000. Similar to the NASDAQ amendment, the NYSE also amended its independence test by increasing from $100,000 to $120,000 the amount of direct compensation (with certain exceptions) that a director or members of a director's immediate family may receive from a listed company in a twelve month period within the prior three years and still be considered an independent director. The NYSE also modified its rules regarding the auditor affiliation test, as it applies to a director's immediate family members. Prior to the amendment, a director could not be deemed independent if the director or an immediate family member was a current partner or employee of the company's internal or external auditor. The amendment provides that a director may still be considered independent if the director's immediate family member currently works for the company's auditor, as long as the immediate family member is not a partner of the company's auditor or is not personally involved in the company's audit. *SEC Release No. 34-58335 (http://www.sec.gov/rules/sro/nasdaq/2008/34-58335.pdf); SEC Release No. 34-58367 (http://www.sec.gov/rules/sro/nyse/2008/34-58367.pdf)*

Securities Lawsuit Filings Reach Six-Year High. The number of securities class action filings rose in 2008 due, in large part, to the subprime mortgage meltdown and ongoing financial crisis, surpassing last year's filings by 37 percent, according to a study by the economic analysis firm NERA Economic Consulting. NERA reports that by mid-December, there were 255 class action filings, the highest annual total in six years. According to the report, the credit crisis is the most significant factor contributing to the increase, continuing a trend that began in 2007. Of the 255 cases filed as of December 14, 2008, 43% or 110 are related to the credit crisis, nearly tripling from 40 in 2007. The study also noted that nearly half of all filings in 2008 named a company in the finance sector as the primary defendant. *http://www.nera.com/PressRelease.asp?pr_ID=3675 (Dec.18, 2008)*

Bailing Out Wall Street Bonuses. Despite huge losses, multi-billion dollar bailouts and the collapse of some of the biggest names in the financial industry, Wall Street still gave out an estimated $18.4 billion in bonuses in 2008 — the sixth-largest bonus pool on record. President Obama denounced the Wall Street banks bonuses as "shameful" and the "height of irresponsibility" given that many of the same financial firms took government funds to prevent their collapse. Similarly, the Obama administration had to demand that Citigroup cancel its order for a $50 million 12-seat luxury jet despite having received $45 billion in Troubled Asset Relief Program ("TARP") funds to stabilize the financial sector. In order to address Wall Street's continuing "irresponsibility," the Obama administration is expected to announce tougher executive-compensation restrictions and greater transparency from companies that get government aid. According to *The Wall Street Journal*, chief executives of companies that receive "exceptional" aid will be banned from receiving any severance payments. The CEOs along with the top 50 executives would also see their bonus pools shrink by about 40% from 2007 levels, the newspaper reported. Some lawmakers are also considering "claw-back" provisions to take back bonuses because they were based on earnings that vanished in the financial crisis. Another proposal would call for bank executives to get most of their bonuses in stock, which they would not be able to sell until the government was no longer a shareholder in the bank. *The Wall Street Journal, Feb. 2, 2009; The New York Times, Jan. 31, 2009*

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Executive Compensation: A "New Ethic of Responsibility" to Cure an Old Problem

By Ian Berg

While executive compensation must be structured with incentives that attract talented leaders and reward them for their success, it is essential that executives do not receive huge payouts while their companies disintegrate around them.

The recent meltdown on Wall Street has brought CEO pay to the forefront of business news and revived a familiar debate on executive compensation. While executive compensation must be structured with incentives that attract talented leaders and reward them for their success, it is essential that executives do not receive huge payouts while their companies disintegrate around them. As expressed by Connecticut State Treasurer Denise Nappier, who oversees $23 billion in state pension funds, a balance needs to be struck between rewarding success and some corporate boards' "tendency toward unfettered greed at shareholder expense."

Since their peak just over one year ago, the financial markets have lost more than $9 trillion. However, numerous executives from the industries at the center of those losses emerged with substantial fortunes. A November 2008 *Wall Street Journal* study examined public filings at 120 companies in such sectors as banking, mortgage finance, student lending, stock brokerage and home building and revealed that top executives and directors at those companies took home over $21 billion in the past five years. According to that study, at least fifteen top executives from home building and financial services firms reaped more than $100 million each in cash compensation and proceeds from stock sales during that time. Four of those executives, including the heads of Lehman Brothers Holdings Inc. and Bear Stearns Cos., ran companies that have filed for bankruptcy protection or have seen their share prices fall more than 90% from their peak.

As is now evident, typical executive compensation packages and pay plans provide executives with outsized rewards for taking big risks. These risks lead to gains and big paydays for executives in the short-term, but too often they also lead to big losses for the company in the long-term. For example, in five years as CEO of Merrill Lynch & Co., Stan O'Neal earned $150 million in salary, bonuses and the value of equity at the time of grants before leaving the company in October 2007 in the wake of an $8.4 billion write-down.

As a result, formal regulations have been enacted across the globe, with at least six countries, including the United Kingdom, Germany, and Switzerland, placing restrictions on executive compensation as part of efforts to rescue their ailing financial and banking systems. In the U.S., Congress intended to impose similar conditions on companies seeking bail-out funds from the $700 billion Troubled Asset Relief Program, or "TARP." Specifically, the final TARP legislation rules limited incentives that encourage top executives to take excessive risks, provided for the recovery of bonuses based on earnings that never materialize, and prohibited "golden parachute" severance pay.

Unfortunately, the intended effects of TARP have not been realized. For example, due to the way that TARP funds have actually been distributed, certain loop-holes have effectively repealed the most meaningful enforcement mechanisms provided in TARP. As characterized by Senator Charles E. Grassley, the ranking Republican on the Senate Finance Committee, certain administrative changes have ensured that "[t]he flimsy executive-compensation restrictions in the original bill are now all but gone." Moreover, according to a report released by the U.S. Department of the Treasury on December 30, 2008, Treasury officials have no way of ensuring that firms receiving billions of dollars from the federal government are in fact complying with TARP's executive compensation rules.

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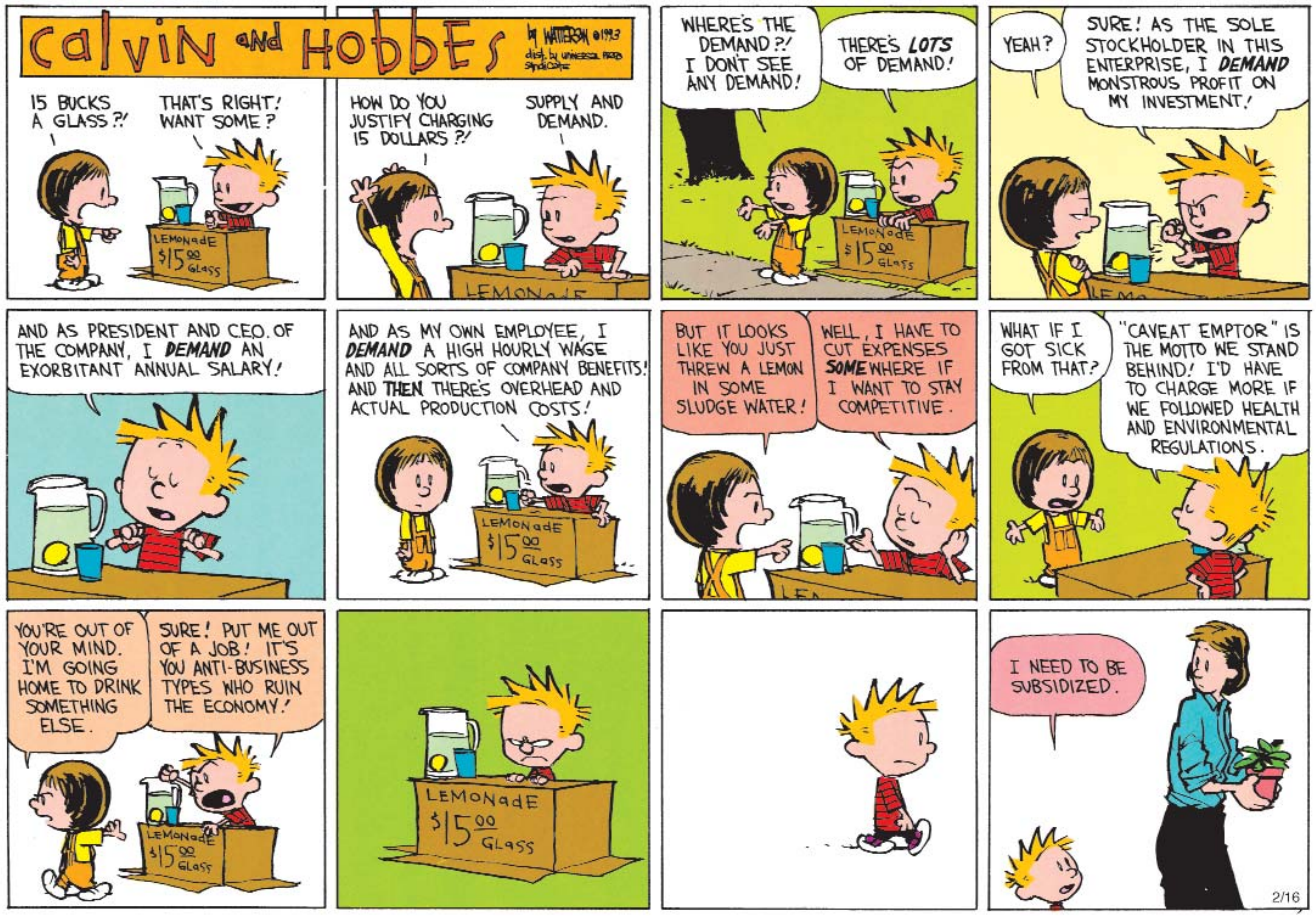

Notwithstanding the shortcomings of the executive compensation provisions in TARP, SEC executive John White has urged that all companies, not just those in finance, should follow the intent of those provisions and consider limiting compensation packages that reward excessive risk-taking by executives. President Barack Obama has echoed that sentiment and asked for even more, calling for a "new ethic of responsibility" for corporate leaders when it comes to executive compensation, encouraging executives to give up some portion of their bonuses to allow more workers to keep their jobs, retain medical insurance and stay in their homes. Obama continued, "[t]hat kind of notion of shared benefits and burdens is something that I think has been lost for too long and is something I would like to see restored."

Many investors, including Richard Ferlauto, director of pension policy at the American Federation of State, County and Municipal Employees union, share President Obama's perspective and believe that he will have a direct and early impact on executive compensation legislation once he takes office. In particular, investors believe that as President, Obama will finally be able to push through "say on pay" legislation similar to that which he proposed last year while a member of the U.S. Senate, which would make non-binding "advisory" shareholder votes on executive compensation packages mandatory at annual meetings.

"Say on pay" shareholder votes have met with mixed results. Since 2006, some 100 companies have voted on the subject, and in close to 20 instances shareholders were in favor of having a "say on pay." Nonetheless, in those 20 cases where the resolutions gained the majority of the votes, most companies have disregarded the vote and failed to adopt the provisions. Moreover, in most cases these say on pay resolutions have failed, gaining on average 42% of the vote supporting them, according to the Corporate Library. Recently, a bill similar to the one proposed last year by then-Senator Obama, requiring an annual shareholder advisory vote on executive pay, was enacted in North Dakota. While the new North Dakota corporate governance law, prompted by famed shareholder activist Carl Icahn, affects only two publicly traded companies incorporated in North Dakota — and was passed only after one of the companies was assured that it wouldn't have to follow the rules — its passage was a significant inroad in curbing excessive executive pay.

Continued on page 8.

HOPEFUL EYE

Continued from page 3.

hold securities in "street name" on behalf of others are permitted to vote those shares as they please, even though the brokers have no economic interest in the corporation. Because the brokers almost always support a company's management, brokers typically vote these "street name" shares in a way that frustrates investors' efforts to elect independent directors. In response, investor advocates will likely propose legislation or rule changes that eliminate broker voting in board of directors elections.

Finally, investors will likely seek reform on the issue of executive pay. Although responsible executives who build long-term shareholder value should be rewarded accordingly, in recent years executive pay systems have incentivized management to increase short-term profit and in turn, their bonuses, by throwing all caution to the wind. Investor advocates likely will pursue two reforms that seek to recalibrate these incentives by aligning them with long-term corporate and shareholder interests. The first is the newly-proposed "say on pay" legislation that allows shareholders to cast advisory votes on corporate compensation policies. This legislation, titled the "Shareholder Vote on Executive Compensation Act," passed in the House of Representatives in March of 2007. In April of 2008, as Senator, President Obama introduced corresponding legislation in the Senate. Expect investor advocates to urge the prompt passage of the Senate bill and its reconciliation with the House legislation. For more on executive pay and "say on pay" legislation, see Ian Berg's article in this month's *Advocate*.

Also expect investor advocates to pursue "claw-back" legislation. This legislation, which has not yet been introduced, would provide for the forfeiture of incentive compensation paid to corporate executives based on fraudulent financial results.

Also expect investor advocates to pursue "claw-back" legislation. This legislation, which has not yet been introduced, would provide for the forfeiture of incentive compensation paid to corporate executives based on fraudulent financial results. The legislation also would likely include a private right of action, so that investors could enforce the claw-back provision on their own, without depending on SEC or other agency action.

Legislative and regulatory change is never easy. Indeed, enacting all of the above initiatives is a tall order, even with the reform-oriented optimism surrounding the incoming Obama administration. The continued support of institutional investors is a key part of the effort to ensure that President Obama's goal of adding significant investor protections becomes a reality.

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EXECUTIVE COMPENSATION

Continued from page 7.

Although "say on pay" resolutions are a step in the right direction, in the words of Charles Elson, a governance expert at the University of Delaware, it "is in and of itself but a baby step." Advisory votes still leave executive pay to the discretion of corporate boards who have demonstrated a willingness to ignore the will of the shareholders, and are thus unlikely to have a meaningful impact on executive compensation levels. Unfortunately, there is little support for binding "say on pay" provisions or legislation for hard caps on executive compensation. Thus, the burden remains with a Company's shareholders to replace directors who approve excessive pay packages or to seek remedies via other methods. However, investors are optimistic that recent economic events and support from President Obama's administration will lead to some form of substantive change and increased shareholder rights on executive compensation.

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288

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The Final Word

Breaking News

First Quarter, 2009

The Final Word takes off where our latest issue ends: at deadline. Here you will find select legislative, regulatory and litigation developments, as well as commentary and media reports breaking at press time. Case pleadings and related documents of interest may be obtained by contacting us by telephone, e-mail, regular mail or by completing the "Contact Us" form on our web site at www.blbglaw.com.

The Economy Needs Corporate Governance Reform

By Carl C. Icahn
January 23, 2009

In his inaugural address this week, President Barack Obama said "our economy is badly weakened, a consequence of greed and irresponsibility on the part of some," and due in part to "our collective failure to make hard choices."

He's offered few policy specifics other than saying we need to undertake massive new infrastructure and education programs. But he is right, there are a lot of hard choices we need to make. And one of them is the decision to fix the way public companies are managed.

Private enterprise forms the basis for our economy. It provides most of the jobs we enjoy and creates the wealth that raises living standards. New government spending can only do so much to repair the economy. Reshaping corporate management can do much more.

The problem with doing nothing is obvious. Faltering companies are now soaking up hundreds of billions of tax dollars, and they are not substantially changing their management structures as a price for taking this money.

How does it serve the economy when we subsidize managements that got their companies into trouble? Where is the accountability? More importantly, where are the results?

The economy continues to sink, jobs are being lost, the markets continue on a downward course. Changes are needed and can come if Congress insists on reforms that make corporate boards and managers more accountable to stakeholders.

First, Congress needs to pass legislation giving shareholders enhanced rights to elect new boards, submit resolutions for stockholder votes, and have far more input on executive compensation and other issues. As companion to these reforms, Congress needs to pass legislation that prevents managers from making it more difficult for shareholders to exercise their ownership rights.

Managers often come up with creative ways to perpetuate their reigns of error. These include myriad takeover obstacles like poison pills, bylaw provisions, and others devices that thwart shareholder efforts to hold managers accountable.

If Congress is reluctant to make wholesale changes at the federal level, it can enact one simple provision that would allow many of the needed changes to take place on the state level: It can give shareholders the right to vote to move a company's legal jurisdiction to a more shareholder-friendly state such as North Dakota. Currently that decision is in the hands of company boards.

It is not reasonable to expect managers with failing track records to improve their performance on their own. They will only improve if they are placed under greater pressure by shareholders empowered to exert more influence on management decisions. Nothing will do more to improve our economy than corporate governance changes.

What we need are measures that let the capitalist system produce jobs and economic activity, with minimal but effective government oversight. Government spending is an important catalyst to economic gains, but we need to focus on improving the way private companies are managed so private capital can flow into them.

Our private sector is the greatest wealth creation machine ever devised, far outperforming any other economic model. Still, major improvements could do a lot to mitigate what Mr. Obama calls "the sapping of confidence across our land."

Lax and ineffective boards, self-serving managements, and failed short-term strategies all contributed to the entirely preventable financial meltdown. It is time for battered shareholders to fight back.

Mr. Obama was right when he said that "it has been the risk-takers, the doers, the makers of things…who have carried us up the long, rugged path towards prosperity and freedom."

I hope this means that the day of reckoning has come for those executives who simply feed at public and private troughs, putting little or no capital of their own at risk, and who produce little of value for the national economy. It is time for change and the place to start is in the corporate boardrooms of America.

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