

TAKING THE STAND

The Options Uproar: Fraud Goes Dating

The latest corporate scandal hyped by the media involves the backdating of options issued by companies to their corporate executives and board members. Fueled by public cries of greed and excess over executive compensation, federal authorities have initiated fraud investigations across the nation. By February 2007 the Securities and Exchange Commission (SEC) had opened some 130 investigations,¹ and criminal authorities were returning indictments and obtaining guilty pleas. But in the rush to investigate and charge, one cannot lose sight that the modification of option dates is not always fraud—and it may even be perfectly legal.

The groundswell began with a front-page Wall Street Journal article in March 2006 questioning the timing of options awarded to executives at several large corporations.² The article reported on an analysis it conducted, which found that the executives fortuitously received option grants on dates coinciding with the company's lowest trading prices of the year. The journal's statistical analysis concluded that the odds for this to occur randomly were about one in 300 billion.³ Compared to the odds of winning the multistate Powerball lottery with a \$1 ticket—one in 146 million⁴—the coincidence was so remarkable that the SEC soon instituted numerous investigations, and many other companies initiated their own internal investigations, to determine whether improper modification of options had occurred.

Stock options are popular with companies of all sizes because of their flexibility and relatively low cost to create and administer. They are a valuable form of employee compensation that preserves the company's cash, provides employees with an opportunity to gain an equity stake in the company, and permits the company to take certain tax advantages.

Fueled by public cries of greed and excess over executive compensation, federal authorities have initiated fraud investigations across the nation.

By Robert Plotkin



"Taking the Stand" appears periodically in Washington Lawyer as a forum for D.C. Bar members to address issues of importance to them and that would be of interest to others. The opinions expressed are the author's own.

Stock options are popular with companies of all sizes because of their flexibility and relatively low cost to create and administer.

Although option plans have existed since the 1920s, they proliferated with a vengeance during the stock market boom of the 1990s, stimulated in significant part by cash-poor technology companies seeking to hire and retain creative employees. Tax law changes in 1993 also encouraged their resurgence.⁵

The stock option gives the holder the right to buy stock in the future at a price fixed on an earlier date. The lower the fixed price, the greater the opportunity for the holder to make a profit if the price goes up, or to minimize losses should it go down. As a result, it is beneficial to the holder to have the pricing date set for a time when the stock is trading at or near its low point.

In permitting the use of stock options, a company's board of directors typically authorizes a detailed procedure for their award and exercise.⁶ These plans, which are approved by shareholders and publicly available to analysts, set the parameters for awarding options and establishing exercise dates. Nevertheless, for at least the past 10 years it appears to have been common practice in public companies small and large to modify option dates. Auditors and regulators paid scant attention to this practice, and option dating simply became "business as usual."

Manipulating Options

The modification of option dates to obtain the lowest possible price has taken many forms. The most publicized is the backdating of options, so that the price fixed coincides not with the date that options were actually awarded, but rather with earlier days on which the company's stock was trading at its lowest price.

Other forms of option modification are referred to as spring loading, bullet dodging, and repricing, to name a few. Executives spring-load options by granting them just before the public disclosure of favorable corporate information that will likely increase the stock price.⁷ The opposite of spring loading is bullet dodging, which occurs when executives wait to issue the options until after the release of negative information, in order to fix a lower exercise price.⁸ Options are repriced simply by lowering the original exercise price on existing options because the market price has fallen since the initial award, and the options are no longer "in the money."⁹

Modification may also include delayed pricing, or taking advantage of price differences between the date that the company's compensation committee approved the grant and the date that management actually allocated the options to employees. Start date pricing occurs by changing employment start dates to

coincide with the dates at which the stock price is near its lowest point.

The modification of options may also have accounting and tax implications. When options are granted "in the money," and the holder has an immediate paper gain, the company must report them as compensation expenses.¹⁰ But backdated options that reduce or cancel the gains also have the effect of minimizing or avoiding the expenses. This, in turn, causes other financial items, such as profits or retained earnings, to be overstated when disclosed in public filings, and it could lead to claims of improper disclosures requiring restatements.

Proving Fraud

The media coverage of option modification has driven much of the public reaction. There already was great public dissatisfaction with excessive executive compensation and perks. Changing option dates is seen as further evidence of corporate greed. There are scorecards¹¹ and bloggers¹² who keep track of every complaint filed and every charge brought. The option scandal has become notorious in part because of its direct link to well-known people at the highest echelons of the corporate structure.

Among the best known of these executives is Steve Jobs, the cofounder of Apple Computer, Inc. According to press reports, Jobs received a grant of 7.5 million options at a special board of directors meeting that, a later investigation determined, did not actually occur.¹³ The company has asserted that Jobs was unaware of the dating of his options and not familiar with the accounting for them.¹⁴ The SEC recently charged the company's former general counsel and former chief financial officer with fraud in connection with those options.¹⁵

Notwithstanding the public outcry, the law still requires the government to prove that the company and/or its officers, directors, and employees actually committed fraud. In a criminal prosecution for securities fraud, guilt of a "willful" violation must be proved beyond a reasonable doubt.¹⁶ The SEC, in civil cases, must establish that the defendants acted with scienter—they knowingly and willfully manipulated options, or they acted with "reckless disregard."¹⁷ And it must be proven that the manipulation is "material" to the company's overall situation,¹⁸ and not the equivalent of a corporate "white lie." The evidence necessary to prove these charges is not always easy to obtain and establish, as not every manipulation constitutes a legal violation.

Scienter can be very problematic in the option context. As

noted earlier, the modification of option dates was such a common practice that many corporate officials may have sincerely believed that it was legitimate. Backdating itself is not per se illegal. As long as it is permitted and described by the corporate policy and carried out in accordance with that policy, it may be perfectly legitimate.

If company policy clearly allowed some choice of dates, and the policy was followed, it would be very difficult to establish scienter as to the company or its executives. Notwithstanding the policies, if the particular option modifications are publicly disclosed, scienter is minimized. Some of the officials responsible for manipulating options may not have personally benefited from the timing of the options, thus limiting their motive—greed—to commit fraud. The changed dates may even result from sloppy record keeping, lost documentation, or mistakes by corporate clerical staff, rather than from a conscious scheme to manipulate grant dates.¹⁹

It may likewise be difficult to demonstrate that the manipulation of options was material to a company's financial records. The Supreme Court defines materiality as having "a substantial likelihood that the disclosure of the omitted or misstated fact would have assumed actual significance in the deliberations of the reasonable shareholder."²⁰ In many large companies, the impact of option date modification on the overall accounts may be so negligible that investors and analysts are not concerned with it. In any event, many analysts do not typically include stock-based compensation expenses in valuing public companies.

Indeed, at some companies that disclosed option manipulation, the stock price did not drop precipitously when the manipulation was revealed. For example, the stock price of KB Home, Dean Foods, and Apple Computer increased the day after public disclosures of their option problems; 90 days later each of the companies was trading higher than it had prior to the disclosure.²¹ This is a strong signal that as long as the rest of the company is sound, the investing public is not worried about the possible abuse of stock option compensation.

Moreover, some of the most egregious manipulations appear to have occurred prior to the enactment of the Sarbanes-Oxley Act in July 2002.^[22] As a result, many of these situations could create timing problems for regulators and civil plaintiffs. The usual statute of limitations for securities fraud is five years.²³ Options issued in or prior to 2001 may therefore be beyond easy legal challenge.

One SEC commissioner, Paul Atkins, has publicly stated that "some commentators . . . have failed to appreciate the nuances of this issue."²⁴ He expressed hope that "innocuous" behavior would not be indiscriminately grouped with "nefarious" behavior "to avoid some sort of mass stampede of restatements."²⁵ Unfortunately, that seems to be exactly what is happening.

The Government Response

Within months of the Wall Street Journal article, the SEC and federal criminal authorities initiated aggressive enforcement actions. Focusing on cases that had all the elements of classic criminal fraud, the government put corporate America on notice that stock option manipulation was on the front burner.

In July 2006 the first criminal complaint based upon option manipulation was filed against former officers of Brocade Communications, Inc.²⁶ The charges included a laundry list of obviously criminal offenses, such as backdating committee min-

utes to make it appear that the committee had actually met and granted stock options on days that the Brocade stock price was relatively low, when in fact no such meetings occurred and the options were not granted on those dates.²⁷ The Brocade executives were also charged with backdating employment offer letters and other personnel records so that it appeared employees who were awarded options upon hire received them when the price was relatively low, although the employees were not actually employed at that time.²⁸ The government claimed that executives took steps to cover up their actions and lied during an internal investigation.²⁹

Shortly after the criminal actions were filed against Brocade, former officials of Comverse Technology, Inc. were hit with similar charges.³⁰ The Comverse executives were accused of a scheme to backdate millions of stock options for themselves and their employees to days when Comverse stock was trading at periodic low points.³¹ It was alleged that from 1991 to 2003 one of the executives exercised options and sold stock worth approximately \$150 million; about \$138 million resulted directly from backdating the options.³² Additionally, the complaints alleged that the executives used fictitious names to generate hundreds of thousands of backdated options, which they then "parked" in a secret slush fund and used when hiring new recruits. One of the named option holders was "I. M. Fanton,"³³ apparently an allusion to phantom, as in *Phantom of the Opera*. The former general counsel for Comverse has since pled guilty to conspiracy to commit securities fraud, mail fraud, and wire fraud,³⁴ as has Comverse's former chief financial officer.³⁵

In the recent Apple Computer case, the SEC charged Apple's former general counsel with falsifying corporate option records.³⁶ It claimed that the general counsel "fabricated" minutes for a nonexistent board meeting in order to conceal the backdating of a 7.5-million-share grant to Steve Jobs, the chief executive officer.³⁷ In addition, the SEC alleged that the chief financial officer knew of the backdating, but failed to disclose it to auditors or the investing public.³⁸ According to the SEC complaint, each of these individuals personally benefited from backdating by receiving several million dollars in unreported option exercise compensation.³⁹

Guilty pleas in option cases have accelerated. The former general counsel of Monster Worldwide, Inc., the parent company of one of the world's largest online job search Web sites, Monster.com, pled guilty to securities fraud and conspiracy in connection with the backdating of stock option grants.⁴⁰ In addition, the former chief executive officer of Take-Two Interactive Software, which produces popular computer video games, pled guilty to falsifying business records.⁴¹

The common theme in all of these cases is that the facts—at least as alleged—fit neatly into the traditional elements of criminal fraud. In the cases so far, not only are the dates manipulated, but the manipulation is coupled with the creation of false records, phony personnel, or nonexistent meetings, as well as with significant personal benefits for the manipulating parties, who may then try to cover up their actions. This clearly is an attempt by the government to avoid arguments about clerical mistakes and lack of scienter.

Although option plans have existed since the 1920s, they proliferated with a vengeance during the stock market boom of the 1990s.

Thus, it is unlikely that the SEC will bring charges in most of the cases currently under investigation. Rather it will focus on “how bad is the conduct and how good is the evidence,”⁴² and look to the most notorious cases that fit traditional fraud theories.

As recently outlined by the SEC’s associate director of enforcement, the factors in selecting option cases for prosecution are the duration of the misconduct, the materiality of any unrecorded compensation to the overall financial statements, and the direct evidence of scienter by the participants, as well as their general level of knowledge and sophistication.⁴³ Efforts to conceal actions or to obstruct investigations will, as always, play a significant role in such charging decisions. Similarly, the Department of Justice announced that it would seek to prove fraud by showing that corporate documents were falsified, that false public disclosures resulted, and that there were efforts to conceal misconduct.⁴⁴

New Trend in Corporate Malfeasance

The plaintiff’s bar has an uncanny knack for sniffing out each new trend in corporate malfeasance, and not surprisingly, option modification has resulted in a plethora of shareholder lawsuits. One of the earliest was a class action filed by the shareholders of Vitesse Semiconductor Corporation alleging misuse of stock option grants in violation of section 10(b) of the Securities Exchange Act of 1934.⁴⁵ The complaint alleged that manipulation of options created gains for at least one executive in excess of \$20 million.⁴⁶

On the heels of the Vitesse suit, a similar suit was filed against UnitedHealth Group, Inc., claiming that the company and certain of its officers and directors issued a series of materially false statements about the backdating of stock options.⁴⁷ The suit also claimed that the options were backdated so that their exercise price correlated to days that UnitedHealth’s stock hit its low point for the year.

Dozens of other lawsuits alleging securities fraud with regard to the manipulation of options have since been filed, claiming a variety of improper actions by corporations and their directors and officials.⁴⁸

Ironically, these class actions may not turn out to be gold at the end of the rainbow for either the shareholders or their contingency fee lawyers. As discussed above, not every change of date violates the law, and so proving fraud is not assured. Moreover, damages in securities fraud cases are typically measured by the “90-day look-back provision” of the Private Securities Litigation Reform Act.⁴⁹ This limits a plaintiff’s damages to the difference,

if any, between his or her purchase or sale price and the stock’s mean trading price for the 90 days following the public disclosure. Although in some of these cases the differences between these prices are substantial, in others there is little or no difference. In the Apple Computer case, for example, the price 90 days after disclosure was \$10 higher than it was the day before the disclosure.⁵⁰ Similar price recoveries appear to have occurred at other option-hampered companies, including Barnes & Noble, Clorox, Dean Foods, The Gap, and KB Home.⁵¹ Such results severely limit possible damages and may discourage expensive class actions.

Increasingly, potential plaintiffs have switched to an old legal standby, the derivative suit. According to the New York Times, at one point there actually were more derivative suits filed about option manipulation than shareholder class actions.⁵² In derivative cases a single shareholder sues on behalf of the corporation and any money recovered from executives who improperly received option profits is paid to the company. Because fraud is not a necessary element in a derivative suit, the issue may be litigated without regard to scienter. The sudden popularity of these suits may have another explanation: the corporation and/or the defendant executives can be required to pay the plaintiff’s attorney’s fees and costs, thus assuring counsel a reasonable payday.

The use of derivative suits received an important boost from the influential Delaware Court of Chancery in two separate cases alleging option manipulation. The lawsuits alleged that the directors of two companies breached their fiduciary duties by approving backdated options. When the directors moved to dismiss the cases, urging that the “business judgment rule” insulated them from liability, the court denied both motions. It found that in violating a shareholder-approved compensation plan, “backdating options qualifies as one of those rare cases [where] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment. . . .”⁵³ These cases essentially sidestep the problems with fraud claims and create alternative bases for liability.

Transformation of Compensation Boards

In November 2006 the Securities and Exchange Commission sought to remedy option modifications by transparency. Recognizing that it needed to alert the regulated community to option date modification issues, it set new disclosure rules for executive compensation that require in public filings a separate compensation discussion and analysis (CD&A), with a strong emphasis on option grant practices.

The new CD&A must discuss, in plain English, the principles underlying executive compensation policies and decisions, specifically explaining how option determinations are made, and whether option grants are coordinated with releases of material information. The rules also require that each option grant to senior officers be reported by the grant date and, if that date is not the date of approval by the compensation committee, by a separate disclosure.

Needless to say, deviations from the publicly reported policies could form the basis for charges that the CD&A was false and/or that particular option grants were made in violation of the stated practice, but proper disclosures to shareholders will generally protect against allegations of fraud.

Just as the excesses at Enron and WorldCom led to the increased importance of audit committees, the option uproar is likely to transform board compensation committees. No longer can they be management's financial "rubber stamp." They must actually spend time and effort reviewing compensation decisions—including option programs.

The committee should be composed solely of independent directors, and should have the authority to retain and seek independent advice from compensation consultants, legal counsel, and other advisers. The committee should oversee the corporation's disclosures with respect to executive compensation, and review and discuss the CD&A and recommend that it be included in proxy statements.

Although option date modification has had significant real-world consequences for many companies and individual executives, it is unlikely that the flood of fraud charges trumpeted by the media will materialize. The issues are just too nuanced, and the evidence is often flimsy.

Notes

1 Rachel McTague, Enforcement Official Suggests Possibility SEC May Pursue Backdating Absent Fraud, *Sec. Reg. & L. Rep.* (BNA) No. 4, at 148 (Jan. 29, 2007) (discussing comments made by Antonia Chion, associate director in the SEC Enforcement Division, on January 25, 2007, during a District of Columbia Bar program).

2 Charles Forelle & James Bandler, The Perfect Payday: Some CEOs reap millions by landing stock options when they are most valuable. Luck—or something else? *Wall St. J.*, Mar. 18, 2006, at A1. See also Charles Forelle, How the Journal Analyzed Stock-Option Grants, *Wall St. J.*, Mar. 18, 2006, at A1, which describes the methodology used by the *Wall Street Journal* to determine the effect backdating had on stock option grants. The journal's methodology was reviewed by Erik Lie, an associate professor of finance at the University of Iowa, and John Emerson, an assistant professor of statistics at Yale University.

3 Forelle & Bandler, *supra* note 2, at A1.

4 *Id.*

5 See 26 U.S.C. § 162(m)(1) (1993).

6 Although federal law does not require shareholder approval of equity compensation plans such as stock option plans, since 2003 most national stock exchanges require approval of equity compensation plans by either shareholders or a majority of independent directors. See generally NYSE Listed Company Manual § 303A.08 (2006); American Stock Exchange Guide § 711 (2006); NASD Manual § 4350(i)(1)(D) (2006).

7 Mark Maremont & Charles Forelle, How Stock Options Become Part of the Problem, *Wall St. J.*, Dec. 27, 2006, at A1.

8 *Id.* at A6.

9 *Id.*

10 See Accounting Principles Board Op. 25 (1973) (accounting for stock issued to employees), which was in effect for most of the relevant period. It has since been revised under Financial Accounting Standards Board Statement No. 123 (rev. 2004).

11 Options Scorecard, *Wall St. J.*, <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html> (last visited Apr. 26, 2007).

12 See Professor Bainbridge, <http://professorbainbridge.com>; see also *Wall Street Journal Law Blog*, <http://blogs.wsj.com/law>.

13 Nick Wingfield, Steve Stecklow & Charles Forelle, Jobs Helped Pick "Favorable" Dates for Option Grants: Apple Report Clears the CEO of Wrongdoing, Blames Ex-Executives in Backdating, *Wall St. J.*, Dec. 30, 2006, at A1.

14 *Id.*

15 *SEC v. Nancy R. Heinen and Fred D. Anderson*, Case No. 07-2214-HRL (Lloyd) (N.D. Cal. filed Apr. 24, 2007).

16 15 U.S.C.S. § 78ff(a); see also *United States v. Cassese*, 428 F.2d 92, 98 (2d Cir. 2004) (citing *United States v. Espaillet*, 380 F.3d 713, 718 (2d Cir. 2004) (quoting *Jackson v.*

Virginia, 443 U.S. 307, 319 (1979)).

17 See 15 U.S.C.S. § 78j(b); 17 C.F.R. § 240.10b-5. See also *SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir. 1998), which held that scienter may be established through a showing of reckless disregard for the truth, that is, conduct that is highly unreasonable and that represents an extreme departure from the standards of care.

18 See *Dura Pharmaceuticals, Inc. v. Michael Broudo*, 544 U.S. 336, 341 (2005) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988)).

19 See Letter From Conrad Hewitt, Chief Accountant, Securities and Exchange Commission, to Lawrence Salva, Chairman, Committee on Corporate Reporting, Financial Executives International, and Sam Ranzilla, Chairman, Center for Public Company Audit Firms, American Institute of Certified Public Accountants, at 2 (Sept. 19, 2006) (accounting for stock options in the historical financial statements of public companies), available at <http://www.sec.gov/info/accountants/staffletters.shtml>.

20 See generally *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (citing *TSC Industries, Inc. v. Northway*, 426 U.S. 438, 448–49 (1976)).

21 See generally <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html> (charting the date that companies released information regarding stock option issues to the public); see also <http://on> 22 15 U.S.C.S. § 7201 et seq.

23 In criminal cases the limitations period is five years. 18 U.S.C. § 3282(a). When the SEC brings an administrative action, the five-year limitation period in 28 U.S.C. § 2462 may apply. See *Johnson v. SEC*, 87 F.3d 484, 486 (D.C. Cir. 1996). The courts have held that when seeking equitable relief in the form of an injunction or disgorgement, the SEC is not subject to the statute of limitations in 28 U.S.C. § 2462. See *SEC v. Rind*, 991 F.2d 1486 (9th Cir. 1993). There is still some debate about the applicability of section 2462 to civil actions brought by the SEC. In private civil actions the period is from two years after discovery of the violation, but no more than five years after the violation. 28 U.S.C. § 1658.

24 See Paul S. Atkins, Remarks at the SEC Open Meeting (July 26, 2006), available at <http://www.sec.gov/news/speech/2006/spch072606psa.htm>.

25 *Id.*

26 *United States v. Reyes and Jensen*, Crim. Complaint No. 3-06070450 (N.D. Cal. filed July 20, 2006).

27 *Id.* at 6–7.

28 *Id.* at 8–9.

29 *Id.* at 9–10.

30 *United States v. Alexander, Krienberg and Sorin*, Crim. Complaint No. 1:06-mj-00817-CLP (E.D.N.Y. filed July 31, 2006).

31 *Id.* at 13–14.

32 *Id.* at 14.

33 *Id.* at 24–25.

34 See *United States v. Sorin*, Crim. Cause for Pleading No. 1:06-cr-00723-NGG-PER (E.D.N.Y. filed Nov. 2, 2006).

35 Press Release, United States Attorney for the Eastern District of New York (Oct. 24, 2006), available at <http://www.usdoj.gov/usao/nye/pr/2006/2006Oct24a.htm>.

36 See *supra* note 15.

37 *Id.* at 8–9.

38 *Id.* at 11–12.

39 *Id.* at 8.

40 *United States v. Myron Olesnkycki*, Crim. Com. line.wsj.com/mdc

/public/page/marketsdata.html (a public source of information regarding stock prices). *plaint No. 1:07-cr-00120-LTS* (S.D.N.Y. filed Feb. 15, 2007).

41 Press Release, District Attorney, New York County (Feb. 14, 2007), available at <http://www.manhattanda.org/whatsnew/index.htm>.

42 McTague, *supra* note 1, at 148.

43 *Id.*

44 See Executive Compensation: Backdating to the Future/Oversight of Current Issues Regarding Executive Compensation Including Backdating of Stock Options; and Tax Treatment of Executive Compensation, Retirement and Benefits: Hearing Before the S. Comm. on Finance, 109th Cong. 6, 7 (2006) (statement of Paul J. McNulty, Deputy Attorney General, U.S. Department of Justice).

45 See *Louis Grasso v. Vitesse Semiconductor Corp.*, Civ. Action No. 2:06-cv-02639-RCT, at 14–15 (C.D. Cal. filed May 1, 2006).

46 *Id.* at 15.

47 See *In re UnitedHealth Group Incorporated PSLRA Litigation*, Civ. Action No. 06-cv-01691, at 6–10 (D. Minn. filed May 5, 2006).

48 See *supra* note 12 and accompanying text.

49 Pub. L. No. 104-67, 109 Stat. 737.

50 See *supra* note 21 and accompanying text.

51 See *supra* note 21 and accompanying text.

52 Julie Creswell, One Route Seems Closed, So Lawyers Try Different Lawsuit in Stock-Option Scandal, *N.Y. Times*, Sept. 5, 2006, at C4.

53 See *Ryan v. Gifford*, Civ. Action No. 2213-N, 2007 WL 416162, at *25 (Del. Ch. Feb. 6, 2007) (quoting *Aronson v. Lewis*, 473 A.3d at 815 (Del. 1984)).

54 17 C.F.R. § 229.402 (2006).

Robert Plotkin is a partner at McGuireWoods LLP and head of the firm's securities enforcement group. He gratefully acknowledges the assistance of Joan M. McClenney of McGuireWoods in the preparation of this article.