

As Seen In

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# It's payback time

As stock-option backdating scandal widens, even lawyers need lawyers

By **RENI GERTNER**  
and **JEREMY HARRELL**

**P**ublic companies are being warned: You can do it the easy way or the hard way.

With new Security and Exchange Commission enforcement proceedings and shareholder suits over stock-option backdating cropping up almost daily, attorneys should be urging public companies to complete internal investigations of their options practices.

The SEC is investigating more than 80 companies for stock-option backdating failures. In the wake of the widening scandal, the commission has released new rules for reporting executive compensation practices. The FBI and the Department of Justice are also stepping up their involvement in the investigations.

And experts say this is only the beginning.

"The storm hasn't even hit yet," predicted John Sten, a former SEC attorney who practices with Greenberg Traurig in Boston.

Given the escalating nature of the investigations, legal experts are recommending that companies take matters into their own hands.

"Don't wait until the issue comes to find you," advised Julie Allen, a corporate governance attorney with Proskauer Rose in New York City. "Do an investigation to the level required by the size and practices of your firm."

## The coming storm

After months of work, the SEC filed its first securities fraud charges July 20 against former executives of Brocade Communication Systems Inc. Company executives pleaded not guilty to the criminal charges late last month, but have already agreed to settle the shareholder suit that followed.



**KAUFMAN:**  
Companies played  
it fast and loose.

More recently, Bethpage-based Cablevision Systems Corp. entered the spotlight, announcing that an internal investigation found irregularities with the company's option dating. The company was forced to delay release of quarterly results and said it would restate financial data back to 1997. The news spawned probes from the SEC and Justice Department and brought an unknown number of shareholder lawsuits.

Companies charged with or even tainted by the possibility of illegal backdating will almost always "have a shareholder suit on their hands," noted Sten.

And for in-house counsel, the issue is more than just the need to give good advice. Some company attorneys may have been personally involved in rubber-stamping any stock-option backdating that occurred.

"What's a little different about this round of corporate issues, as distinguished from Enron and WorldCom, is those lawyers had no role," noted Jahan P. Raissi of San Francisco,

a former SEC enforcement attorney who represents executives and directors in stock-related matters. "It was accounting executives cooking the books. With options, more lawyers were involved, and the government will be more likely to look at the conduct of in-house attorneys."

Former SEC attorney Elizabeth Nowicki, now a visiting professor teaching securities regulation at Cornell Law School, agreed.

"Lawyers are going to start to get nervous," she said.

In fact, last month the SEC filed securities fraud charges against the in-house lawyer for Comverse Technology, formerly based in Woodbury, for his alleged involvement in illegal backdating. By the time the charges came, the general counsel and two other top executives had already resigned.

## It's the accountability thing

So what's illegal about backdating stock options? Nothing, if it's done properly, said

Dennis O'Rourke, of counsel to Moritt Hock Hamroff & Horowitz in Garden City.

"Backdating" is a practice in which stock-option grant dates are adjusted to an earlier time when the stock was trading at a lower price. This allows recipients of the options to receive greater profits when they sell their shares at higher market prices.

Granting "in-the-money" options is legal as long as it's properly disclosed to shareholders, approved by the company's board and accounted for on company earnings statements, according to O'Rourke.

"As long as you do these things, companies are allowed to issue in-the-money options," he said. "One of the benefits of being a public company is that you can use stock as currency."

Neil H. Kaufman, a securities lawyer with Davidoff, Malito & Hutcher in Garden City, chalked up much of the potentially illegal activity to the go-go-go era of the late 1990s. Companies in Silicon Valley often took ill-advised governance steps, such as creating committees of one to quickly approve stock option grants, and competitors nationwide followed suit. Years later, they're all vulnerable to scrutiny.

"These rules were always there," Kaufman said. "People by and large ignored them, and now people are paying the price."

Backdating is governed by federal securities laws, including the Securities Exchange Act of 1934, as well as some more recent disclosure requirements mandated by Sarbanes-Oxley.

Of the companies under investigation, Raissi said it's still unclear what behavior will rise to the level of securities fraud.

"An awful lot of conduct falls into the unintentional, unknowing, sloppy category, and no one knows yet what the government is going to say about whether certain companies need to restate their financials," said Raissi, who practices with Shartsis Friese in San Francisco.

For example, a company may have granted options, but its board didn't meet to approve it for two weeks.

"Technically they may have backdated those options, but is that wrong?" asks Raissi.

The question investigators will have to answer, O'Rourke said, is whether executives set out to compensate employees and themselves or whether they intended to file false financial statements.

## Counselors for counselors

In-house counsel play a major role in creating procedures related to options grants, often including authorizing backdating.

Raissi noted that under a 2003 rule issued pursuant to Sarbanes-Oxley, the SEC has the authority to bring disciplinary sanctions against a lawyer who fails to meet "minimum

standards of professional conduct for attorneys appearing and practicing before the commission," which might include failing to report material violations of securities laws.

He predicted that claims like that are coming, even against lawyers who didn't participate directly in illegal backdating but simply failed to prevent it.

Nowick said a lawyer who reviewed a stock-option grant could also get into trouble for authorizing an award of options that "conflicted with internal governing documents" of



Bob Giglione

**O'ROURKE:** Using stock as currency is fine, as long as you play by the rules.

the company.

In-house counsel could be stuck in a tough spot because they will be asked to help with internal investigations while they themselves may have been involved in a questionable stock option grant process.

In addition, outside lawyers who played a role in a company's backdating plan could be implicated, although it would be more difficult to hold them accountable than in-house counsel.

"A lot of lawyers didn't have the knowledge or fortitude to tell clients they were acting illegally," Kaufman said.

O'Rourke recommended that in-house attorneys – and company executives – hire their own counsel right away, especially since attorney-client privilege may not apply to in-house counsel.

"It's easier right off the bat to retain a law firm that's unrelated," he said.

This will help lawyers make sure "they don't inadvertently say something that compromises their own position," Raissi said. "I tell clients, 'We have to remember this may be playing out on the front page of The New York Times.'"

## Auditing options

All public companies that grant options need to start an internal investigation, if they haven't already done so.

"Companies should not wait until their next audit cycle," Allen said, noting that the Public Company Accounting Oversight Board has already announced that it will require specific documentation on options grants "at a more focused level than it has in the past."

The extent of the investigation really

depends on the size of the company, its internal compliance and legal staff and its past stock-option grant practices. The audit committee or company board will likely play a key role in the inquiry.

"Clients need to be clear on the terms of the company stock option plan, the price of the options at the time of the grant and how it was accounted for," said Sten. "You definitely need human resources, finance professionals and attorneys to help evaluate this."

A company that finds it has backdating irregularities must go back and account for those mistakes when it finds them, including changing financial statements and informing shareholders, said Allen.

Raissi said taxes might also have to be recalculated, because options grants generally allow companies certain deductions, which may have been improperly taken if they failed to account for backdating.

*Reni Gertner is a staff writer for Lawyers USA, a sister paper.*