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A legal update from Dechert's White Collar and Securities Litigation Group

Stock Options "Backdating": Regulator Investigations and Shareholder Lawsuits Show No Signs of Waning

The revelation of alleged stock option grant abuses in a March 18 *Wall Street Journal*[1] report has led to a surge of investigations by the Securities and Exchange Commission ("SEC"), the Department of Justice ("DOJ"), and the Internal Revenue Service ("IRS") into alleged stock option "backdating." Federal investigators are examining whether some option grants to officers were backdated to coincide with days when the stock price was low, which may have had the effect of increasing the profits realized by the executives awarded the options.

Thus far, some 30 companies have disclosed that they have been notified of being the focus of criminal or regulatory investigations, or that they are themselves conducting internal investigations. At least 15 executives and directors, including five chief executives and three general counsels, have resigned or been ousted from eight different companies after questions arose about manipulation of dates of option grants. The media, analysts, and academics continue to identify and make public any improbable or suspiciously timed stock option grants at public companies.

The DOJ has issued subpoenas to at least 15 companies,[2] and more are certainly forthcoming. Some reports indicate that IRS investigators are also serving subpoenas on the companies and their executives. We believe that the threat of criminal prosecution may be quite substantial, perhaps reaching beyond the affected officers and even reaching Board members, if it appears that the Board was aware of the "backdating" practice. Predictably, nearly 30 civil lawsuits have been filed against at least 10 companies.[3] We expect dozens more to be filed in the coming weeks.

In the wake of this wave of investigations and lawsuits, many public companies are examining both past stock option grants and their current stock option procedures. These reviews are designed to assess their exposure and to reduce the possibility of potential abuse.

Government Investigations

Companies have used stock options as an effective tool to tie the compensation of officers and other employees to performance. Typically, stock-option

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1 Forelle, Charles and Bandler, James, *The Perfect Payday*, *The Wall Street Journal*, March 18, 2006, at A1, (*also available at*, http://online.wsj.com/article/SB114265075068802118.html?mod=Hot-Topic).

2 *Stock Option Inquiries Bring an Ouster and a Lawsuit*, *The New York Times*, May 31, 2006, (*available at*, http://www.nytimes.com/2006/05/31/business/31option.html); *Options Scorecard*, *The Wall Street Journal*, last updated June 1, 2006, (*available at*, http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html); *see also*, *Options Questions*, *The Wall Street Journal*, May 24, 2006, (*available at*, http://online.wsj.com/article/SB114736977174950350.html); *see also*, *Probing Stock-Options Backdating*, *The Wall Street Journal*, May 27, 2006, at A5, (*available at*, http://online.wsj.com/article/SB114869141879364933.html).

3 Copies of virtually all class action complaints are available on the Stanford Law School Securities Class Action Clearinghouse website, http://securities.stanford.edu/; the site is updated regularly.

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plans, which outline how many shares are to be granted as options and how the options are to be awarded, are first put to a shareholder vote. Generally, once the plan is approved, the compensation committee of the board of directors approves individual option grants.

The alleged backdating that has been the focus of attention so far includes:

- Alleged changes or alteration to the recorded date of a board resolution, board meeting, award notification, or option agreement
- The use of a grant date that precedes the date of the compensation committee meeting at which the option grants were awarded
- The use of an "effective as of" or "look back" grant date[4]
- The manipulation of the trading dates for stock sales in order to gain favorable pricing

Government investigations may result in the criminal prosecution of individuals or companies, disgorgement of financial gains during any period affected by backdating, civil penalties for violating securities laws and rules, officer and director bars, and exchange delisting.

Stock Option Backdating Lawsuits: The Next Wave of Securities Fraud Class Actions?

In addition to the perils of regulatory scrutiny, public companies face the real possibility of an onslaught of shareholder lawsuits alleging violations of Sections 10(b) and 20 of the Securities Exchange Act of 1934, and of SEC Rule 10b-5[5] as well as derivative actions asserting breaches of fiduciary duty in connection with backdated stock options.

Restatements

Because a backdated option grant may result in the award of an "in the money" option, a compensation expense should be recorded at the time of the grant. For companies that discover that backdating occurred, restatements of financial statements may be necessary, with an adjustment of expenses, net income, tax deductions, and earnings.

Restatements frequently trigger shareholder lawsuits. The lawsuits filed to date against companies implicated in the option backdating investigations allege that the companies violated federal securities laws by issuing false statements to the public, overstating net income, operating income, and retained earnings in financial statements filed with the SEC. They have also alleged insider trading. Derivative actions attack the failure of the board to implement stock option plans properly and to account fairly for such grants in the company's financial statements.

Financial Disclosures

Options backdating also raises another serious financial disclosure issue. Stock option plans are described in a company's SEC filings, and these disclosures might be found to be false or misleading as a result of their failure to disclose the practice of backdating options awards.

Prior to the Sarbanes-Oxley Act of 2002, option grants were required to be disclosed only once a year, and did not have to be reported to the SEC until 45 days after the close of the fiscal year in which the options were granted. Some commentators have suggested that the delay between the options grant date and the disclosure of the option grant may have allowed some of the "backdating" to remain undetected. However, Section 403 of Sarbanes-Oxley, which, in 2002, amended the Securities and Exchange Act of 1934, now requires that grants of stock options be reported to regulators within two days of the grant date.[6] Accordingly, we would expect that the financial disclosures challenged in civil actions will focus primarily on option grants from periods prior to the effective date of Sarbanes-Oxley.

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4 *Probing Stock-Options Backdating*, *The Wall Street Journal*, May 27, 2006, *supra*.

5 15 U.S.C. §§ 78j(b) (Manipulative and deceptive devices) and 78t (Liability of controlling persons and persons who aid and abet violations); 17 C.F.R. § 240.10b-5 (Employment of manipulative and deceptive devices).

6 Sarbanes-Oxley Act of 2002, Section 403, "Disclosures of Transactions Involving Management and Principal Stockholders."

Sarbanes-Oxley Certifications

A growing number of securities fraud class actions allege violations of Rule 10b-5 based on allegations that the Chief Executive Officer and/or the Chief Financial Officer signed Section 302 certifications[7] that were false. The SEC has promulgated rules regarding certification of quarterly and annual reports by a company's principal executive and financial officers. Section 302 requires that the certification state that:

- He or she has reviewed the report
- Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report
- Based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report
- He or she and the other certifying officers are responsible for establishing and maintaining "disclosure controls and procedures" (a newly-defined term reflecting the concept of controls and procedures related to disclosure embodied in Section 302(a)(4) of the Act) for the issuer; have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared; have evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report; and have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of that date
- He or she and the other certifying officers have disclosed to the issuer's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function) all significant deficiencies in the design or operation of internal controls (a pre-existing term relating to internal controls regarding financial reporting) which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls
- He or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses[8]

Although the plain text of Section 302(a) does not address private enforcement, SEC Securities Act Release No. 8124, promulgated on August 28, 2002 pursuant to Sarbanes-Oxley Section 302(a), is explicit about the interplay between the rules of certification and the securities laws. Under the heading "Liability for False Certification," the SEC states that executives or financial officers who falsely certify any of the reports listed in the August 30, 2002 SEC Release could face private actions under Section 10(b) and Rule 10b-5.

Although the majority of courts that have considered whether an inference of scienter may be drawn based on allegations that Section 302 certifications were false have held that it cannot, at least one court has held the opposite. In *In re Lattice Semiconductor Corp. Sec. Litig.*, the court held that:

> Sarbanes-Oxley certifications give rise to an inference of scienter because they provide evidence either that defendants knew about the improper journal entries and unreported sales credits that led to the over-reporting of revenues (because of the internal controls they said existed) or, alternatively, knew that the controls they attested to were inadequate. . . . *The Sarbanes-Oxley certifications, in combination with plaintiffs' allegations of regular finance meetings, extensive access to databases, pe-*

[7] Exchange Act Rules 13A-14 and 15D-14 (Certification Of Disclosure In Annual And Quarterly Reports); Investment Company Act Rule 30A-2 (Certification of Form N-CSR and Form N-Q).

[8] SEC Securities Act Release No. 8124 [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,720 at 86,125-157 (Aug. 28, 2002), (*available at*, http://www.sec.gov/rules/final/33-8124.htm).

riodic reports and special reports, and the allegations that they were micromanagers, are sufficient to create a strong inference of actual knowledge or of deliberate recklessness. Id. (emphasis added).[9]

Stock Option Class Actions

The recently filed options backdating class actions reflect the effort to link alleged backdating of stock options to allegedly incorrect financial statements and Section 302 certifications. In one such newly-filed complaint, plaintiffs assert that, taken together, the backdating of option grants coupled with an executive signing Section 302 certifications permits the inference of scienter.[10] Plaintiffs may even attempt to implicate an officer who did not personally receive any backdated option grants if he or she signed Section 302 certifications containing alleged false statements related to backdated grants.

Although the option grant backdating complaints filed thus far take slightly different pleading approaches, the following observations fairly capture the overall trend:

- The putative class period alleged by nearly every complaint takes advantage of the new 5-year statute of limitations for federal securities fraud (which was extended by Sarbanes-Oxley in 2002 to be the earlier of two years after the discovery of the facts constituting the violation or five years after such violation)[11]
- Nearly every complaint relies heavily on the extensive press coverage of the option grant backdating issue (including the March 18, 2006 *Wall Street Journal* article that discussed the examination of option grants conducted by Professor Eric Lie of the University of Iowa)[12]
- Nearly every complaint alleges that the company's incentive stock option plan contained in its annual reports was false and misleading for failing to specify that option grants were or could be backdated
- Several complaints allege that backdating resulted in the grantees receiving excess and unjustified compensation
- Nearly all of the complaints assert a fraud-on-the-market theory

Recommended Next Steps

There is every reason to expect that more examples of suspected abuse will be found, and that the SEC, DOJ, IRS, and, inevitably, the shareholders, will pursue the backdated stock option issue vigorously and thoroughly. Companies should immediately conduct a review of their option grant practices to ensure that there is no practice—formal, informal, or coincidental—that awards options in any way other than on a properly determined fixed date. Companies should confirm that there is proper and adequate documentation of the award of options, that compensation committee meetings took place when stated in minutes, and that there are no irregularities in the records of the company. Moreover, companies should ensure that their process of awarding options is documented carefully and reviewed by independent auditors.

Audit committees should be apprised of the progress and status of the review, and immediately informed of any suspicious practices. It is incumbent on each company to conduct its own compliance review and not wait for a government subpoena or regulatory inquiry to trigger an internal examination into these issues. These matters should be taken seriously, and companies should begin to plan now for expanded governmental investigations, and the myriad class action lawsuits that inevitably will follow.

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Dechert LLP is a multi-practice global law firm, with over 900 lawyers located in 18 offices throughout the United States, the United Kingdom, and continental Europe. Our attorneys have extensive experience with regulatory investigations, internal investigations, and securities fraud and financial litigation, and currently has legal teams advising at least two of the companies that have been identified in the option grant backdating investigations.

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9 *In re Lattice Semiconductor Corp. Sec. Litig.*, No. CV04-1255-AA, 2006 WL 538756, at *18 (D. Or. Jan. 3, 2006).

10 *Grasso v. Vitesse Semiconductor Corp.*, (C.D. Ca. May 1, 2006).

11 Sarbanes-Oxley Section 804, "Statute of Limitations for Securities Fraud."

12 Forelle, Charles and Bandler, James, *The Perfect Payday*, *The Wall Street Journal*, March 18, 2006, *supra*.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work or one of the attorneys listed. Visit us at www.dechert.com/financialserviceslit or www.dechert.com/whitecollar.

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