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**OPTING OUT OF OPTIONS BACKDATING:
PREVENTING CONTINUING CORPORATE FRAUDS IN LIGHT OF THE
OPTIONS BACKDATING SCANDAL**

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INTRODUCTION

Recently, options backdating has come to the forefront of corporate America's scandals. Questions over executive compensation in the form of stock options have sparked local and federal investigations from a number of agencies. Over 120 companies have come under scrutiny for their stock option granting practices. The Securities and Exchange Commission (SEC) and the United States Department of Justice (DOJ) are investigating whether companies backdated stock options for employees, retroactively changing the date an option grant became effective to a date that created a bigger windfall for those who held the options.

The consequences of a backdating inquiry are great. Some organizations are faced with federal criminal charges, civil penalties and fines. A number of top executives at various organizations have been fired and others have resigned. Many organizations face accounting and tax problems that may cost substantial sums of money to both investigate and correct. Some businesses are faced with restating financial results going back several years.

Although it has recently come into the spotlight, options backdating has arguably been in existence for many years. It was not until academic studies began to note backdating's widespread use that the practice came under scrutiny. Many organizations and agencies have reacted in an attempt to stop the practice of undisclosed options backdating, both through a focus on enforcement of new guidelines and disclosure rules as well as through structural reforms beginning with the Sarbanes-Oxley Act of 2002. However, additional academic studies have noted that the practice still exists.

As the government, investors and the organizations themselves demand accuracy and disclosure, the question remains what is the fair, just, and most effective resolution for

companies and individuals caught up in this problem, will this practice stop, and who will ultimately pay the price for illegal backdating of options?

This paper will set forth a two-prong solution to limit the future implications of both options backdating as well as similar corporate frauds. The first prong entails forcefully pursuing punishment of illegalities in order to create a strong deterrent effect. At this initial stage of the investigations into previous illegal options backdating, the justice system is not doing enough to create a deterrent effect. In order to create the reform that the practice of options backdating requires, blame must be assessed on everyone who participated in the illegal actions. If some culpable members of an organization are able to escape liability, the deterrent effect is reduced. Although top executives are the only ones being held liable at this stage, accountability should be extended to company attorneys and auditors, compensation committees, boards of directors, and, perhaps, the company itself.

The second prong requires the creation of a uniform scheme for option granting going forward. By requiring organizations to set options grants to occur on the same date each year, enforcement agencies and the public are able to more effectively monitor the grant process for potential illegalities. This ability to monitor the process will ensure that violations such as this do not occur in the future. Additionally, by streamlining the process, automatic penalties would be feasible, making punishment easier and more efficient, adding to the deterrent effect. This two-prong solution of deterrence and effective regulation will create a system where potential violators have limited opportunity to violate the law and where they fear the potential consequences of any possible violations.

I. HISTORY

A. What is options backdating?

1. *Definition*

The intended result of the customary practice in issuing options is that the options have value only if, after the grant, the market value of those shares has increased. Therefore, options serve as a form of incentive compensation but not as a form of immediate remuneration.¹

Options backdating is the practice of marking a document with a date that precedes the actual date. Typical stock options give the holder (the receiver of the option) the right to purchase a share of stock at a predetermined price, the "exercise price."² The exercise price is typically the closing price of the company's stock on the date that the company grants the option. Thus, on the grant date, the option shares typically have the same value as the shares that are trading that day, it has no intrinsic value. The option's lack of intrinsic value is deemed to be "at the money."³

Generally, in authorizing a stock option, a company first adopts a stock option plan, which requires a vote of approval by shareholders. Next, the board of directors typically assigns the administration of the plan to the compensation committee. This committee officially determines the size and timing of stock option grants.⁴ The stock option's exercise price is "usually the stock's 4 p.m. [eastern time] price on the date of the grant, an average of the day's

¹ *Option and Other Equity Grant Practices*, WEIL BRIEFING: CORPORATE GOVERNANCE (Weil, Gotshal & Manges LLP, New York, N.Y.), Feb. 23, 2007, at 2, <http://www.knowledgemosaic.com/gateway/memo/Weil%20Briefing%20-%2023%20Feb%2007%20-%20att%202.pdf> [hereinafter WEIL BRIEFING].

² Spencer C. Barasch et al., *Stock Option Scandal*, 22 TX LAWYER 1, 1 (Dec. 25, 2006) <http://www.infominder.com/webminder/RD.jsp?a=1&aref=m3z1ow0ij>.

³ *Id.*

⁴ 5 Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 Mgmt. Sci. 802, 803 (May 2005), available at <http://www.biz.uiowa.edu/faculty/eliel/Grants-MS.pdf>.

high and low, or the 4 p.m. price the day before [the grant]."⁵ If the committee does not award options on the same date every year they are considered unscheduled. It is with these unscheduled options awards that executives or other officials might time the awards to have been "granted" on a date when the stock prices had been particularly low.⁶ By timing an option to reflect a stock price that is lower than the market price on the actual date of the grant, the company is providing the grantee with an "in the money" benefit; the option has intrinsic value on the date the grantee receives it.

Options backdating is frequently related to another form of potentially fraudulent options granting, "spring loading." Spring loading is different in that it is forward looking in strategy (as opposed to looking back to find a low grant price). In spring loading, a company times its option grants so that they occur just before a good news announcement of which the investing public is not aware. Spring loaded options result in an exercise price that reflects the low stock price before the announcement and ends up immediately in the money following the stock price increase from the good news announcement.

Options backdating is also compared to "bullet dodging." Bullet dodging involves setting an option grant date later than the approval date so that information that is expected to cause a decrease in the market value of the company's shares can be disclosed, resulting in an exercise price that reflects the market's reaction to the information.⁷

2. What are the "benefits" of options backdating?

The recent stock option backdating "scandal" centers around the efforts by executives and officials of numerous companies to grant options to employees with exercise prices below the

⁵ 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., March 18, 2006, available at <http://www.biz.uiowa.edu/faculty/eliel/wsj2.htm> [hereinafter Forelle & Bandler, *CEOs Reap Millions*].

⁶ 5 Lie, *supra* note 4, at 804.

⁷ WEIL BRIEFING, *supra* note 1, at 2.

closing price of the company's stock on the actual grant date.⁸ This can be accomplished by backdating (selecting an earlier past date) or forging corporate documents and financial statements to make it appear that the company granted the option on a date when its stock price was lower than on the true grant date.⁹ By selecting a date in which the stock had a lower dollar value the option has an intrinsic value on the date that it is granted.¹⁰ It is an in the money option. Executive Stock Options (ESOs) are usually granted at the money. Because the option value is higher if the exercise price is lower, executives obviously prefer to be granted options when the stock price is at its lowest. Backdating inflates the value of the options.¹¹

An example illustrates the impact of backdating: The board of ABC Corporation adopts a stock option plan after shareholder approval. The compensation committee later elects to issue 1,000 options to its Chief Executive Officer (CEO) on December 1st. The closing price for ABC's stock on December 1st was \$100. A company executive notes that the closing price on November 6th was only \$75. The executive decides to alter company records to "grant" the options on November 6th. This fraud results in an in the money benefit of \$25 per share granted.¹²

The backdating of options to executives defeats the purpose of these grants. The point of stock options is that the executive only benefits if the stock goes up, tying executive compensation to that of the company and its performance. When the grants are fixed to provide

⁸ Barasch et al., *supra* note 2, at 1.

⁹ *Id.*

¹⁰ *Options Dating Issues*, SIMPSON THACHER REPORT (Simpson, Thacher & Bartlett), June 22, 2006, at 1, <http://www.stblaw.com/content/publications/pub556.pdf>.

¹¹ Erik Lie, *Backdating of Executive Stock Option (ESO) Grants*, Jan. 15, 2006, <http://www.biz.uiowa.edu/faculty/elielie/backdating.htm> [hereinafter Lie, *Backdating of ESO Grants*].

¹² See, e.g., Mark Maremont, *Authorities Probe Improper Backdating of Options – Practice Allows Executives to Bolster Their Stock Gains; A Highly Beneficial Pattern*, WALL ST. J., Nov. 11, 2005, available at <http://www.biz.uiowa.edu/faculty/elielie/wsj1.htm> (Noting a CEO option grant dated October 1998. The number of shares subject to option was 250,000 and the exercise price was \$30. Given a year-end price of \$85, the intrinsic value of the options at the end of the year was $(\$85 - \$30) \times 250,000 = \$13,750,000$. In comparison, had the options been granted at the year-end price when the decision to grant to options actually might have been made, the year-end intrinsic value would have been zero).

an immediate profit, this risk is largely eliminated. In a June 8, 2006 speech, SEC Chairman Cox stated that backdating is "antithetical to the presumptive purpose of stock options – to provide a 'powerful motivational tool' to promote future performance."¹³ Cox acknowledged that stock options can be positive incentives for employees and that "the proper use of stock options in compensation can make a very positive contribution to our economy by offering significant future rewards."¹⁴ He further stated in his June speech that the immediate effect of backdating "cuts the direct connection to future performance" and criticized the effect that undisclosed backdating has on shareholders' right to knowledge of executive level compensation.¹⁵

3. This is not a new phenomenon

In the academic study that brought to light much of the practice of backdating, Dr. Erik Lie, Associate Professor and Research Fellow at the University of Iowa's Henry B. Tippie College of Business, estimated that ten percent of all option grants made prior to 2002 may have been backdated.¹⁶ Others have alleged that the number of companies involved may have been around 2,000.¹⁷

It is said that options to buy shares at a preset "strike" price, a point at which recipients can convert them to shares, "became a widespread form of compensation during the 1990's boom, especially at technology firms. Along the way they attracted controversy, in part because

¹³ *Backdating Stock Options Controversy Heats Up: The Brocade Case and its Implications for the Future*, DEWEY BALLANTINE REPORT (Dewey Ballantine LLP), July 28 2006, at 4, <http://www.deweyballantine.com/docs/publications/2043.pdf?u=%22Backdated%20Stock%20Options%20Controversy%20Heats%20Up%3A%20The%20Brocade%20Case%20and%20its%20Implications%20for%20the%20Future%22>. See Christopher Cox, Chairman, Securities and Exchange Comm'n, Address to the New York Financial Writers Association (June 8, 2006) at <http://www.sec.gov/news/speech/2006/spch060806cc.htm> [hereinafter Cox, Address to NY Financial Writers Ass'n].

¹⁴ DEWEY BALLANTINE LLP, *supra* note 13, at 4. See Cox, Address to NY Financial Writers Ass'n, *supra* note 13.
¹⁵ *Id.*

¹⁶ *Legal News: Transactional and Securities Update*, INFO. BULLETIN (Foley & Lardner LLP), Aug. 15, 2006, at 1, http://www.foley.com/files/tbl_s31Publications/FileUpload137/3533/LegalNews%20TS%208-15-06.pdf

¹⁷ *An Option to Steal?*, THE WEEK, Dec. 29, 2006 – Jan. 12, 2007, at 47 [hereinafter THE WEEK].

some executives made huge fortunes off them as their stock prices soared."¹⁸ David Yermack of New York University was the first researcher to document some unusual stock price patterns around executive grants. Yermack found, in his 1997 study published in the *Journal of Finance*, that stock prices tend to increase shortly after the grants and attributed this pattern to grant timing, whereby executives would be granted options before predicted price increases.¹⁹ Thus, Yermack did not opine that the executives might be backdating, rather he believed that a spring loading type theory existed.

A number of companies have been alleged to be involved in past backdating practices. The caliber of some of these organizations is an example of the scope of how far the practice of backdating may have reached. Large, recognizable companies have been under investigation, including Microsoft, Home Depot, Barnes & Noble, Gap, Intuit, Apple Computers, Michaels Stores, and Monster Worldwide.²⁰ For example, Mercury Interactive Corporation's stock price pattern shows that it chose low points for every major grant from 1996 to 2002. Mercury gave 1.3 million options to executives on March 31, 1997. Its stock had fallen 21% during the ten prior trading days and rose 22% in the ten days afterward. Similarly, on January 6, 2000, executives were given 1.2 million new options after the stock had dropped 20% during the previous ten trading days and rose 56% in the ten trading days afterward, creating a gain of \$27 million for the recipients.²¹

The Corporate Library, an entity that monitors corporate governance, notes that "the practice of illegal backdating likely spread through networks of directors and executives serving

¹⁸ Maremont, *supra* note 12.

¹⁹ Lie, *Backdating of ESO Grants*, *supra* note 11.

²⁰ FOLEY & LARDNER LLP, *supra* note 16, at 1. See also *Perfect Payday: Options Scorecard*, WALL ST. J., Updated Feb. 20, 2007, available at <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html> [hereinafter *Options Scorecard*] (List of companies that have disclosed government probes, misdated options, restatements and/or executive departures).

²¹ Lie, *Backdating of ESO Grants*, *supra* note 11.

on multiple boards of directors."²² The return patterns around options awards intensified over time, "suggesting that executives ... gradually learned how to better time awards to their advantage or become more aggressive in their timing efforts."²³

4. Why is options backdating a concern now?

A number of contributing factors have created the attention that now surrounds options backdating. Options backdating has become a major issue at a time of rising shareholder attention to high executive compensation.²⁴ Yet the main cause for the recent attention stems from the publication of a study conducted by Dr. Erik Lie which suggests that backdating may be the main cause for the abnormal rise in the value of options granted to many corporate executives.²⁵

Lie's study documented that stock returns are negative before unscheduled executive option awards and positive afterward. Lie postulated that "[u]nless executives possess an extraordinary ability to forecast the future market-wide movements that drive these predicted returns, the results suggest that at least some of the awards are timed retroactively."²⁶ Lie noted that stock prices (after adjustment for market effects) started to decline more than a month before the award. However, there was a sharp reversal of the price trend on the award dates; immediately after the awards, the prices tended to increase.²⁷

²² Mary-Laura Greely & Pamela Greene, *Options Backdating: Why the Fuss and How to Avoid it*, BOSTON WOMEN'S BUS., Feb. 2007, at 2, available at <http://www.mintz.com/images/dyn/publications/MLPG.pdf>.

²³ 5 Lie, *supra* note 4, at 810.

²⁴ Charles Forelle & James Bandler, *Backdating Probe Widens as Two Quit Silicon Valley Firm – Power Integrations Officials Leave Amid Options Scandal; 10 Companies Involved So Far*, WALL ST. J., May 6, 2006, available at <http://www.biz.uiowa.edu/faculty/elie/wsj3.htm> [hereinafter Forelle & Bandler, *Backdating Probe Widens*]. See also 5 Lie, *supra* note 4, at 810.

²⁵ FOLEY & LARDNER LLP, *supra* note 16, at 1.

²⁶ 5 Lie, *supra* note 4, at 802 (Lie's sample consisted of 5,977 CEO stock option awards from 1992 through 2002, 1,668 of which had "sufficient information to be classified as unscheduled and 1,426 as scheduled").

²⁷ 5 Lie, *supra* note 4, at 805. See also *Options Backdating – The Controversy Continues*, BLANK ROME UPDATE (Blank Rome LLP), Sept. 2006, at <http://www.blankrome.com/index.cfm?contentID=37&itemID=1015> (noting the appearance of impropriety that some companies have faced due to this statistical examination of options that demonstrate a "pattern of (a) granting options at the lowest stock price during a period or (b) the price of the

Lie went on to compare his results with previous studies. He examined whether the options trends changed over time. His results found that the unusual return trends did increase with time.²⁸ Lie noted that this either suggested that "executives [were] getting better or more aggressive at opportunistically timing awards during the sample period."²⁹ Lie discredited the possibility that the stock pattern was "attributable to executives timing awards relative to expected future price patterns, [because then] their collective ability to forecast future price movements based on inside information [would be] striking."³⁰ He went on to note that "retroactive timing obviously requires little skill, although outsiders might perceive it to be fraudulent. In any event, it is unlikely that outsiders would ever learn of it, because the company does not publicly report the grant date until months thereafter."³¹ It is this difficulty in discovering such fraud that may have prevented it from earlier discovery. Further, Lie's study had different results because during earlier studies, fewer companies had been backdating. It was a growing trend as it spread from directors of one corporation to directors of others.

Lie's paper has "[shaken] corporate America and set in motion a series of investigations and press reports that exposed a practice that few had thought much about."³² The study in the paper looked at thousands of option grants. Lie found a "pattern of stocks dipping sharply just before the date of option grants, then rising immediately afterward – even after adjusting for overall market returns."³³ Additionally, Lie found market prices as a whole tended to rise after

company's stock spiking shortly after the grant date of options." Because it is "statistically unlikely that companies could consistently 'pick' these dates at random, thereby calling into question the company's actual practices.")

²⁸ 5 Lie, *supra* note 4, at 803.

²⁹ *Id.* (noting that executives might have become more effective in timing the awards to their advantage).

³⁰ *Id.* (Lie did note that it was not impossible that insiders may be able to predict future short-term market-wide movements, explaining some of his results).

³¹ *Id.* at 803, 806.

³² THE WEEK, *supra* note 17, at 47.

³³ Maremont, *supra* note 12. See also 5 Lie, *supra* note 4, at 810.

grants, which he suggested "shows that executives may have backdated options, already knowing how the market moved."³⁴

Since *The Wall Street Journal's* March 18, 2006 front page story on backdating, based on Lie's study and paper, there have been numerous disclosures by public companies under investigation by the SEC, the DOJ, or both.³⁵ In the past year "over 200 companies, including some of the best known and most successful, have reported that they have commenced internal reviews of their option grant practices."³⁶ Many of these reviews have found that option grants were in fact misdated.

An additional reason why the options backdating scandal has garnered so much attention is that it has become the "new focus of the federal government's corporate fraud initiative, which was launched in July 2002 amid the accounting fraud scandals involving Enron, Adelphia, WorldCom and other major corporations, and was followed ... by the passage of the Sarbanes-Oxley Act."³⁷ With the accounting fraud investigations nearing completion after the convictions of various former CEO's, the backdating options issue has "provided a vehicle for the federal government to publicize its continuing corporate fraud enforcement campaign."³⁸ The highly publicized charges currently being brought against various companies "demonstrate the government's effort to send a forceful message that it will proceed aggressively."³⁹

B. Is options backdating illegal?

Issuing stock options with an exercise price less than the market price of the shares on the date of grant is not inherently improper or illegal so long as the issuance complies with the terms

³⁴ *Id.*

³⁵ DEWEY BALLANTINE LLP, *supra* note 13, at 2.

³⁶ WEIL BRIEFING, *supra* note 1, at 2.

³⁷ DEWEY BALLANTINE LLP, *supra* note 13, at 2.

³⁸ *Id.*

³⁹ *Id.*

of the stock option plan that the shareholders approved and the issuance is properly approved, disclosed, accounted for, and the appropriate tax treatment for such options is applied.⁴⁰ SEC Commissioner Paul S. Atkins remarked that "the mere fact that options were backdated does not mean that the securities laws were violated ... [T]here is no securities law issue if backdating results from an administrative, paperwork delay. A board, for example, might approve an option grant over the telephone, but the board members' signatures may take a few days to trickle in. One could argue that the grant date is the date on which the last director signed, but this argument does not necessarily reflect standard corporate practice or the logistical practicalities of getting many geographically dispersed and busy, part-time people to sign a document. It also ignores that these actions reflect a true meeting of the minds of the directors, memorialized by executing a unanimous written consent."⁴¹

1. Backdating options is not always illegal

Stock option grants that are backdated are not illegal so long as a number of conditions are met. The most important condition is that no documents in connection with the grant have been forged. The acceptance by the company of a backdating scheme (and when it may be applied) must be clearly communicated to the organization's shareholders. Any backdating must be properly reflected in earnings. Neglecting to account for an in the money option leads to an illegal artificially inflated earnings statement for the company. "For example, because backdating is used to choose a grant date with a lower price than on the actual decision date, the options are effectively in the money on the decision date, and the reported earnings should be

⁴⁰ WEIL BRIEFING, *supra* note 1.

⁴¹ 46 Stephen J. Crimmins, *Sorting Out the Option Backdating Cases*, 38 SEC. REGULATION & LAW REPORT, Nov. 20, 2006, 1955, 1958, available at <http://www.mayerbrownrowe.com/publications/article.asp?id=3135&nid=6> (quoting remarks of Paul S. Atkins, Commissioner, Securities and Exchange Comm'n, Address (July 6, 2006) at www.sec.gov/news/speech).

reduced for the fiscal year of the grant."⁴² Additionally, backdating must be properly reflected in taxes.⁴³ If all of these conditions are met it is likely that the backdating would be legal.

However, there is little reason for backdating options in these situations, because the firm can grant bonuses or in the money options instead.

Whether or not a company allows the backdating of options can be questionable in and of itself, leading to inadvertent or undiscovered violations. Standard legal documents relating to stock option plans generally do not specify whether a grant date can be set retroactively.⁴⁴ Stock option documents are often "vague as to how the grant date should be determined, and do not specifically prohibit the grant date from preceding the decision date."⁴⁵ Additionally, it was difficult for "outsiders" to uncover any illegal practices as individual option agreements were often not publicly disclosed.⁴⁶

Some specific situations create questions as to whether or not a company has done something illegal in issuing options. One such situation occurs when the compensation committee decides to grant an option on a certain date, but the corporate formalities, such as board of director consents, are not completed until a later date when the stock price has increased.⁴⁷ There is "usually no intent to deceive" in these situations but even an inadvertent

⁴² Lie, *Backdating of ESO Grants*, *supra* note 11 ("Under ... the accounting rule that was in effect until 2005, firms did not have to expense options at all unless they were in-the-money. However, under the new FAS 123R, the expense is based on the fair market value on the grant date, such that even at-the-money options have to be expensed").

⁴³ *Id.* ("The exercise price affects the basis that is used for estimating both the company's compensation expense for tax purposes and any capital gain for the option recipient. Thus, an artificially low exercise price might alter the tax payments for both the company and the option recipient. Further, at the money options are considered performance-based compensation, and can therefore be deducted for tax purposes...however...in the money [options] ... might not qualify for such tax deductions.")

⁴⁴ 5 Lie, *supra* note 4, at 803.

⁴⁵ *Id.* at 804, 807 ("...stock option plans that [Lie] looked at do not explicitly prohibit such activities. The plans generally state that the exercise price should be the market price at the grant date, but does not state that the grant date cannot precede the decision date").

⁴⁶ *Id.*

⁴⁷ *Stock Options: Backdating and Other Issues Involving Stock Option Grants: New Rules from the SEC and a Game Plan for Avoiding Liability*, K&LNG ALERT (Kirkpatrick & Lockhart Nicholson Graham LLP), July 2006, at 2-3, at

delay in the approval process can have adverse consequences."⁴⁸ In these situations, "the company may be able to argue that any [past incident of] misdating was merely a mistake."⁴⁹

However, such a claim may not be sufficient to avoid tax, accounting and other issues.⁵⁰

Another questionable situation is when stock options were awarded to an employee on a date before the employee actually began employment with the organization.⁵¹ In such situations the question in avoiding liability is whether such a procedure was permitted by the company's option plan and procedures.⁵²

Unfortunately, the conditions to ensure that the backdating of options is not in violation of the law were infrequently met in the organizations now under investigation by various agencies, making the backdating of such option grants illegal in most cases.

2. When backdating options is illegal

The options that have prompted concern from the government, shareholders and the media are those in which the exercise price of a stock option grant made by a company to its executives and other employees may have been set at below-market prices, contrary to the

<http://www.klgates.com/files/Publication/6c4d05a2-a093-4bd0-9ce6-f2008a60b5ac/Presentation/PublicationAttachment/2d0a911e-5821-4b41-bf30-01db96f4ec21/SOA0706.pdf> ("This may occur, for example, if a unanimous consent is not signed by all directors or committee members until a later date when the stock price is higher (the laws of many states provide that a unanimous consent is not effective until the last director signs it." Additionally, companies using this approach sometimes "fail to develop adequate procedures for contemporaneously documenting the grant decisions made by the [compensation] committee").

⁴⁸ *Id.*

⁴⁹ SIMPSON, THACHER & BARTLETT, *supra* note 10, at 2.

⁵⁰ *Id.*

⁵¹ KIRKPATRICK & LOCKHART NICHOLSON GRAHAM LLP, *supra* note 47, at 2-3 (Some organizations have granted options to new hires as of a date prior to the new employee's first day of employment. For example, "an employment offer letter issued pre-employment may promise a prospective employee an option grant at the then prevailing market price").

⁵² SIMPSON, THACHER & BARTLETT, *supra* note 10, at 2. *See also* 8 Mark Tarallo & Ted Hanselman, *All You Wanted to Know About Back Dating of Options but Were Afraid to Ask*, 14 THE METROPOLITAN CORPORATE COUNSEL 1 (Aug. 2006) available at <http://www.metrocorpcounsel.com/pdf/2006/August/07.pdf> ("For new hires, some companies may have listed an employee's start date as earlier than the actual start date in order to take advantage of a low stock price").

company's stated practice of only issuing options with an exercise price equal to the market price on the date of grant.⁵³ Such a practice would be illegal.

Various practices may violate laws or regulations. If the terms of an option plan prohibit grants at less than fair market value, a company that issues such may face claims of breach of fiduciary duty and corporate waste.⁵⁴ If anyone in the organization "purposefully falsified or manipulated documents in an effort to hide the backdating practice" the company and the individual may be subject to both criminal and civil liability.⁵⁵ For example, a company may report in its public documents that the strike prices for options are always equal to the market value on the date of a grant but then choose a different date. This could constitute a securities-fraud violation for misleading disclosures.⁵⁶ If the granted options did not receive the requisite approvals by the appropriate members of the company, those issuing the grants could face "allegations of self-dealing, breach of fiduciary duty, failure of internal controls, and/or corporate waste."⁵⁷

There are also possible repercussions if an organization that engaged in backdating violated accounting rules by failing to include as an expense the extra compensation created by discounted stock options.⁵⁸ There were different accounting rules in effect at the time of the grants now under scrutiny. Under these, if the option price was set below the fair market value of the stock on the date granted, "the company was required to take a charge to earnings in its financial statements to account for this in the money grant."⁵⁹ Failure to disclose backdating and

⁵³ WEIL BRIEFING, *supra* note 1, at 1.

⁵⁴ SIMPSON, THACHER & BARTLETT, *supra* note 10, at 1-2.

⁵⁵ *Id.* E.g. KIRKPATRICK & LOCKHART NICHOLSON GRAHAM LLP, *supra* note 47, at 2-3.

⁵⁶ Maremont, *supra* note 12.

⁵⁷ SIMPSON, THACHER & BARTLETT, *supra* note 10, at 1.

⁵⁸ Maremont, *supra* note 12.

⁵⁹ Greely & Greene, *supra* note 22, at 1 (This changed with recent accounting rule changes). *Accord* Forelle & Bandler, *Backdating Probe Widens*, *supra* note 24.

recognize adverse tax and accounting consequences can also result in a number of legal consequences.⁶⁰

In general, "recent evidence suggests that the SEC has adopted the view that backdating violates securities laws and constitutes financial fraud when firms fail to record as compensation expense the amount by which the option grants were actually in the money at the time the grant decision was made."⁶¹

3. If backdating could be considered illegal, why do it?

There are a number of reasons why various organizations engaged in questionable options backdating procedures. The question arises of why a compensation committee would not instead award more options or provide an additional bonus? There are a number of reasons.

However, those in favor of such claim that the "need for incentives such as discounted stock options to retain and recruit valuable employees in a competitive environment. Additionally, they argue that issuing discounted options is just a compensation decision and does not involve the actual payment of company cash or a guarantee that the option will be in the money upon ultimate vesting."⁶² Supporters have argued "[n]othing can be more frustrating than issuing options to an employee with the intent of rewarding the employee only to have the price of the shares drop after the issuance, rendering the options of little value. The company could reissue or reprice the options, but there is a price for doing this, including reporting costs and a

⁶⁰ Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?* Forthcoming, J. OF FIN. ECON. 1, at 8 available at <http://www.biz.uiowa.edu/faculty/elie/Grants-JFE.pdf> [hereinafter Heron & Lie, *Does Backdating Explain*] ("Most stock options are non-qualified stock options, in which case the tax implications arise when the options are exercised. At this time, the executive is taxed at their ordinary income tax rate on the spread between the current market price and the exercise price....The corporation records a compensation expense deduction for tax purposes in the amount of the difference between the market price at exercise and the option's exercise price. Because opportunistic backdating of option grant dates results in lower exercise prices for option grants, it reduces corporate taxes... Tax consequences of backdating non-qualified stock option grant dates would effectively net out to zero, as the additional taxes paid by the executive would be offset by the reduced taxes at the corporate level.").

⁶¹ *Id.*

⁶² FOLEY & LARDNER LLP, *supra* note 16, at 2.

potentially negative impact on the issuer's financial statements."⁶³ Often, the company's stock option plan limits the number of options that can be awarded so issuance of "corrected" options is not possible. Additionally, "stockholders dislike the potential dilutive effect generated by a large number of outstanding options."⁶⁴

Additional advantages of backdating over other possible incentives are gained in the accounting arena. Under older accounting principles, a company that granted options at a purchase price equal to the price of its stock underlying the option on the date of grant did not have to state such as an expense on the company's financial statements. This made option compensation, unlike salary or a cash bonus which had to be accounted for, an accounting advantage.⁶⁵

C. Options backdating legal issues after Sarbanes-Oxley

The Sarbanes-Oxley Act (SOX) went into effect on August 29, 2002 and effectively changed a company's ability to engage in questionable backdating practices.⁶⁶ Until the passage of SOX, companies did not have to report option grants until months later. Some organizations had time to look at the "company's stock price performance ... to determine the stock's low point and designate that date as the retroactive stock option grant date."⁶⁷ SOX changed reporting requirements, effectively forcing organizations to report grants within two days, thus leaving "less leeway to retroactively date a grant."⁶⁸

⁶³ Tarallo & Hanselman, *supra* note 52, at 1.

⁶⁴ 5 Lie, *supra* note 4, at 804.

⁶⁵ Greely & Greene, *supra* note 22, at 1 (this changed with recent accounting rule changes).

⁶⁶ FOLEY & LARDNER LLP, *supra* note 16, at 2. *E.g.*, Heron & Lie, *Does Backdating Explain*, *supra* note 60, at 2 ("Effective August 29, 2002, and in response to changes to Section 16 reporting of the Securities and Exchange Act of 1934 mandated by the Sarbanes-Oxley Act, the SEC changed the reporting regulations for stock option grants").

⁶⁷ FOLEY & LARDNER LLP, *supra* note 16, at 2.

⁶⁸ 5 Lie, *supra* note 4, at 805 n.3. Accord Tracy Nichols, *Beyond back-dating: Think your option concerns are in the past? Now it's time to deal with the tax experts*, DAILY BUS. REV., Jan. 18, 2007, at 1-2, available at <http://www.hklaw.com/content/whitepapers/SpecialReportSecuritiesLawBeyondBackDating.pdf>. See *e.g.*, BLANK ROME LLP, *supra* note 27.

A second study by Professor Erik Lie estimated that over 2,000 companies (29.2% of a total sample of 7,774 companies) manipulated grants to top executives between 1996 and 2002, before SOX.⁶⁹ This study showed that the patterns that indicated backdating sharply declined after August 2002, when SOX rules began requiring executives to report option grants within two days, instead of months later as previously allowed. "With less leeway to choose a favorable grant date most of the effect disappeared."⁷⁰ Before August 2002, employees receiving stock option grants were:

... required to report them to the SEC on Form 5, which was not due until 45 days after the company's fiscal year end and also to stockholders in the proxy statement for the following year's annual stockholder meeting. [F]ollowing the legislative change, stock option grant recipients must report them to the SEC on Form 4, and must do so within two business days of receiving the grant. The SEC makes this information available to the public one day after it receives the information. Firms with corporate websites are also now required to make the option grant information available on their website on the day following when they disclose the information to the SEC....the ability to backdate option grants to coincide with days with low stock prices is greatly diminished.⁷¹

However, while Professor Lie's second study found that the return pattern after the new reporting requirements was weaker, it was still present.⁷² Lie notes "it is possible that the two day lag between the grant date and the reporting date still gives some leeway to opportunistically backdate grants. Further, to the extent that executives don't comply with the reporting requirements, they can still backdate the grants."⁷³

⁶⁹ Crimmins, *supra* note 41, at 1958 (citing Heron & Lie, *Does Backdating Explain*, *supra* note 60, at 4, 29 (the study compared a sample of 3,735 stock option grants to CEOs between August 29, 2002 and November 30, 2004 to the return pattern discovered in Lie's earlier study which included a sample from January 1, 2000 through August 28, 2002. It found "the abnormal return pattern is much more pronounced for the earlier period."))

⁷⁰ Crimmins, *supra* note 41, at 1958.

⁷¹ Heron & Lie, *Does Backdating Explain*, *supra* note 60, at 2-3. *But see* FOLEY & LARDNER LLP, *supra* note 16, at 2 (noting "nearly 20 percent of executives are filing their Form 4s up to two to four weeks late").

⁷² Heron & Lie, *Does Backdating Explain*, *supra* note 60, at 4. *See generally* William Meade Fletcher, FLETCHER CYCLOPEDIA OF THE LAW OF CORPS., FLETCHER-CYC § 3:109 (Sept. 2006).

⁷³ Heron & Lie, *Does Backdating Explain*, *supra* note 60, at 4-5 (noting that most executives in the second sample group chose to delay the reporting as much as possible, until the second day after the grant date. Furthermore, one-fifth of reports violated the two-day reporting requirements).

By implementing a fixed option grant date any possible delay in reporting is eliminated and there is no way to backdate options. Those executives who do not comply with the reporting requirements established by a fixed grant date scheme would be subject to automatic fines. These automatic fines serve as a deterrent, limiting the amount of late reporting that occurs.

D. The harms of backdating

1. Harm to corporations

There are a wide range of repercussions facing organizations that have been involved in backdating. Even companies which did not backdate but engaged in questionable stock option transactions are encountering harmful consequences. An organization that is under suspicion faces costly internal investigations (in addition to inquiries by the SEC, the United States Justice Department, and federal prosecutors), the loss of their top executives due to resignations and/or firings, financial loss from improper grants, financial loss due to the high costs related to restating several years' worth of earnings, potential declines in the company's stock price upon announcements of potential backdating, and even possible delisting of shares on the market due to inability to meet SEC reporting requirements.

Most companies under suspicion are conducting internal investigations, often through board appointed special committees composed of disinterested members of the audit committee. Some investigations are resulting in the company pursuing claims against various executives that were involved.⁷⁴ Other companies are not penalizing executives but rather paying the taxes and penalties owed by executives who received improperly timed options.⁷⁵

⁷⁴ Ted Allen & Subodh Mishra, *An Investor Guide to the Stock Option Timing Scandal*, INSTITUTIONAL SHAREHOLDER SERVICES 1, 5 (July 2006) available at <http://www.issproxy.com/pdf/OptionTiming.pdf>. E.g., Barasch et al., *supra* note 2.

⁷⁵ Allen & Mishra, *supra* note 74, at 4 ("Brocade Communications said it will pay \$3.3 million to executives and employees who received questionable options and it has offered to cancel the options or to raise their exercise price, and then pay the employees for the difference in cash").

The primary consequences that companies face from backdating relate to accounting and tax reporting.⁷⁶

Because of the misdating of option grants, many companies have reported that their accounting for options was erroneous and that they must take additional charges for compensation expense against their income. A significant portion have restated, or expect to restate, their historical financial statements to reflect these charges and have announced that, as a result, their previously issued financial statements can no longer be relied upon, in some cases going back more than a decade.⁷⁷

Some companies have not been able to file their periodic SEC reports when they become due, as the organization has "not been able to determine the amount of the compensation charges they will need to take and, accordingly, cannot prepare consistent and comparable financial data for current and prior periods."⁷⁸ The companies that do not file required reports with the SEC run the risk of being delisted from stock exchanges.⁷⁹ Further, failure to file certain reports and/or "material errors in previously issued financial statements may violate covenants or representations or warranties in debt instruments, presenting a risk of default...[and may] disrupt key license, joint venture or other business relationships for which current SEC reporting or financial statements are required."⁸⁰

⁷⁶ BLANK ROME LLP, *supra* note 27 (financial consequences include:

Material errors in financial statements requiring restatement; Inaccurate executive compensation disclosure in proxy statements and Annual Reports on Form 10-K; Inaccurate Section 16 filings by officers and directors; Voiding of options not granted in compliance with applicable stock option plans; Exposure of deficiencies or material weaknesses in internal control over financial reporting and disclosure controls; Liability of CEOs and CFOs for false certifications of SEC reports; Loss of tax deductions and imposition of penalties and interest for failure to withhold and report income and employment tax correctly; Potential imposition of federal income taxes, excise taxes, interest and penalties upon employees under Section 409A of the Internal Revenue Code of 1986, as amended, as a result of the creation of a "disqualified deferred compensation plan).

⁷⁷ WEIL BRIEFING, *supra* note 1, at 1.

⁷⁸ *Id.*

⁷⁹ *U.S. Option Scandal Swells Nasdaq Delistings Docket*, REUTERS, Oct. 3, 2006, at <http://today.reuters.com/news> (noting "[o]ver 50 companies presently face NASDAQ delisting, and a half-dozen more face NYSE delisting, as a result of option backdating problems forcing delayed financial reporting.").

⁸⁰ WEIL BRIEFING, *supra* note 1, at 1.

2. Harm to the market

The controversy and concern over backdating stock options has affected the markets as well. Distrust in the marketplace has led to a decline in stock prices of many organizations. Investors who lose confidence in an organization and its management have "bid down the stock prices of some of the companies caught up in the various probes."⁸¹ It has been estimated that companies involved in backdating have "lost on average a market value of \$510 million per firm during a window of 21 days around the first announcement that implicated a firm in backdating."⁸² Ultimately, shareholders are hurt by the decline in the market value of a company's shares as their investment.

II. CAUSES OF ACTION

A. Potential areas of violation

1. Corporate governance and violations of the option plan

Liability arises in a number of scenarios where the illegal backdating of stock options has occurred. Corporations and executives are liable to the organization and its shareholders when they violate the company's stock option plan and/or shareholder approval requirements. These violations may occur whether the backdating was intentional or not.⁸³ These companies face "the possibilities of loss of leadership resulting from executive resignations or removals,

⁸¹ Forelle & Bandler, *Backdating Probe Widens*, *supra* note 24 (for example, Vitesse Semiconductor Corporation's shares fell 40% after suspending a number of executives, and UnitedHealth Group Incorporated's shares fell 18%, decreasing the company's market capitalization by more than \$13 billion). *Accord* Allen & Mishra, *supra* note 74, at 4; Tarallo & Hanselman, *supra* note 52, at 2.

⁸² M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Option*, Aug. 2006, at 4-5, at <http://sitemaker.umich.edu/optiondating/files/060905mlr.pdf>.

⁸³ Elizabeth A. Brower et al., *Stock Option Grant Practices Under Scrutiny: The SEC Weighs In*, CLIENT ALERT (Paul, Hastings, Janofsky & Walker LLP), Sept. 2006, at 1, at http://www.paulhastings.com/Backup/Client_Alerts/38483.PDF?wt.mc_ID=38483.pdf.

significant civil penalties, additional tax liabilities, securities fraud charges, exchange delisting, bank defaults, departure of directors and possibly criminal charges."⁸⁴

Some potential areas of concern include the granting of options even though the company's stock option plan does not allow the exercise price to be less than its fair market value on its grant date or where shareholder approval is necessary before such an option may be granted.⁸⁵ The board of directors may face allegations that it did not adhere to the company's principles of corporate governance or code of conduct.⁸⁶

Companies may encounter problems with the removal of directors and the reelection of compensation committee members who shareholders feel are liable for past violations and obtaining future shareholder approval of stock option plans.⁸⁷ Shareholders have begun to sue, claiming fundamental unfairness and unjust enrichment as executives realized "significant monetary gains" while breaching their fiduciary duty of loyalty to the organization in placing their own interests ahead of those of the company and its shareholders.⁸⁸

Finally, in some situations where directors intentionally violate an option plan and a company makes fraudulent disclosures regarding its compliance with such plans in filings or other public disclosures, the directors may be deemed to have acted in bad faith and to have breached the duty of loyalty by acting deceptively (and therefore outside the protections of the business judgment rule). Director and Officer insurance policies may not protect organizations in these situations.⁸⁹ "In such circumstances, directors may lose the indemnification and other

⁸⁴ Greely & Greene, *supra* note 22, at 1.

⁸⁵ FOLEY & LARDNER LLP, *supra* note 16, at 3.

⁸⁶ *Id.*

⁸⁷ *Id.* at 4. See also Linda Chatman Thomsen, Enforcement Director, Securities and Exchange Comm'n, Remarks, (Oct. 30, 2006) at www.sec.gov/news/speech (observing "[m]any companies have lost an entire generation of seasoned executives ... undoubtedly causing enormous disruption and upheavals at the affected companies").

⁸⁸ FOLEY & LARDNER LLP, *supra* note 16, at 1.

⁸⁹ *Timing is Everything: Stock Option Practices Under Scrutiny*, CORPORATE GOVERNANCE ADVISORY (Hughes, Hubbard & Reed LLP), Aug. 2006, at 2,

liability protections ... and may be personally liable for resulting damages to the company."⁹⁰ It has been said that "intentional backdating is one of those 'rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.'"⁹¹

2. Major theories of liability

Companies and various executives who are involved in the illegal backdating of stock options face liability in a number of additional scenarios. The Securities and Exchange Commission, the DOJ, and shareholders have a variety of potential causes of action available to them. The government may bring criminal, civil fraud or nonfraud charges against alleged violators and shareholders may bring civil actions.⁹²

a. Disclosure

Publicly traded companies are required by law to make various disclosures, typically through SEC filings. "Disclosure, which focuses on what the [public] knew, and when, is at the heart of many securities fraud cases."⁹³ Companies that have engaged in illegal backdating may be found to have violated federal securities law disclosure rules. For example, a company's proxy statements may have been misstated from either an executive compensation disclosure or

http://www.hugheshubbard.com/files/tbl_s20NewsPring/PDFUpload103/1433/Corp_Gov_August_2006_Options_Timing_Alert_Advisory_rev9.pdf (Certain D&O policies "(i) exclude coverage for 'intentionally wrongful acts,' (ii) contain 'options exclusions,' which exclude policy coverage for claims relating to the issuance or use of stock options, or (iii) contain 'personal profit' exclusions, which exclude coverage for claims involving an insured person who gained a personal profit to which he or she was not legally entitled."). *See generally* KIRKPATRICK & LOCKHART NICHOLSON GRAHAM LLP, *supra* note 47, at 6.

⁹⁰ *Two Delaware Chancery Court Cases on Backdating and Spring-Loading Stock Options Increase the Stakes for Directors*, JONES DAY COMMENTARY (Jones Day), Feb. 17, 2007, at 1-2, at <http://www.jonesday.com/files/Publication/9babe2ef-6d5b-4671-b250-059781b1d40a/Presentation/PublicationAttachment/438f1b32-cf01-4838-94ce-41db55f1b272/Two%20Delaware.pdf>.

⁹¹ *Id.* at 1.

⁹² Crimmins, *supra* note 41, at 1958 (the determination between charges that the government may bring will "largely turn on the state of mind of those involved. Criminal cases can be based on 'willful' violations of the securities laws. (Securities Act § 24; Exchange Act § 32(a)) [while] civil fraud cases can be based on reckless conduct. (*Aaron v. SEC*, 446 U.S. 680 (1980); *Ponce v. SEC*, 345 F.3d 722, 729 (9th Cir. 2003))).

⁹³ DEWEY BALLANTINE LLP, *supra* note 13, at 4.

an option plan approval standpoint. The company may have inaccurate periodic reports that reflect these misstatements.⁹⁴

It is important to note that violations may occur based on non-required disclosures. Even if information is not required to be disclosed, any information that is disclosed voluntarily must nonetheless be accurate.⁹⁵ Further, backdating of options may lead to the identification of weaknesses in the internal controls or the disclosure controls of a company.⁹⁶

It appears that the majority of complaints brought by the SEC and/or DOJ will be brought for some form of failure to disclose. These charges are the most likely to succeed as they will be the easiest to prove after illegal backdating is uncovered (as material information was either disclosed in periodic reports and proxy statements or it was not).

b. Accounting

Financial reporting issues arise with illegally backdated stock options. Illegal backdating may "cause the improper statement or underreporting of compensation expense, triggering a restatement of the company's financials going back to the date of the misdated option grants."⁹⁷ The potential issue relating to liability is whether the stock option grants were properly recorded as expenses. Until recently, companies did not have to expense stock options that were granted at the money. However, with in the money options, the difference between the strike price and the then current share price was required to be identified as an expense.⁹⁸ "Thus, to the extent backdating occurred, it may have affected the amount a company expensed."⁹⁹

⁹⁴ FOLEY & LARDNER LLP, *supra* note 16, at 3.

⁹⁵ *Id.* at 4.

⁹⁶ *Id.* at 3.

⁹⁷ *Id.*

⁹⁸ DEWEY BALLANTINE LLP, *supra* note 13, at 5.

⁹⁹ *Id.* at 4.

If options are later determined to have been in the money on the date they were actually granted, substantial earnings restatements may be required to recognize the newly accounted for expense. This may place "CEOs and CFOs at risk of a violation of the Sarbanes-Oxley certification requirements (and may trigger its disgorgement provisions)."¹⁰⁰ Penalties for these accounting violations will be assessed against a number of companies as these violations are easily recognizable after the discovery of illegal backdating.

c. Tax violations

The Internal Revenue Service (IRS) will be working with the DOJ and the SEC on the options backdating investigations.¹⁰¹ Potential negative tax consequences may occur when there is illegal backdating. Generally, at the money option grants comply with Internal Revenue Code rules allowing for favorable tax treatment for both the company and the recipients. However, in the money options do not qualify for this favorable tax treatment.¹⁰²

Backdating to a lower strike price, in effect, creates in the money options. Thus, "any tax reporting that occurred prior to the revelation of the backdating may need to be revised, with the likelihood of additional tax liability to the company, and to the recipients."¹⁰³ Backdating may

¹⁰⁰ HUGHES, HUBBARD & REED LLP, *supra* note 89, at 1.

¹⁰¹ Mark Everson, Internal Revenue Commissioner, Senate Finance Committee Testimony (Sept. 6, 2006) at www.senate.gov/~finance.

¹⁰² DEWEY BALLANTINE LLP, *supra* note 13, at 5-6. *See also* Nichols, *supra* note 68, at 2 (explaining that [t]here are two common types of employee stock options: nonstatutory stock options (NSOs) and incentive stock options (ISOs). When an employee exercises an NSO, the difference between the exercise price and the fair market value of the stock on the date of exercise is taxed at ordinary income tax rates. The company has withholding obligations on the employee's gain, but also gets a corresponding tax deduction. With backdated or misdated options, the employee may have a larger tax obligation. And while the company has a larger tax deduction, it also has a greater withholding obligation. An option grant loses its favorable ISO status if the option is awarded "in the money." Thus a company that granted options at a discount which it believed were ISOs would not have withheld income tax or FICA upon exercise of the option. The company could now be liable for the amount of income tax and FICA it failed to withhold on exercise of the discounted option that did not meet ISO requirements.).

¹⁰³ DEWEY BALLANTINE LLP, *supra* note 13, at 5-6.

"lead to Internal Revenue Code § 409A tax problems, where there is an immediate taxation of the option spread on the option vesting date, rather than the option exercise date."¹⁰⁴

Another issue likely to arise applies to options granted to the company's CEO and highest paid officers.

Under Internal Revenue Code section 162(m), companies may not deduct more than \$1 million in compensation to each of these five individuals. 'Performance-based compensation,' however, is exempted from the \$1 million limit. In order for a stock option to qualify as 'performance-based compensation,' the amount of the compensation the employee receives must be based on an increase in the stock price after the date of the grant.¹⁰⁵

Backdated options generally do not meet this qualification and, therefore, the grants will be counted toward the \$1 million limit that companies are permitted to deduct as opposed to being exempted. Similar to penalties for accounting violations, tax-based charges are quite likely to be brought against a number of companies as these violations are easily recognizable once backdating has been uncovered.

d. Insider trading

A less discussed potential theory of liability exists in insider trading, the buying and/or selling of stock based on material, non-public information. Companies which face allegations of spring loading, granting options immediately prior to the release of good news, or those who "backdate[d] stock options on the eve of a company receiving favorable news, but before such

¹⁰⁴ FOLEY & LARDNER LLP, *supra* note 16, at 3. See generally Patrick McCabe & Paul Borden, *Tax Issues Arising Out of Stock Options Back-Dating Investigations*, LEGAL UPDATE (Morrison Foerster), June 2006, at <http://www.mofo.com/news/updates/files/update02204.html>; *Compliance Resolution Program for Employees Other than Corporate Insiders for Additional 2006 Taxes Arising Under § 409A due to the Exercise of Stock Rights*, ANNOUNCEMENT 2007-18 (Internal Revenue Service), Feb. 8, 2007, at <http://www.irs.gov/pub/irs-drop/a-07-18.pdf>; Press Release, Internal Revenue Service 2007-30, IRS Offers Opportunity for Employers to Satisfy Tax Obligations of Rank-and-File Employees with 'Backdated' Stock Options (Feb 8, 2006) <http://www.irs.gov/newsroom/article/0,,id=167643,00.html>.

¹⁰⁵ DEWEY BALLANTINE LLP, *supra* note 13, at 5-6.

news was made public" may encounter charges for insider trading.¹⁰⁶ Insider trading is a favorable method for the SEC and the DOJ to pursue because it "is a relatively simple concept to explain compared to other securities fraud theories, and carries with it tremendous juror appeal."¹⁰⁷ It is unlikely that insider trading claims will be brought in "traditional" backdating cases unless it can be shown that the backdating occurred due to material nonpublic information. Therefore, this is a weaker cause of action.

3. Analysis

Ultimately, there are a number of possible theories in which a person may face liability for illegal options backdating. At this stage, inaccurate or inadequate disclosure is the primary violation that is being litigated. Thus, it is the top executives, the ones who enacted or knew about illegal policies, who are facing blame. However, this is not enough. Under the first prong of the proposed solution all possible causes of action should be utilized where appropriate. This would hold accountable auditors who either ratified illegal procedures by doing nothing upon discovery of such, or who failed in their duties to detect such illegalities. It would hold liable the attorneys who gave advice in contravention of the law or who ratified illegal behavior by doing nothing to prevent it. It would hold entire compensation committees who enacted illegal options practices liable. Finally, it may even hold the company itself liable for, among other things, enacting inadequate procedures to prevent illegal options practices.

The justice system must make an example out of these offenders in order to truly deter illegal options practices in the future. Litigation must be pursued under every cause of action available and against all violators in order to penalize those who profited off of the manipulation

¹⁰⁶ *Id.* at 6-7. See also *The Stock Option Controversy – The Scrutiny Escalates*, CLIENT ALERT (Proskauer Rose LLP), July 2006, at 2-4, http://www.proskauer.com/news_publications/client_alerts/content/2006_07_18/_res/id=sa_PDF/12745-071406-The%20Stock%20Option%20Controversy-v5.pdf.

¹⁰⁷ DEWEY BALLANTINE LLP, *supra* note 13, at 5-6.

and deceit to their organizations shareholders and the investing public. Only when people such as attorneys and auditors fear that they will face large penalties along with the top executives will there be a deterrent effect.

Under the second prong of the proposed solution, all backdating will be prohibited and a uniform grant date will be required of every organization. This will streamline the options granting process, limiting the potential for continuing backdating violations. This part of the solution is essential because of the limited resources that the SEC and DOJ have to pursue violators. By enacting a standardized structure for the grant process, the punishment of violations can also become more efficient. Standard fines can be imposed where reporting requirements have not been met. Not only will these be easy to monitor due to a fixed grant date, but they can be imposed automatically, without the cost and delay of the current litigation process. The deterrent effect created by prong one of the solution is strengthened by imposing such penalties. By enacting a uniform grant date requirement, a number of the aforementioned causes of action will not be necessary as backdating will be virtually non-existent and any failures can be efficiently punished.

B. Consequences to those who profited from and/or participated in options backdating

The most important question facing companies which have been alleged to have participated in options backdating is how these cases will be prosecuted and how the government will determine whether to bring criminal charges, civil fraud actions or nonfraud charges.

1. Shareholder lawsuits

As allegations of illegal options backdating come to light, shareholders are becoming more and more displeased and are holding the companies and their executives accountable for the misconduct. A number of complaints have been filed against various organizations. Thus

far, over 25 companies have been sued by shareholders.¹⁰⁸ These shareholder derivative suits accuse various executives of having manipulated stock options grants for their own benefit, thus "wasting" corporate assets.¹⁰⁹

Recent derivative suits have asserted claims based upon breach of fiduciary duty and unjust enrichment, and sought damages suffered by the company as an entity.¹¹⁰ Shareholders are seeking "recovery of profits resulting from option grants and the costs of internal investigations, and to a lesser extent, class actions seeking damages in connection with alleged backdating."¹¹¹

Courts have refused to dismiss complaints against directors who were allegedly involved in option backdating. Although the court recognized that a board of director's "decisions regarding executive compensation generally are entitled to great deference – the court's holdings emphasize that directors may face fiduciary liability for their actions – or inaction – related to option grant practices."¹¹²

Defendant directors will argue that the organization was not injured as a result of option backdating. Among other things, a "plaintiff in a derivative suit must prove that but for the breach of fiduciary duty (here the backdating of the option and the failure to accrue a compensation expense) the company would not have suffered injury."¹¹³ They may argue that

¹⁰⁸ Allen & Mishra, *supra* note 74, at 5.

¹⁰⁹ *Focus on Backdating of Stock Option Grants Intensifies*, SEC. LITIG. ALERT (Bingham McCutchen LLC), Aug. 10, 2006, at 2, at <http://www.bingham.com/ingham/webadmin/documents/radD7328.pdf> [hereinafter BINGHAM McCUTCHEEN LLC, *Focus on Backdating*].

¹¹⁰ *Stock Option Backdating – Regulators and Plaintiffs Take the Controversy to the Next Level*, SEC. UPDATE (Mayer Brown Rowe & Maw), Aug. 1, 2006, at 3, at <http://www.mayerbrownrowe.com/litigation/securitiesenforcement/publications/article.asp?id=2889&nid=4525>.

¹¹¹ Crimmins, *supra* note 41, at 1958 (quoting Atkins, *supra* note 41).

¹¹² Stephen Alexander et al., *Delaware Court of Chancery Issues Two Important Decisions on Stock Options Backdating, Spring-Loading and Bullet-Dodging*, SEC. & CORPORATE GOVERNANCE LITIG. ALERT (Bingham McCutchen LLC), Feb. 15, 2007, at 4, at <http://www.bingham.com/Bingham/webadmin/documents/radEFA88.pdf>.

¹¹³ MAYER BROWN ROWE & MAW, *supra* note 110, at 3. See also Paul Vizcarrondo, Jr. & Joshua A. Naftalis, *Delaware Chancery Court Addresses Stock Option Backdating and "Spring-Loading,"* UPDATE (Wachtell, Lipton,

the cost of the backdated options would have alternatively come from an equivalent cash bonus that would be required to attract and retain talented employees, thus costing the organization the same amount and amounting to no injury to the company. Although the costs of executive compensation may have had to come from the company one way or another, the directors should be held responsible for their deceit and their violations of the law relating to such. It is imperative that culpable executives are not able to lay blame on others in this manner. Arguments claiming that equivalent bonuses would have been given must be dismissed for ignoring the frauds that were enacted on both the company and the market by concealing the illegal backdating.

Other class action lawsuits allege violations of the securities laws. "[M]ore suits can be anticipated where companies have a significant stock price drop following the announcement of a restatement of financial results."¹¹⁴ Again, even if the price does decrease, defendants may argue that the drop was not caused by the announcement of past alleged incorrect financial statements.

There has been a great deal of variation in the market's responses to corporate announcements of options backdating issues, which suggests that there is much more at work than merely the elimination of stock price inflation, if any, traced to alleged false financial statements in the past. Some companies' stock prices have declined while others have not. Some have declined much more than others. In addition, many companies have made multiple announcements, provoking different stock price reactions to each one. Economists and econometricians should be able to analyze this data and show that the observed stock price declines were due to factors other than the disclosure of the accounting adjustments. This could in turn support arguments that the plaintiffs' alleged damages were not

Rosen & Katz), Feb. 8, 2007, at 1-2, *at*

<http://blogs.law.harvard.edu/corpgov/files/2007/02/20070210%20Postdating%20Memorandum.pdf> (noting A plaintiff bringing a derivative complaint is generally required to first make a demand on the corporation's board of directors to remedy the alleged misconduct and to decide whether a lawsuit would be in the best interests of the corporation. This demand requirement is excused, however, where there is a reason to doubt whether the challenged transactions involved valid exercise of business judgment or that a majority of the directors would have been independent and disinterested when considering the demand.)

¹¹⁴ BINGHAM McCUTCHEN LLC, *Focus on Backdating*, *supra* note 109, at 2.

caused by the alleged backdating misconduct and are not recoverable, but rather were the result of the market's reaction to the possibility of other adverse developments distantly related to the option backdating, but not necessarily foreseeable at the time of the alleged misconduct – e.g., disruption to management, fear of firing of key employees, the specter of litigation, etc. Defendants may argue that these damages were not proximately caused by the alleged backdating misconduct and are not recoverable.¹¹⁵

Again, although defendants may be able to escape liability by making such a showing in shareholder derivative suits, their failure to disclose and criminal violations must not be dismissed.

Although a number of cases have been filed, most are in the preliminary stages. Therefore, it is difficult to analyze whether or not the companies and directors will be held liable. However, it is helpful to analyze some of these cases and their precedential (and deterrent) effects.

1. *Ryan v. Gifford*

In *Ryan v. Gifford* a shareholder of Maxim Integrated Products Incorporated filed a derivative lawsuit alleging that the board of directors breached its fiduciary duties of due care and loyalty by approving or accepting backdated stock option grants to the CEO that violated the company's shareholder approved stock option and stock incentive plans.¹¹⁶

Maxim's compensation committee had granted stock options for the purchase of millions of shares of Maxim's common stock to Gifford, the company's CEO and chairman, pursuant to shareholder approved stock options plans which required that the exercise price be "no less than the fair market value" of the company's stock on the date of the grant. The plaintiff alleged that

¹¹⁵ MAYER BROWN ROWE & MAW, *supra* note 110, at 4.

¹¹⁶ *Ryan v. Gifford*, No. 2213-N, 2007 WL 416162 (Del. Ch. Feb. 6, 2007).

the defendant directors knowingly and intentionally violated the terms of the plan by backdating the actual dates of nine specific option grants.¹¹⁷

In bringing the action, the shareholder relied on a Merrill Lynch report released in 2006 analyzing the timing of stock options grants by certain companies, including Maxim. Merrill Lynch reported "the return on options grants to Maxim's management averaged an annualized return of 243%, almost ten times higher than the 29% annualized market returns in the same period."¹¹⁸

Here, the court excused the plaintiff from making demand, stating "backdating options qualifies as one of those 'rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists."¹¹⁹ The court stated that "intentional violation of a shareholder approved option plan, coupled with inaccurate disclosures in proxy statements regarding the directors' purported compliance with that plan, constitutes conduct that is disloyal to the corporation and in bad faith as a board has 'no discretion to contravene the terms of stock option plans."¹²⁰ The court rejected the defendants' claim that the allegations were based upon nothing more than statistical abstractions.¹²¹ However, in order to prevail at trial, the plaintiff would

¹¹⁷ *Id.*

¹¹⁸ Alexander et al., *supra* note 112, at 1 (citing *Ryan*, 2007 WL 416162 at *2, *3). *Accord* JONES DAY, *supra* note 90, at 3; *Delaware Court of Chancery Addresses Stock Option Dating and Timing Issues*, LATHAM & WATKINS BULLETIN NO. 568 (Latham & Watkins LLP), Feb. 8, 2007, at <http://www.lw.com/resource/Publications/ClientAlerts/clientAlert.asp?pid=1775>.

¹¹⁹ *Ryan*, 2007 WL 416162 at *10 (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)). *See also* JONES DAY, *supra* note 90, at 3 (the allegations here were "sufficient to raise a reason to doubt the disinterestedness of Maxim's board and to suggest that they were incapable of impartially considering demand").

¹²⁰ JONES DAY, *supra* note 90, at 3 (citing *Ryan*, 2007 WL 416162 at *8 (The court found that the "intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitute[d] conduct that is disloyal to the corporation and is therefore an act in bad faith.")).

¹²¹ Alexander et al., *supra* note 112, at 3 (citing *Ryan*, 2007 WL 416162 at *9 n.34 (explaining True, the Merrill Lynch report does not state conclusively that Gifford's options were actually backdated. Rather, it emphatically suggests that either defendant directors knowingly manipulated the dates on which options were granted, or their timing was extraordinarily lucky. Given the

need to demonstrate by a preponderance of the evidence that the defendants had illegally backdated options and "intended to circumvent company approved policies and procedures regarding the grant or exercise price of company stock options."¹²²

Ryan v. Gifford "raise[s] the possibility that officers and directors who engage in the type of backdating ...alleged in those cases could face personal liability. Such conduct, if proven at trial, would be a breach of the duty of loyalty, for which Section 102(b)(7) of the DGCL [(Delaware General Corporate Law)] will not afford any protection."¹²³ If individual directors and officers are held personally liable for their backdating misconduct, shareholders will not be forced to pay for these wrongs another time. Because the company's Director and Officer insurance would not be available, damages would be assessed on the individual executives as opposed to coming from such a company-paid policy. Such personal liability will have tremendous deterrent effect on officers and directors, preventing future corporate frauds for fear of personal financial loss.

2. *In re Tyson*

Another example of a shareholder derivative suit is *In re Tyson*, which recently withstood a motion to dismiss. In this case shareholders brought derivative and class actions against the Tyson corporation, its controlling shareholder, and current and former directors and officers to recover for breach of fiduciary duties.¹²⁴

Tyson had adopted a Stock Incentive Plan granting the board, and the compensation committee, permission to award various incentives to employees, officers, and directors but

choice between improbable good fortune and knowing manipulation of option grants, the Court may reasonably infer the latter...)).

¹²² JONES DAY, *supra* note 90, at 3.

¹²³ See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (stating "good faith" is a subsidiary element of the duty of loyalty as distinct from a duty separate from the duties of care and loyalty).

¹²⁴ *In re Tyson Foods, Inc.*, No. Civ. A. 1106-N, 2007 WL 416132 (Del. Ch. Feb. 6, 2007).

requiring that the price of stock options be no lower than the fair market value of the company's stock on the day of the grant.¹²⁵ The plaintiff shareholders alleged that the defendant board members ordered the compensation committee to spring-load these options by granting them to key employees days before Tyson issued press releases that were very likely to drive stock prices higher.¹²⁶ It is alleged that approximately 2.8 million shares of Tyson stock were awarded to the various defendants in this manner. The plaintiffs contend that the board violated its fiduciary duties by approving these options during 1999 to 2003 as well as for failure to investigate self-dealing payments and misrepresentation in the proxy statement.¹²⁷

The court denied the defendants motion to dismiss, finding that the Tyson directors' alleged spring loading of stock options involved bad faith and was not protected by business judgment rule.¹²⁸ The court noted that the granting of spring-loaded options, without shareholder authorization, "clearly involves an indirect deception...[as a] director's duty of loyalty includes the duty to deal fairly and honestly with the shareholders for whom he is a fiduciary."¹²⁹ The court stated that the issue:

... is not, as plaintiffs suggest, whether spring-loading constitutes a form of insider trading as it would be understood under federal securities law. The relevant issue is whether a director acts in bad faith by authorizing options with a market-value strike price, as he is required to do by a shareholder approved incentive option plan, at a time when he knows those shares are actually worth more than the exercise price. A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed

¹²⁵ *Id.* at *5 (the proxy stated:

The Plan provides for the grant of incentive stock options and nonqualified options.... The exercise price of an option shall be set forth in the applicable Stock Incentive agreement. The exercise price of an incentive stock option may not be less than the fair market value of the Class A Common Stock on the date of the grant (nor less than 100% of the fair market value if the participant owns more than 10% of the stock of the Company or any subsidiary)).

¹²⁶ *Id.*

¹²⁷ *Id.* at *9.

¹²⁸ *Id.* at *18.

¹²⁹ *Id.* (citing *In re Walt Disney*, 907 A.2d 693, 755 (Del. Ch. 2005) ("To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation"))).

requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary.¹³⁰

The court did note that a plaintiff must meet the requirement to "show adequately at the pleading stage that a director acted disloyally and in bad faith and is therefore unable to claim the protection of the business judgment rule."¹³¹

This case exemplifies the potential liability that an organization and its directors face for intentional misrepresentations or other illegalities relating to option granting practices. The penalties that are assessed to the corporation will serve as an important precedent. The deterrent effects of personal liability in illegal options backdating cases will be increased.

2. The Justice Department

Organizations that have found themselves involved in the illegal backdating scandal do not have to worry only about suits brought by shareholders of the company. In a coordinated enforcement action, the SEC and the DOJ have begun to file civil and criminal cases. The SEC has publicly stated that it is sharing the results of its investigations with the DOJ and the IRS, allowing for concerted actions that are more efficient.¹³²

The Justice Department has said it "will bring criminal charges for option backdating where defendants intentionally (i) falsify corporate books and records; (ii) issue false financial statements; (iii) lie to boards, auditors and the SEC; and (iv) file false reports with the SEC."¹³³

¹³⁰ *In re Tyson Foods, Inc.*, 2007 WL 416132 at *18.

¹³¹ *Id.* at *19 (two things are required in order to show that a spring-loaded option issued is beyond the bounds of business judgment. "First, a plaintiff must allege that options were issued according to a shareholder-approved employee compensation plan. Second, a plaintiff must allege that the directors that approved spring-loaded options (a) possessed material non-public information soon to be released that would impact the company's share price, and (b) issued those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options.").

¹³² Nichols, *supra* note 68, at 1.

¹³³ Paul J. McNulty, Deputy Attorney General, Senate Finance Committee Testimony (Sept. 6, 2006), at www.senate.gov/~finance.

Criminal charges may also be brought for obstruction of justice, perjury, criminal tax violations, and in more recent matters, Sarbanes-Oxley violations.¹³⁴

On the criminal side, the FBI recently reported active criminal investigations of 52 companies concerning option backdating.¹³⁵ United States Attorneys' Offices throughout the country, assisted by agents of the Federal Bureau of Investigation, are pursuing option backdating matters. States such as California have even formed a stock option backdating task force.¹³⁶ The United States Attorneys' offices in New York, Boston and elsewhere have been conducting criminal investigations parallel to the SEC involving some of the same companies.¹³⁷

The DOJ is assessing criminal charges in dozens of cases. Executives who participated in backdating are open to criminal fraud charges of enriching themselves through false or misleading records or filings. Such criminal charges would require that an executive who took part in backdating did so intentionally yet it is likely that, like past corporate-fraud cases, executives will attempt to use the defense that they relied on advice of lawyers or other experts and, therefore, did not intentionally participate in any illegal activities.¹³⁸ As previously stated, defenses such as reliance on the advice of an attorney should not be permitted to allow directors who knew or should have known that what they were doing was illegal or in violation of company policy to escape liability.

¹³⁴ *Id.*

¹³⁵ *FBI Promises Crackdown on Stock-Option Fraud as Cases Increase*, BLOOMBERG BUS. NEWS, Sept. 26, 2006, www.bloomberg.com (quoting Chip Burrus, FBI Assistant Director).

¹³⁶ Crimmins, *supra* note 41, at 1958 (quoting *Kevin v. Ryan*, U.S. Attorney (July 13, 2006), *available at* www.usdoj.gov/usao/can/press).

Independent actions, such as these, by the states lends to the deterrent effect created through strict enforcement of laws relating to backdating violations.

¹³⁷ BINGHAM MCCUTCHEN LLC, *Focus on Backdating*, *supra* note 109, at 2 (for example, on July 21, 2006, the U.S. Attorney in San Francisco filed criminal charges against Brocade Communications Systems, Inc.'s former CEO Gregory Reyes and another executive, while the SEC filed a related civil case against the same defendants plus a former CFO).

¹³⁸ Forelle & Bandler, *Backdating Probe Widens*, *supra* note 24.

To date, criminal charges have only been brought against former executives of two public companies, Brocade Communications Systems, Incorporated and Comverse Technology, Incorporated, for securities fraud stemming from options handling. Although both of these cases are in their preliminary stages, they will be closely followed and scrutinized as they will set the standard for executive liability in illegal backdating cases.

a. Brocade Communications Systems, Incorporated and CEO Gregory Reyes

In the first criminal backdating case,¹³⁹ the U.S. Attorney in San Francisco charged Gregory Reyes, former CEO and Chairman, and Stephanie Jensen, former Vice President of Human Resources, of Brocade Communications Systems, Inc. with willfully violating Exchange Act § 10(b) and Rule 10b-5 through a scheme to backdate stock option grants between 2000 and 2004.¹⁴⁰ It is alleged that Reyes and Jensen were "briefed on the relevant accounting principles, but disregarded them by backdating options without taking the required compensation expenses."¹⁴¹

The DOJ alleges that:

(a) Brocade's board granted Reyes sole authority to grant options, with certain exceptions – making him the board's one person compensation committee; (b) Reyes often waited until the end of a quarter to grant options; (c) Jensen's staff routinely printed out historical stock prices, highlighted the low dates during the quarter, and drafted compensation committee minutes showing option grants; (d) Jensen or her staff gave these materials to Reyes, who routinely signed the meeting minutes and dated them as if the meetings occurred on the highlighted

¹³⁹ In the SEC's companion civil case, the Brocade defendants are charged with securities fraud, falsification of books and records, making false or misleading statements to accountants, filing false and materially misleading statements with the SEC, filing false certifications with the SEC under Sarbanes Oxley, and failing to devise and maintain internal controls. *See generally S.E.C. v. Reyes*, No. C. 06-4435, 2007 WL 528718 (N.D. Cal. Feb. 13, 2007).

¹⁴⁰ *U.S. v. Reyes*, No. 3-06-70450 (N.D. Cal. filed July 20, 2006), Complaint and Supporting Affidavit at www.usdoj.gov/usao/can/press (the charges carry a maximum sentence of 20 years in prison). Suits have also been brought by the SEC (*see S.E.C. v. Reyes*, 2007 WL 528718) and by shareholders (*see In re Comverse Technology, Inc.*, No. 06-CV-1849, 2006 WL 3511375 (E.D.N.Y. Dec. 5, 2006)). Additionally, the company has had to restate its results for fiscal years 1999 – 2004. Specifically, between 1999 and 2001, its income declined by a total of \$304 million; in 2002, its income increased by \$60 million; in 2003, its net loss increased by \$11 million; and in 2004, its net loss increased by \$30 million.

¹⁴¹ Crimmins, *supra* note 41, at 1960.

low dates, and the options were then priced on those dates; and (e) Reyes and Jensen also backdated offer letters and other records for new hires to include them in option grants priced before they were employed and at a time when the stock was relatively low.¹⁴²

Ultimately, the government's case is based on alleged inaccuracies in Brocade's disclosures. In particular, "the cases proceed on the theory that the defendants deliberately understated Brocade's compensation expenses and made material misrepresentations in the corporation's financial statements."¹⁴³ The allegations focus on documents related to stock option grants, and "allege discrepancies between the circumstances in which the documents were created and the information contained in the documents. Based on those alleged discrepancies, the government contends that the company's financial statements, which reflected the content of the documents, were materially false and misleading."¹⁴⁴ Although the complaint suggests that the government's case is based primarily on documentary evidence, it has been suggested "that the government may have one or more whistleblowers, perhaps including current or former employees of Brocade, who are expected to testify that they received backdated option grants."¹⁴⁵

What is unusual about this case is that the U.S. Attorney's complaint does not allege that Reyes personally profited from the activity charged. Reyes backdated options not to enrich himself but to attract talent to his organization. The DOJ therefore indicates there is no need to show personal gain.¹⁴⁶ However, a parallel SEC filing does allege that Reyes "knew that he, and other officers of the Company, similarly received options backdated as of the same dates as the backdated employee options. He was thus motivated to continue the scheme, in part, to

¹⁴² *Id.*

¹⁴³ DEWEY BALLANTINE LLP, *supra* note 13, at 2-3.

¹⁴⁴ *Id.* at 5.

¹⁴⁵ *Id.* at 2-3.

¹⁴⁶ See generally John C. Grugan & Alison Tanchyk Dante, *DOJ and SEC Options Backdating Investigations Net First Indictments*, PRESS ROOM NEWS & PUBL'NS (Ballard Spahr Andrews & Ingersoll, LLP), July 26, 2006, at <http://www.ballardspahr.com/press/article.asp?ID=1485>; DEWEY BALLANTINE LLP, *supra* note 13.

enrich himself and his fellow officers."¹⁴⁷ It should be irrelevant whether or not Reyes personally profited from an illegal backdating scheme. The relevant issue is Reyes' knowledge that what he was doing was wrong and illegal and his continued violations in light of this.

This case is important in setting the precedent for the extent to which executives may be held liable when they have been involved in intentional backdating schemes. Should Reyes receive a harsh penalty it will set the standard for other board members and the likelihood is that a number of bargained plea agreements will result in order to avoid a similar sentence. Should Reyes avoid liability under the DOJ charges, he will still face charges from the SEC and shareholders. Ultimately, it is likely that Reyes will be found liable under both actions.

b. Comverse Technology, Incorporated and CEO Jacob Alexander

In the second criminal backdating case¹⁴⁸ investigated by the DOJ, the U.S. Attorney in Brooklyn charged Jacob "Kobi" Alexander, former CEO and Chairman; David Kreinberg, former CFO; and William Sorin, former General Counsel, of Comverse Technology, Incorporated with willfully violating Exchange Act § 10(b) and Rule 10b-5, and the mail and wire fraud statutes, through a scheme to backdate options, including "every company-wide grant from 1998 through 2001, ... and grants of options to new employees."¹⁴⁹

The DOJ has alleged that:

(a) Alexander and Kreinberg had an assistant insert backdated option grant dates into unanimous written consents transmitted to Compensation Committee members; (b) Sorin received contemporaneous copies of the documents; (c) Defendants backdated options for new employees to days before they actually began working for Comverse; (d) Alexander and Kreinberg issued hundreds of thousands of backdated options to fictitious employees, and after approval of these grants by the compensation Committee, parked them in a

¹⁴⁷ See Complaint, *S.E.C. v. Reyes*, No. C-06-4435.

¹⁴⁸ Suits have also been brought by the SEC (*see* Complaint, *S.E.C. v. Alexander*, (E.D.N.Y. filed Aug. 9, 2006) <http://www.sec.gov/litigation/complaints/2006/comp19796.pdf>) and a class action lawsuit has commenced in the United States District Court for the Southern District of New York on behalf of stockholders (*see In re Comverse Technology, Inc.*, 2006 WL 3511375).

¹⁴⁹ See Complaint, *U.S. v. Alexander*, at <http://www.sec.gov/litigation/complaints/2006/comp19796.pdf>.

"slush fund" to be awarded in Alexander's discretion to favored employees; and (e) Defendants personally exercised options, sold stock and obtained profits of \$138 million for Alexander (\$6.4 million from backdating), \$12.6 million for Kreinberg (nearly \$1 million from backdating), and \$14 million for Sorin (over \$1 million from backdating).¹⁵⁰

One of the options granted by Alexander on October 21, 2001 was analyzed by *The Wall Street Journal* as having odds of occurring of about one in 6 billion (the stock had fallen right before the date of the options grants and then rose immediately afterward).¹⁵¹ Alexander fled to Namibia to avoid prosecution two months after the story ran in 2006. Currently, federal authorities are working to get him extradited from Namibia.

Kreinberg entered a guilty plea on October 24, 2006.¹⁵² He stated to the court that "[he] was asked by the CEO to bring him a printout of the company's trading prices over a past year period to enable him to select the 'as of' date that would be used for the exercise price of the option grant."¹⁵³ Sorin, the former Comverse General Counsel said, in entering his own guilty plea, that he "knew what [the CEO] was doing was wrong and did not challenge his conduct or share my knowledge with the board of directors and auditors of the company."¹⁵⁴

¹⁵⁰ Crimmins, *supra* note 41, at 1960.

¹⁵¹ *Comverse's Former Finance Chief Pleads Guilty*, WALL ST. J., Oct. 25, 2006, at C3 [hereinafter *Chief Pleads Guilty*].

¹⁵² *David Kreinberg, Former CFO of Comverse Technology Inc., Pleads Guilty to Securities Fraud Charges, Separately Resolves Related Case with the Securities and Exchange Commission (U.S. Department of Justice)*, Oct. 24, 2006, <http://www.usdoj.gov/usao/nye/pr/2006/2006Oct24a.htm>

Kreinberg pleaded guilty to one count of conspiracy to commit securities fraud, mail fraud, and wire fraud, and one count of securities fraud. The conspiracy charge carries a maximum sentence of five years' imprisonment and a fine of up to \$250,000, or twice the gain or loss from the offense. The securities fraud charge carries a maximum sentence of ten years' imprisonment and a fine of up to \$1,000,000. The charges also require restitution in an amount to be determined by the Court, estimated at \$51 million. Separately, the Securities and Exchange Commission settled its civil charges against Kreinberg under an agreement that provides for a permanent injunction enjoining him from violating or aiding and abetting violations of the antifraud, reporting, record-keeping, internal-controls, false-statements-to auditors, Sarbanes-Oxley certification, and ownership-reporting provisions of the federal securities laws; a permanent officer-and-director bar; the payment of \$2,394,917.68 in disgorgement and prejudgment interest; and a permanent suspension from appearing or practicing before the Commission as an accountant.

¹⁵³ Crimmins, *supra* note 41, at 1960 (citing *Chief Pleads Guilty*, *supra* note 151, at C3).

¹⁵⁴ *Id.* (citing *A Second Comverse Ex-Executive Pleads Guilty*, WALL ST. J., Nov. 3, 2006, at A3). *See also William F. Sorin, Former General Counsel of Comverse Technology Inc., Pleads Guilty to Securities Fraud Charge (U.S. Department of Justice)*, Nov. 2, 2006, <http://www.usdoj.gov/usao/nye/pr/2006/2006Nov02b.htm> [hereinafter

This second criminal case holds great precedential value. However, because of the delay due to the pending extradition of CEO Alexander, it may not prove to be as instrumental as the *Brocade* case will likely be. I expect that the strict plea agreements that were entered into with Comverse executives, Kreinberg and Sorin, will prove to deter litigation and criminal prosecution in general, opting instead for plea agreements. Unfortunately, these plea agreements will not help deterrence of future corporate frauds as much as the fear of criminal prosecution and the related public shaming do.

3. *The Securities and Exchange Commission*

As previously noted, the DOJ investigations and charges have been accompanied by investigations by the SEC. Where there are criminal charges, the SEC will always file a parallel civil case.¹⁵⁵ However, "the SEC can also file its own fraud charges in federal court civil actions where the Justice Department decides not to pursue a criminal case."¹⁵⁶ The SEC will bring civil fraud charges under the Securities Act § 17(a), the Securities Exchange Act § 10(b) and Rule 10b-5. Generally, these charges require proof of scienter.¹⁵⁷

William F. Sorin] (Sorin "pleaded guilty to a one-count felony information charging conspiracy to commit securities fraud, mail fraud, and wire fraud... [carrying] a maximum sentence of five years' imprisonment and a fine of up to \$250,000, or twice the gain or loss from the offense" and restitution in an amount to be determined by the Court, estimated at up to \$51 million).

¹⁵⁵ Crimmins, *supra* note 41, at 1960 n.40 (The SEC filed parallel civil fraud actions in the *Brocade* and the *Comverse* matters to obtain additional relief available only in civil proceedings. SEC Lit. Rel. 19878 (Oct. 24, 2006)). See e.g. Exchange Act Release No. 19878 (Oct. 24, 2006) (the "SEC filed parallel civil fraud actions in both the *Brocade* and the *Comverse* matters to obtain additional relief available only in civil proceedings. The former Comverse CFO settled the SEC's parallel civil charges by agreeing to a permanent officer and director bar, an additional bar from practice as an accountant before the SEC, payment of disgorgement and interest totaling almost \$2.4 million, and injunctive relief.").

¹⁵⁶ Crimmins, *supra* note 41, at 1960.

¹⁵⁷ *Aaron*, 446 U.S. at 680. See generally Crimmins, *supra* note 41, at 1960 (citing *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044-45 (7th Cir. 1977) (generally defining scienter as "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, ... which presents a danger of misleading buyers or sellers [of securities] that is either known to the defendant or is so obvious that the actor must have been aware of it.")).

The SEC's civil complaint in *Brocade* "provides some indication of the kinds of conduct that may result in a civil fraud action..."¹⁵⁸ The SEC brought charges against former CFO, Antonio Canova, even though he was not named in the criminal case. In charging Canova with a civil fraud violation, the SEC alleged that he understood that what he and the company were doing was illegal yet he continued to both allow it and facilitate it.¹⁵⁹ In cases such as *Brocade* where the SEC does charge fraud, "it can be expected to add the usual variety of related charges traditionally found in SEC financial reporting cases."¹⁶⁰ These charges include the "core Rule 10b-5 charges" as well as knowingly falsifying books and records, knowingly circumventing or failing to implement systems of internal controls (in violation of Securities Exchange Act § 13(b)(5) and Rule 13b2-1); making material misstatements or omissions to accountants, and/or taking actions to mislead or fraudulently influence accountants (in violation of Rule 13b2-2); aiding and abetting their company in filing materially false and misleading annual and quarterly reports (in violation of Securities Exchange Act § 13(a) and Rules 12b-20, 13a-1 and 13a-13); aiding and abetting their company in failing to keep accurate books, records and accounts (in violation of Securities Exchange Act § 13(b)(2)(A)); and aiding and abetting their company in

¹⁵⁸ Crimmins, *supra* note 41, at 1960-61 (citing *S.E.C. v. Reyes*, No. C-06-4435).

¹⁵⁹ *Id.*

(a) was "well-versed in the accounting rules that applied to the accounting for stock options," and discussed the rules with Brocade's outside auditors; (b) saw an email stating that Brocade's option price was "usually the lowest closing price" between meetings granting options, and responded by cautioning against making such statements; (c) heard Brocade's controller express concern about delay between grant dates and delivery of supporting documentation to the finance department, but did nothing to investigate; (d) saw an email stating that a newly-hired executive got an option grant through a process involving "forging option paperwork and offer letters so he could get better priced option," but he again did not investigate or advise the Audit Committee; (e) "helped facilitate the fraud" by telling the finance department to make sure the grant dates in Compensation Committee minutes matched the hiring dates in employee records; and (f) signed annual and quarterly reports and certifications while knowingly or recklessly disregarding that Brocade was failing to record compensation expenses for its backdated option grants.).

¹⁶⁰ Crimmins, *supra* note 41, at 1961.

failing to maintain a sufficient system of internal accounting controls (in violation of Securities Exchange Act § 13(b)(2)(B)).¹⁶¹

The SEC will not likely file non-fraud charges in any less serious backdating situations that arise. The SEC has suggested that they will not be inclined to recommend such cases, and the SEC Enforcement Director commented that "[t]he matters we are pursuing involve blatant and intentional conduct."¹⁶² Further, prior to 2006, there was only one civil case (and no criminal cases) involving stock option grants.¹⁶³ By explicitly stating that lesser cases will not be pursued, executives will be able to continue perpetrating frauds, so long as they are not to the extreme extent as those that are being litigated. This provides no deterrence and allows for a receptive climate for options fraud.

a. SEC investigations

The SEC began examining options backdating in 2005.¹⁶⁴ Investigations began after allegations of improper financial reporting of stock option grants and intentional misconduct relating option grants. It is reported that upwards of 130 investigations are being currently conducted.¹⁶⁵ However, the SEC has been quick to caution that people "should not expect that all of these investigations will result in enforcement proceedings."¹⁶⁶ Further, to date, these

¹⁶¹ *Id.* at 1961 n.45 (the *Comverse* complaint added claims that defendants failed to file Forms 3 and 4, or filed such forms containing false and misleading statements regarding option expiration dates and exercise prices (in violation of Securities Exchange Act § 16(a) and Rule 16a-3)).

¹⁶² *Id.* at 1961 n.44 (citing Thomsen, *supra* note 87).

¹⁶³ Christopher Cox, Chairman, Securities and Exchange Comm'n, Congressional Testimony to Senate Banking Committee (Sept. 6, 2006), at www.sec.gov/news/testimony [hereinafter Cox, Congressional Testimony].

¹⁶⁴ Forelle & Bandler, *Backdating Probe Widens*, *supra* note 24.

¹⁶⁵ WEIL BRIEFING, *supra* note 1, at 1 - 2.

¹⁶⁶ Cox, Congressional Testimony, *supra* note 163. *See e.g.* Thomsen, *supra* note 87 (stating "[w]e do not expect to bring 100 enforcement cases regarding stock options—we are focusing on the worst conduct"). *See also Delaware Chancery Court Finds Backdating and Spring-Loading may Violate Fiduciary Duties*, WOMBLE ALERT (Womble Carlyle Sandridge & Rice PLLC), March 1, 2007, at 3, at <http://www.wcsr.com/resources/pdfs/cs030107.pdf> (the Division of Enforcement has stated that "in evaluating stock option backdating cases, the Division will consider factors such as the egregiousness of the conduct, the number of instances of backdating, the quantitative materiality of unrecorded compensation expense, whether a restatement was necessary, the existence of scienter and evidence of concealment, obstruction or lying").

actions have been brought against officers of companies and not against the companies themselves.

Based on case filings in recent years, the SEC is able to handle approximately 600 cases per year.¹⁶⁷ However, only a "limited portion of this 600-case capacity can be allocated to option backdating matters, as the SEC must stretch its resources over program areas as diverse and demanding as insider trading, market manipulation, other disclosure matters, offering cases and regulation of assorted professionals."¹⁶⁸ This limited capability for violation enforcement will allow options backdating violators to escape liability and, more importantly, limit the deterrent effect that SEC prosecutions would provide.

The second prong of the proposed solution would minimize this problem. By mandating a fixed date grant scheme with mandatory disclosure requirements, options grants would become more transparent. The price of the stock on the date of the grant would be clearly ascertainable and allow for no variations. Violations of the fixed date or reporting requirements would be punished through the imposition automatic fines. This would alleviate the strain on the SEC's resources as penalties would be automatic. The DOJ would also experience these beneficial effects as the loopholes that continue to allow backdating today would be closed, limiting the number of criminal charges brought. The establishment of uniform option grant dates will also deter future violations as organizations will not want to be assessed penalties for violations, significantly assisting the SEC's and DOJ's limited resources.

¹⁶⁷ See *Number of SEC Enforcement Actions Declines for Third Successive Year*, 38 SEC. REG. & L. REP. 1897 (Nov. 13, 2006) (in the 2006 fiscal year (ending Sept. 30, 2006) the SEC brought 574 enforcement actions).

¹⁶⁸ Crimmins, *supra* note 41, at 1958.

b. S.E.C. sample cases

i. S.E.C. v. Kent H. Roberts (McAfee, Incorporated)

The SEC recently charged Kent H. Roberts, the former General Counsel and Corporate Secretary of McAfee, Incorporated, with securities fraud for allegedly wrongfully repricing option grants to himself and others.¹⁶⁹ The SEC alleges that Roberts, secretly and without authorization, changed the date of a grant made to him in order to take advantage of McAfee's then-declining stock price, which increased the value of his option grant by approximately \$197,500.¹⁷⁰ Roberts is said to have concealed this fraud by filing false stock ownership reports with the SEC as well as by failing to properly disclose the illegal repricing and the benefit conferred to him in a proxy statement which he signed.¹⁷¹

Roberts is charged with violating Section 10(b) of the Securities Exchange Act, and Rule 10b-5 thereunder (the antifraud provisions), violating Section 13(b)(5) of the Securities Exchange Act and Rule 13b2-1 thereunder (for circumventing internal controls), and with violating Section 16(a) of the Exchange Act, and Rule 16a-3 thereunder (regarding disclosures of stock ownership by public company officers).¹⁷² Additionally, Roberts is charged with violating, and aiding and abetting in violations by McAfee under Section 14(a) of the Securities Exchange Act and Rules 14a-3 and 14a-9 thereunder (for proxy statement disclosure violations).¹⁷³

The SEC is seeking "injunctive relief, disgorgement, and money penalties against Roberts, in addition to a permanent bar to prohibit Roberts from serving as an officer or director

¹⁶⁹ *SEC v. Roberts*, Civ. A. No. 07-CV-00407 (D.D.C. Feb. 28, 2007) at <http://www.sec.gov/litigation/complaints/2007/comp20020.pdf>.

¹⁷⁰ *See Id.*

¹⁷¹ *See Id.*

¹⁷² *SEC Charges Former General Counsel of McAfee, Inc. for Fraudulently Re-Pricing Option Grants*, Litigation Release No. 20020 (Feb. 28, 2007) at <http://www.sec.gov/litigation/litreleases/2007/lr20020.htm>.

¹⁷³ *Id.*

of a public company."¹⁷⁴ Ideally, the final penalties assessed on Roberts will be high enough to deter both backdating and other potential future corporate frauds.

ii. S.E.C. v. Myron F. Olesnyckyj (Monster Worldwide, Incorporated)

The SEC recently announced the charges against Myron F. Olesnyckyj, the former General Counsel of Monster Worldwide, Incorporated. The SEC charged Olesnyckyj with securities fraud for allegedly participating in a multi-year scheme to secretly backdate stock options granted to thousands of Monster officers, directors and employees.¹⁷⁵

The SEC alleges that, from 1997 through 2003, Olesnyckyj backdated stock options grants to coincide with the dates of low closing prices for Monster's stock, resulting in grants of in the money options to numerous individuals.¹⁷⁶ It is alleged that this occurred by allowing certain officers and employees to select a closing stock price at which they wanted their stock options granted. Olesnyckyj then prepared, or directed others to prepare, backdated documentation for the company's Compensation Committee containing the manipulated grant date reflecting the low stock price. Olesnyckyj then caused Monster to illegally misrepresent in its periodic filings and proxy statements that all stock options were granted at the fair market value on the date of the award.¹⁷⁷

The SEC estimates that in backdating options, "Monster granted undisclosed compensation to its employees, failed to recognize compensation expenses, and overstated its net income by \$340 million from 1997 through 2005."¹⁷⁸ Olesnyckyj is charged with violating the antifraud provisions of the federal securities laws (Section 10(b) of the Securities Exchange Act,

¹⁷⁴ *Id.* See also See Complaint, *SEC v. Roberts*, No. 07-CV-00407.

¹⁷⁵ *S.E.C. v. Olesnyckyj*, Civ. A. No. 07 CV 1176 (S.D.N.Y. Feb. 15, 2007).

¹⁷⁶ See Complaint, *S.E.C. v. Olesnyckyj*, Civ. A. No. 07 CV 1176, at <http://www.sec.gov/litigation/complaints/2007/comp20004.pdf>.

¹⁷⁷ *SEC Charges Former General Counsel of Monster Worldwide, Inc. for Role in Options Backdating Scheme*, Litigation Release No. 20004 (Feb. 15, 2007) at <http://www.sec.gov/litigation/litreleases/2007/lr20004.htm> [hereinafter *Monster Worldwide Litigation Release*].

¹⁷⁸ *Id.*

and Rule 10b-5) and with violating or aiding and abetting the violation of Monster's reporting requirements (in contravention of Section 14(a) of the Securities Exchange Act and Rules 14a-3 and 14a-9).¹⁷⁹

The SEC is seeking "permanent injunctive relief, disgorgement of ill-gotten gains, civil monetary penalties, and an officer and director bar."¹⁸⁰ The fact that Olesnyckyj was an attorney who committed these frauds is particularly reprehensible as he violated both his duty to the organization and the ethical duties of his profession. Because of this, the legal community must take note of his punishment and not only limit their own bad acts but make efforts to actively dissuade their clients and colleagues from engaging in similar frauds.

iii. S.E.C. v. Landmann & Gerhardt (Engineered Support Systems, Incorporated)

The SEC has also recently filed charges against Gary C. Gerhardt, former Chief Financial Officer, and Steven J. Landmann, former Controller, of Engineered Support Systems, Incorporated. The SEC alleged that Gerhardt and Landmann "participated in a six-year fraudulent options backdating scheme in which they granted undisclosed, in the money stock options to themselves and to other Engineered Support officers, employees, and directors."¹⁸¹

The SEC alleged that Engineered Support employees and directors received approximately \$20 million in unauthorized compensation as a result of the illegal backdating.¹⁸²

¹⁷⁹ Complaint, *Olesnyckyj*, Civ. A. No. 07 CV 1176.

¹⁸⁰ Monster Worldwide Litigation Release, *supra* note 177. See also Complaint, *Olesnyckyj*, Civ. A. No. 07 CV 1176.

¹⁸¹ SEC Files Actions Against Former CFO and Former Controller of Engineered Support Systems, Inc. Relating to Options Backdating Scheme; Former Controller Consents to Permanent Injunction, Officer-and-Director Bar, and Payment of \$886,557, Litigation Release No. 19990 (Feb. 6, 2007) at <http://www.sec.gov/litigation/litreleases/2007/lr19990.htm> [hereinafter Engineered Support Systems Litigation Release]. See, e.g., *S.E.C. v. Landmann*, Civ. A. No. 4:07-CV-270 (E.D. Mo. Feb. 6, 2007); Complaint, *S.E.C. v. Gerhardt*, Civ. A. No. 4:07-CV-271 (E.D. Mo. Feb. 6, 2007).

¹⁸² Complaint, *S.E.C. v. Landmann*, Civ. A. No. 4:07-CV-270 (E.D. Mo. Feb. 6, 2007), at <http://www.sec.gov/litigation/complaints/2007/comp19990sjl.pdf>; Complaint, *S.E.C. v. Gerhardt*, Civ. A. No. 4:07-CV-271 (E.D. Mo. Feb. 6, 2007), at <http://www.sec.gov/litigation/complaints/2007/comp19990gcg.pdf>.

From 1997 through 2002, Gerhardt is said to have ordered Landmann to backdate the company's option grants to "coincide with historically low closing prices of Engineered Support's common stock."¹⁸³ Further, it is alleged that these two caused the company to misrepresent in its financial and proxy statements filed with the SEC that all of the stock options had been granted at the fair market value of the stock on the date of the award.¹⁸⁴

Gerhardt is charged with violating Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(b)(5), and 14(a) of the Securities Exchange Act, and Rules 10b-5, 13a-14, 13b2-1, 13b2-2, and 14a-9 thereunder, and with aiding and abetting violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Securities Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder.¹⁸⁵ The SEC is seeking a "permanent injunction, disgorgement of ill-gotten gains, including prejudgment interest, civil penalties, and a bar from serving as an officer or director of any public company."¹⁸⁶

Unlike Gerhardt, Landmann has already "consented to a permanent injunction from violating and/or aiding and abetting violations of the antifraud, proxy statement, reporting, record-keeping, and the false statements to auditors' provisions of the federal securities laws."¹⁸⁷ Additionally, Landmann will pay disgorgement of \$518,972, prejudgment interest of \$108,099, and a civil penalty of \$259,486, will be permanently barred from serving as an officer or director

¹⁸³ Engineered Support Systems Litigation Release, *supra* note 181 (in addition, the complaints allege that Gerhardt ordered Landmann to cancel previously issued options that had fallen out of the money and to reissue them with new backdated grant dates and exercise prices, to bring them back in the money).

¹⁸⁴ *Id.*

¹⁸⁵ Complaint, *Gerhardt*, Civ. A. No. 4:07-CV-271.

¹⁸⁶ Engineered Support Systems Litigation Release, *supra* note 181.

¹⁸⁷ *Id.* ("Specifically, Landmann has consented to be enjoined from violating Section 17(a) of the Securities Act, Sections 10(b), 13(b)(5), and 14(a) of the Exchange Act, and Rules 10b-5, 13b2-1, 13b2-2, and 14a-9 thereunder, and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder.").

of a public company, and will be permanently suspended from appearing or practicing before the Commission as an accountant.¹⁸⁸

It is likely that Landmann's agreement will serve as a strong precedent in settling cases out of court. It is especially notable that Landmann's penalty will be paid by him personally, as opposed to the organization. Additionally, Landmann will suffer as he can no longer work in his chosen profession. The imposition of these personal monetary penalties and bar as an accountant are significant enough to deter many professionals from pursuing corporate frauds in the future.

It is likely that most, if not all, of the cases that the SEC is bringing will settle before court in order to limit potential judgments as well as the possibility of being made an "example" for other offenders. However, without fully litigating such an action, the deterrent effects that the SEC should hope to obtain are limited.

4. Other Consequences

The focus of litigation to date has generally been on the executive sponsoring, issuing, and benefiting from the allegedly offending options. Other groups that should be held accountable are the attorneys and auditors who were consulted about the structure and disclosure of the illegal options programs.

a. Attorney liability

It is unclear why attorneys have escaped much of the scrutiny up to this point. Some avoidance of responsibility may be due to the limited grounds on which attorneys may be held liable as aiders and abettors. This is not to say that attorneys have not been held responsible in some situations. Many organizations have required the resignation of general counsel.¹⁸⁹

¹⁸⁸ *Id.* (the settlement is subject to approval by the United States District Court for the Eastern District of Missouri).

¹⁸⁹ Allen & Mishra, *supra* note 74, at 5. *E.g.*, Barasch et al., *supra* note 2 (McAfee fired its general counsel after its investigation into option timing).

However, attorneys should be held accountable for illegal options backdating in many additional instances.

Attorneys should be liable for faulty advice that leads to, or allows the continuation of, illegal options backdating. "It is the failure adequately to disclose, properly account for, and pay taxes as a result of such programs that can transform a permissible method of compensation into a violation of law."¹⁹⁰ Further, "[c]orporate counsel have a special role to fill in ensuring the integrity of U.S. financial markets ... [w]hen they fail in that role, they not only do a disservice to their companies' shareholders, they fail as members of the bar."¹⁹¹

Attorneys often play an integral role in the development and implementation of a company's stock option plan as these require "detailed analysis of corporate legal structure, securities law considerations, employee benefits concerns, executive compensation issues, complex tax rules and disclosure obligations."¹⁹² Attorneys should be held both criminally liable (for their part in the falsification of books, records, and reports) and civilly liable (for their breach of duties, misstatements, and falsification of records and reports) where they have assisted with, or had knowledge of, illegal backdating in circumstances such as failure to make accurate or adequate disclosures and inaccurate stock option grant dating procedures.

It is likely that attorneys will be blamed by those who are facing litigation in connection with illegal options backdating. A charged executive will likely defend himself by "explaining that their intent was to provide a lawful compensation mechanism to reward and incentivize their managers for superior performance in the best interests of the company and its shareholders" and

¹⁹⁰ *Attorney and Auditor Potential Liability for Options Backdating*. MCDERMOTT NEWSLETTERS (McDermott, Will & Emery), Aug. 11, 2006, at http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/ab10cb18-72f2-44ae-a5ce-24e86002a1e0.cfm.

¹⁹¹ William F. Sorin, *supra* note 154.

¹⁹² MCDERMOTT, WILL & EMERY, *supra* note 190.

that any illegalities were due to the attorney's inadequate implementation of such a plan.¹⁹³ It should be expected that the SEC and DOJ will bring more causes of action against attorneys for both criminal and civil liability. Additionally, private litigants' (such as shareholders) will bring claims against these professionals for negligence or intentionally wrongful conduct.

Overall, attorneys involved in illegal options backdating should expect to face charges. It is imperative that all illegal options practices stop and holding general counsel liable will lend to the deterrent effect.

b. Auditor liability

Auditors, like attorneys, have escaped much of the initial spotlight in illegal options backdating. However, auditors should be held both criminally and civilly liable for allowing or participating in the illegal acts. A company's auditor often provides advice concerning issuance of stock options and related tax ramifications, and reviews the financial statements. If any of the auditor's advice leads to the creation or perpetuation of an illegal of stock option plan then the auditor should be held accountable.

The Public Company Accounting Oversight Board has stated that auditors should be aware that "[q]uantitatively small misstatements may be material when they relate to unlawful acts,' and that under certain circumstances, such unlawful acts may trigger auditors' obligations under Securities Exchange Act § 10A to report 'illegal acts' to the SEC."¹⁹⁴ Ultimately, auditors should be held accountable for their falsification of financial statements as well as for when they allow executives to continue with illegal options backdating practices.

¹⁹³ *Id.*

¹⁹⁴ Crimmins, *supra* note 41, at 1957 n.10 (quoting *Matters Related to Timing and Accounting for Option Grants*, PCAOB STAFF AUDIT PRACTICE ALERT No. 1 (Public Company Accounting Oversight Board, July 28, 2006), at http://www.pcaobus.org/News_and_Events/News/2006/07-28_Release.pdf).

5. Analysis of the various penalties

In order to create the reform that the practice of options backdating requires, under the first prong of the proposed solution blame must be assessed on everyone who participates in the illegality. If some members of an organization are able to escape liability, the deterrent effect is reduced.

In addition to the necessity of holding everyone who participates in illegal options backdating accountable, it is necessary that these violators are punished to the full extent of the law. These people have violated numerous laws, often at the expense of the shareholder who loses value in the stock of the corporation as it declines after restating financials and announcements of backdating.

Only when the DOJ, SEC, the states, and even shareholders force responsibility through litigation will the illegalities cease. At this stage, both the DOJ and the SEC need to make examples out of the cases that they have pending. Instead of entering lesser charges in plea bargaining, these cases should be brought to trial. The publicity that surrounds such would hold essential deterrent effects in and of itself. Reform is often required after the public becomes aware of the inequities occurring in corporations. Further, harsh criminal and civil penalties that are public record will serve to deter individual misconduct in the future.

Ultimately, it is the criminal penalties that hold the most potential for punishment, and, therefore, will prove to be the most essential catalyst for change. The DOJ and the SEC have limited resources that are available to pursue options backdating cases. Because of this, numerous violators are "going free." This is unacceptable. Resources must be allocated to punish this injustice. It is only once people fear the penalties that they will curb their actions.

The SEC is attempting to punish and deter. It has over 100 open investigations, and any number of these will probably result in criminal and civil case filings soon. As new charges are brought, the government should punish all violations, large and small. In those cases where the individual did not knowingly violate the law or deceptively cover up their activities, where individuals lacked an understanding of the accounting and tax rules involved in option grants, where they relied on professionals to alert them to potential compliance issues, and where problems stemmed from inadequate formalities in options practices, charges must still be pursued, although the penalties may be lesser. Perhaps a standard fine structure could be implemented to punish these "small" violations efficiently. This would both promote the justice and efficiency that the SEC and the DOJ require.

Shareholder derivative suits play an essential role in the deterrent effect of illegal practices. The shareholders of many corporations have lost significant value in their stock due to illegal backdating practices. By forcing those who unjustly encouraged, enacted and profited from these acts to repay the organization, not only do the shareholders and the corporation itself benefit, but the market as a whole benefits. Trust and stability is restored to the market when the investing public feels as though injustices acted upon the organizations in which they invest will not be tolerated.

At this initial stage of enforcement against illegal options backdating the justice system is not doing enough to create a deterrent effect. In order to create the reform that the practice of options backdating requires, blame must be assessed on everyone who participated in the illegality. If some members of an organization are able to escape liability, the deterrent effect is reduced. Although top executives are the only ones being held liable at this stage, accountability should be extended to company attorneys and auditors, compensation committees, boards of

directors, and, perhaps, the company itself. Further, all avenues of liability should be pursued, both civil and criminal charges should be brought by the DOJ and SEC, and shareholders must continue to hold violators accountable.

III. OPTIONS BACKDATING TODAY AND IN THE FUTURE

The present causes of action that are available may not be enough to stop future backdating violations nor to stop other corporate frauds. They are not a sufficient deterrent against future illegal acts. Under the first prong of the proposed solution, the SEC and DOJ must bring charges against everyone who participated and promoted illegal options backdating, not just the company's top executives. Additionally, shareholders must hold their organizations liable. Attorneys, auditors, compensation committees and entire boards, where appropriate, should be charged. At this initial stage it may be most effective to include the entity itself in any litigation.¹⁹⁵ By assessing blame on all of those who were involved, directors and other officials will stop "rubberstamping" proposals and instead begin to be more actively involved in the organization and the matters at hand. We must hold these people accountable in order to deter them in the future.

Under the second prong of the proposed two-part solution, uniform option grant requirements must be established. This second prong requires the creation of a uniform scheme for option granting going forward. Organizations would be required to set options grants and related reporting to occur on the same date each year. Such a requirement would make options grants more transparent. In creating such a scheme, enforcement agencies and the public are able to more effectively monitor the grant process for potential illegalities. This ability to

¹⁹⁵ This might be an inappropriate remedy as shareholders who did not profit from many illegal grants would be forced to accept decreased share value as the company fights the litigation and pays any damages. However, in situations where the company did not accurately account for options, to the benefit of the company (and thus the shareholder's value in the company) litigation against the organization may be appropriate.

monitor the process will leave minimal room for violations to go unnoticed. Additionally, by streamlining the option grant process, automatic penalties would be feasible, making punishment easier and more efficient, adding to the deterrent effect.

This two-prong solution of deterrence and effective regulations creates a system where potential violators have a limited opportunity to violate the law and where they fear the potential consequences of any possible violations.

A. The Two-Part Solution

1. *The crackdown must continue*

Lie and Heron's study estimated that 23% of unscheduled, at the money options grants to top executives between 1996 and August 2002 were backdated or otherwise manipulated.¹⁹⁶

"This fraction was roughly halved as a result of the new two day reporting requirement that took effect in August 2002."¹⁹⁷ However, illegal backdating practices continue.

Many companies avoid obligations and file grant reports late. In these late reports the "prevalence of backdating is roughly the same as before August 2002."¹⁹⁸ This study illustrates the need to continue regulations and to continue to hold organizations and individuals liable for illegal backdating. The practice of filing grant reports late is unacceptable. Significant fines should be imposed to deter organizations from late reports.¹⁹⁹ Until all possible avenues are closed that enable a company to participate in illegal backdating, justice is not being served. This is a simple and efficient way to promote trust in the marketplace.

¹⁹⁶ Randall A. Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?* (Nov. 1, 2006) (unpublished paper), available at <http://www.biz.uiowa.edu/faculty/erie/Grants%2011-01-2006.pdf> [hereinafter Heron & Lie, *Fraction of Stock Option Grants*].

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* ("the fraction of grants that are filed late is estimated to be approximately 13%").

¹⁹⁹ Obviously, fines should be great enough that a company is dissuaded from engaging in any illegal activity. The fine must be larger than any gains the company may receive from deceptive accounting and reporting.

Under the first prong of the proposed solution charges must be assessed against everyone who participated in illegal options backdating. By assessing blame on all of those who were involved, directors and other officials will fear consequences and more actively avoid potential corporate frauds. We must hold these people accountable in order to deter them in the future.

While stock option backdating is a practice in which (generally) companies no longer engage, the restatement and investigation process and the pending civil and criminal charges will, and must, continue. Additionally, the media frenzy surrounding illegal backdating currently assists in the public shaming of involved organizations and officials. The threat of a tarnished reputation for the company and its executives may alone serve as one of the most effective deterrents and prompt further reform.

2. Structural Changes

The second portion of the proposed solution seeks to alleviate the strain on the resources of the SEC and DOJ. This prong would require companies to adopt a fixed date for all option grants and related disclosures. This date would be the same from year to year, allowing for regulators and the investing public to promptly recognize violations. This creates a transparent option granting system where no leeway is left for backdating; the price of the stock on the date of the grant would be clearly ascertainable.

Under this proposal, executives who are awarded options will receive a promise to grant such options on the fixed grant date. Any loss in value to the employee that occurs due to the wait can be provided in the form of a cash bonus. This fixed date will allow an organization to obtain the requisite approvals and finalize administrative work in advance, eliminating the inadvertent delays that were one of the alleged causes of past violations. Setting a fixed date will prevent the significant costs and penalties associated with later discoveries of inadvertent tax

and/or accounting violations from inaccurate reports. There will be no need for restatements. Additionally, there will be no question as to whether an organization allows for backdating as such will be uniformly prohibited.

The requirement for a fixed option grant date could be implemented in a number of different ways. The SEC should create disclosure requirements that a uniform date be set and disclosed. The tax code should be amended to require that a fixed date be set in order to receive the performance-based incentives that are afforded to option grants. The stock exchanges can require a fixed date in order to be listed on the index. State legislatures can amend state corporate laws to reflect this requirement. Similarly, shareholders should petition the legislatures to enact these requirements and petition the organizations themselves to amend the bylaws and articles of incorporation to reflect a fixed option date requirement.

Violations of the fixed date or reporting requirements would be punished through the imposition automatic fines. This would alleviate the strain on the SEC's resources as penalties would be automatic. The DOJ would also experience these benefits as the potential to violate options grant procedures would be restricted, limiting the number of criminal charges that would need to be brought. The establishment of uniform option grant dates will also deter future violations as organizations will not want to be assessed penalties for violations, significantly assisting the SEC's and DOJ's limited resources.

3. Regulatory Controls

Additional regulatory controls already in effect attempt to deter illegal backdating. Unfortunately, the SEC has attempted to take the focus off of the violators by publicly stating that the SEC believes that option misconduct is not likely to be a significant problem going

forward. By devaluing the enormity of this problem, violations will continue and litigation will be less likely to occur to limit such illegal acts.

SEC Chairman Cox stated that the changes that have taken place since the enactment of Sarbanes-Oxley have "effectively slammed the door shut on . . . secretive option grants,' and that 'almost all of the stock option abuses . . . started in periods prior to these reforms.'"²⁰⁰

Additionally, changes in NYSE and NASDAQ listing standards in 2003 requiring shareholder approval of equity compensation plans and the issuance, on July 26, 2006, of SEC compensation rules that require fuller disclosure of options grants have been said to have assisted in the "elimination" illegal options backdating. As previously mentioned, these standards could be further amended to reflect the second part of the proposed solution, a fixed option grant date requirement. Although these procedures and rules do assist in the decline of illegal options backdating, the practice continues. Public statements that minimize the issue hurt the reform process. If people believe that there is no problem, they stop looking for such. This is exactly how so many options grants went unnoticed initially. We are not doing enough when we publicly minimize the problem.

a. SEC regulations and reforms

The SEC has attempted to effectuate controls to limit an organization's ability to engage in illegal options backdating. The SEC recently released new executive compensation disclosure rules that "seek to make option grant practices transparent, and single out for explanation practices such as making grants immediately before a positive announcement, or immediately

²⁰⁰ Crimmins, *supra* note 41, at 1962 (quoting Cox, Congressional Testimony, *supra* note 163). These comments are ironic considering the public outcry relating to option backdating. Cox also stated in this testimony that in the 72 years of the Commission's history no issue has generated as much interest.

after a negative one."²⁰¹ The new rules "require companies, in their compensation discussion and analysis (CD&A), to discuss practices regarding the timing and pricing of stock option grants, including practices of selecting option grant dates for executive officers in coordination with the release of material, nonpublic information; the timing of option grants to executive officers in relation to option grants to employees generally; the role of the compensation committee and the executive officers in determining the timing of option grants; and the formula used to set the exercise price of an option grant."²⁰²

The SEC's rules are a strong attempt at reform of the entire options granting practice. The new rules better assist others in identifying when options are not at the money grants. However, the SEC did not formally address the accounting for options where backdating is involved. As noted, the second prong of the proposed solution would solidify accounting and reporting procedures by setting a fixed date for options to be granted (therefore limiting the possible accounting ambiguities that exist when a date must be "selected"). These regulations do assist in the creation of a system that requires accountability, thus limiting the desire to violate the law. A fixed grant date would further these aims. By forcing disclosure in periodic reports and proxy statements an organization is inhibited from hiding illegal practices. Further, if they do not report required information, liability will be imposed. The clearer the standards, the less "wiggle room" organizations will have to violate the law. The SEC must clearly set forth what acceptable practices are and then punish those who deviate from them.

Additionally, the SEC has imposed substantial civil penalty payments on organizations that have been found to have engaged in illegal options backdating. These civil penalties have a

²⁰¹ Brower et al., *supra* note 83, at 1. See Press Release, Securities and Exchange Comm'n, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006) at <http://www.sec.gov/news/press/2006/2006-123.htm>.

²⁰² JONES DAY, *supra* note 90, at 2.

substantial and significant deterrent effect, effectuating the first prong of the proposed two-part solution. The imposition of fines is one of the top deterrents available and should be used more rigorously against violators. The SEC and Mercury Interactive Corporation recently settled a backdating violation for a \$35 million fine.²⁰³ It is this kind of significant penalty that serves as a deterrent. Organizations that consider engaging in illegal practices will be deterred by multi-million dollar penalties imposed on other organizations. This effect extends beyond the options grant practice. It allows for a sense of fear to be instilled in a corporation for there is proof that large penalties will be imposed. Although there is no way to determine whether Mercury's fine will be considered a benchmark in backdating cases, it is still very significant and will likely be considered in future settlements.

Unfortunately, concern that fines imposed on organizations will ultimately come out of the pockets of the company's shareholders has limited the SEC's desire to hold the company itself liable. As previously noted, so long as fines are imposed on organizations that have been unjustly enriched by their violations of reporting, accounting and tax violations then the shareholders are not unjustly punished. Instead, the organization is forced to pay for ill-gotten gains. The potential for decreased stock value simply reflects the opposite of any increases that may have been caused by the illegality. The bad publicity and shareholder distaste for such organizations will serve as a very significant deterrence to illegal activities in the future. It is for this reason that organizations should be held directly accountable by the SEC.

b. PCAOB

Another agency that is currently attempting to limit the possibility of illegal options granting is the Public Company Accounting Oversight Board (PCAOB). In July 2006, the PCAOB "issued guidance requiring auditors to review more carefully company option grant

²⁰³ Crimmins, *supra* note 41, at 1958 (citing Mercury Interactive Corp., Form 10-K., filed Oct. 5, 2006, p. 33-34).

practices."²⁰⁴ This requirement "will substantially increase the scrutiny of option granting practices...."²⁰⁵ By identifying that a problem exists and defining the standards that auditors are to use in their handling of such issues the PCAOB has reformed options granting practices by limiting potential ways in which violations could go unnoticed or undocumented or when company procedures are inadequate or inappropriate. Additionally, by implementing the proposed fixed date requirement, accountants will be further shielded from potential violations. The stricter requirements for auditors serve as deterrence both for auditors who do not want to be held liable for an organization's violations as well as for companies themselves as they will be less likely to violate laws when others will be double-checking their procedures and actions.

4. Internal company controls

The prevention and correction of illegal option granting cannot be left exclusively to the government. There are a number of things that an organization should implement in order to avoid illegal activities. By encouraging organizations to hold themselves and their boards, executives, attorneys, and auditors accountable, faith in the organization (and the market) is revived.

Companies should take steps to enact certain procedural safeguards to ensure, not only that there will be no illegal backdating, but that there will be no appearance of impropriety either. Under the proposed solution, companies should grant options on the same date each year, regardless of whether or not such is required by law. They should set strict guidelines as to how the exercise price will be determined on this date, modify the terms of the company's

²⁰⁴ WEIL BRIEFING, *supra* note 1, at 2. See *Matters Relating to the Timing and Accounting for Option Grants*, STAFF AUDIT PRACTICE ALERT NO. 1 (PCAOB, July 28, 2006), available at http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2006/07-28_APA_1.pdf. See generally *SEC and PCAOB Provide Guidance on Disclosure, Timing and Accounting for Stock Option Grants*, CLIENT ALERT (Akerman Senterfitt), Aug. 2, 2006, at http://www.akerman.com/documents/Client%20Alert_Stock%20Option%20Grants_8_06.pdf.

²⁰⁵ BLANK ROME LLP, *supra* note 27.

compensation plan to state that backdating is not acceptable, require shareholder approval of the company compensation plan, limit the ability of the compensation committee to change grant practices and dates, require strict compliance with accounting and tax guidelines and recommendations, assure the independence of the compensation committee, and require proper and detailed documentation of all grants.

By enacting internal controls, individuals within the organization will be unable to break the law and subject the organization to potential liability. Further, investor relations will be strengthened as there will be no fear of undisclosed compensation or future liability.

5. Executives illegalities continue

The fact that some executives continue to violate options backdating rules and regulations is proof that we are not doing enough. We must enact and enforce strong deterrents and regulations that eliminate illegal backdating. Until organizations and executives fear the consequences of misconduct, they will continue to seek easy gains by breaking the rules.

Not only are individuals continuing to illegally backdate option grants, as mentioned above, but they are relying on alternative deceptive practices to line their pockets. Bullet dodging and spring loading options are becoming more apparent. By awarding options after the release of negative information that causes the company's stock to decline in value or before the release of good news that is expected to increase the company's stock value, a director violates his fiduciary duty to the company. These actions are becoming more prevalent because there are no deterrents against them. The SEC has suggested that it will limit itself to cases where options were backdated and will not pursue spring loading and bullet dodging cases.²⁰⁶ Statements such as this have the effect of authorizing the deceptive and potentially illegal practices that they do not punish. By setting a fixed grant date, these "alternative" deceptive grant practices would also

²⁰⁶ Atkins, *supra* note 41.

be eliminated. This secondary effect of eliminating corporate frauds in addition to illegal backdating makes the second prong of the proposed solution so important.

It is imperative that we punish all misconduct relating to options grants to the full extent of the law. These questionable stock option grant practices harm the shareholder, the company, and the markets. Until officials and organizations fear punishment these acts will continue.

B. Implications for the Future

The question that is raised at this initial stage in the investigations and publicity relating to illegal options backdating is "what now"? The illegal conduct has rocked corporate America and significantly decreased recognized profits at a number of top organizations. The public outcry has been strong. This deceptive conduct will not be tolerated. Unfortunately, due to the novelty of the situation, the difficulty and expense in discovering violations, the limited resources available for enforcement and prosecution of violations, and the time delay in enforcement actions that are currently before the courts, the deterrent effect that is necessary to prevent future misconduct is limited. This is why a fixed grant date must be required. Not until the mechanisms to prevent illegal grant practices are established will the illegal acts stop.

As the investigations continue and publicity soars, the SEC, DOJ, the media, and the investing community will certainly uncover many more violations. As more violations are uncovered we will be able to learn exactly how organizations perpetrated this fraud and, therefore, become more able to recognizing similar misconduct. Additionally, as stricter rules and regulations are promulgated in response to the illegalities (such as uniform option grant date requirements) there will be less room for questionable practices by organizations and their executives. Additionally, as the prosecutions continue and increase in number, as well as the publicity involved in such high-profile cases, the deterrent effects will become apparent. Fewer

individuals will risk severe punishment and high civil fines and organizations themselves will not tolerate such.

Unfortunately, it is unlikely that we will "catch" all the violators due to the cost of investigation and the difficulty in identifying illegal acts (as well as the extreme difficulty in proving some of these violations).²⁰⁷ Those violators that are caught must be prosecuted and precedent set. A signal must be sent that similar behavior will be punished severely. Companies must do their part by enacting measures, regardless of required regulation, and tightening requirements to protect themselves from liability and to prevent executives and directors from being able to violate the law. Investors must demand disclosure, shareholder approved options plans, and fixed option grant dates. The SEC, DOJ and other law enforcement agencies must allocate the additional resources that are required to enforce improved disclosure practices for options grants and to enact and enforce laws and regulations.

CONCLUSION

Most people would agree that illegal option grant practices should not be tolerated. With the severe consequences to the organizations themselves, their shareholders, and the market as a whole, the past violations must be punished and future violations prevented. As the government, investors and the organizations themselves demand accuracy and disclosure.

The proposed two-prong solution limits the future implications of options backdating and similar illegalities. The first prong requires the forceful pursuit of punishment of violations in order to create a strong deterrent effect. At this initial stage of the investigations into illegal options backdating the justice system is not doing enough to stop these corporate frauds. In order to create the reform that the practice of options backdating requires, blame must be

²⁰⁷ Additionally, many companies are utilizing a 30-day look-back period. Often the price on the grant date is not the lowest for the period, lending to difficulty in proving illegal backdating by concealing intent. *See generally* Lie, *Backdating of ESO Grants*, *supra* note 11.

assessed on everyone who participated in the illegal acts and uniform grant date requirements must be enacted. If some members of an organization are able to escape liability, the deterrent effect is reduced. Although top executives are the only ones being held liable at this stage, accountability should be extended to company attorneys and auditors, compensation committees, boards of directors, and, perhaps, the company itself.

The second prong creates a uniform scheme for option granting going forward. By requiring organizations to set options grants to occur on the same date each year, enforcement agencies and the public are able to more effectively monitor the grant process for potential illegalities. This ability to monitor the process will ensure that violations such as this do not occur in the future. Additionally, by streamlining the process, automatic penalties would be feasible, making punishment easier and more efficient, adding to the deterrent effect. This two-prong solution of deterrence and effective regulations will create a system where potential violators have limited opportunity to violate the law and where they fear the potential consequences of any possible violations.

In order to put an end to this practice the DOJ, SEC, and shareholders must continue to pursue charges against violators. Precedent must be set and efficient regulations enacted that truly work as deterrents. The more severe the charges and the higher the potential fines, the less likely executives and organizations will continue illegal option grant practices. The more difficult it is for an individual to violate the law, the less frequently it will occur. The proposed two-prong solution will substantially assist in putting an end to illegal backdating.