



# D&O Newsletter

## THE STOCK OPTION BACKDATING SCANDAL

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DIRECTORS & OFFICERS

The stock option backdating scandal, which emerged during the spring of 2006 following an article in The Wall Street Journal, has expanded to encompass investigations into the stock option issuance practices of approximately 160 companies and the restatement of over \$5 billion in profits. These companies, largely centered in the technology and health care industries, face regulatory scrutiny from the Securities and Exchange Commission ("SEC") and the Department of Justice ("DOJ"), as well as civil lawsuits brought derivatively and, to a lesser extent, as shareholder class action lawsuits. To date, over twenty companies have restated their financial results and over eighty companies face derivative and securities class action lawsuits against the company and/or its directors and officers arising out of backdating. While the scandal has caused approximately 60 directors or officers to resign, or to be fired, as of December 2006, criminal indictments have only been brought against five executives at two companies, Brocade Communications ("Brocade") and Comverse Technologies, Inc. ("Comverse").

Professor Erik Lie of the University of Iowa published a paper in 2005 analyzing stock performance and determined that the odds that stock option grants were actually made on the dates claimed were so miniscule that at least some of the options issued must have been backdated. Thereafter, the stock option backdating scandal ignited when The Wall Street Journal published its *The Perfect Payday* article on March 18, 2006, scrutinizing the stock option grants made by UnitedHealth, Comverse, Vitesse Semiconductor, Affiliated Computer Services, Brooks Automation and Jabil Circuit. The Wall Street Journal reported that the chance that stock option awards made by Affiliated Computer Services to its former CEO were randomly issued at time periods when the company's stock was trading near period lows over the course of six years was one in 300 billion. Similarly, the article reported that the chance that the former CEO of Comverse Technologies Inc. received his options at trading lows by chance was approximately 1 in 6 billion.

While corporate boards and their compensation committees are generally responsible for issuing stock options, executives frequently maintain control over the timing of such offerings. UnitedHealth reported that as a result of its option grant-date practices, it may need to restate three years of financial results, wiping away \$286 million in net income. Comverse disclosed that it would restate more than five years of financial results, while Vitesse Semiconductor placed its CEO on leave and disclosed that it may need to restate three years of financial results.

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### Stock Option Improprieties

While stock options are typically issued with an exercise price (the price the option may be purchased from the company) at the closing share price on the date that the option is granted, improper timing of options can occur by (1) backdating options to an earlier grant date, enabling the company to set a lower exercise price for the stock option such that it is already “in-the-money” when issued and (2) spring-loading the stock option by issuing the option shortly before the release of positive news or during a temporary price decline based on material insider information. Prior to the enactment of the Sarbanes-Oxley Act of 2002 (“SOX”), companies were not required to report stock option grants until 45 days after the end of the fiscal year in which they were granted. These lax reporting requirements gave companies significant leeway to time option grant dates to periods when the stock price traded at historically low levels. After the enactment of SOX, companies are now required to file Form 4 reports within two business days following a stock option grant, significantly limiting the opportunity to engage in classic backdating of stock options.

### Legal Issues Arising out of Stock Option Backdating

While backdating options is not itself illegal, companies that issue stock options with exercise prices that are below-market value must maintain and disseminate accurate grant records while treating the options as discounted for financial accounting and tax purposes. Companies that engaged in backdating rarely accounted for the stock options as discounted and now face accounting, plan compliance, securities law and tax implications. Unlike qualified incentive stock options, discounted stock option grants are generally not considered to be performance-based compensation, and the options do not qualify for certain tax deductions. As such, companies that issued backdated “in-the-money” stock options face losing tax deductions for compensation paid to senior executives, along with tax penalties. Companies may be required to restate their financial results to take into account lost deductions and to recognize the cost of issuing discounted options to the company.

Misrepresenting option grant dates may violate shareholder-approved stock option plans and applicable securities laws, and companies must determine whether proper internal controls are in place, as required by SOX, to prevent future option plan violations. Companies may face delisting proceedings by the New York Stock Exchange (“NYSE”) and/or NASDAQ as a result of improper stock option policies, or for failing to file regularly required SEC reports. Investors have brought in excess of 80 derivative and securities class action lawsuits, and certain institutional investors are pushing for the removal of directors and officers who engaged in, or allowed, backdating to occur.

An analysis of the SEC action against Brocade demonstrates some of the tax and accounting consequences arising out of backdating. Brocade granted options to purchase two million shares of its stock at its October 30, 2001 exercise price of \$24.20, but the complaint alleges that the grant was not actually approved until January 2002 when the company’s stock price had increased to \$36.56. Tax and accounting issues that arose from issuing “in-the-money” options include: (1) Brocade was required to report compensation expenses in excess of \$20 million; (2) stock option recipients who paid taxes on gains at capital gains rates owe additional taxes on the difference between their ordinary income tax rate and the more favorable capital gains tax rate on profits realized at the time options were exercised; and (3) compensation expenses associated with options granted to senior executives no longer qualify for tax deductible status under Section 16(m) of the Internal Revenue Code because the options do not qualify as incentive stock options.

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### Damages Attributable to Stock Option Backdating

Given the volatility of stock prices and that most options require at least one year to vest, the true value of a stock option can be difficult to calculate. While many preliminary reports have focused on the exercise-price discount attributable to backdating when calculating damages, stock options are typically valued using the Black-Scholes model, which takes into account: (1) the current stock price; (2) the option exercise price; (3) the time until the option expires; (4) the stock's volatility; and (5) the risk-free rate of return. While the model is particularly sensitive to volatility until the time the option may be exercised, the stock's exercise price plays a lesser role in determining the option's value, such that a dollar reduction in exercise price typically increases the option's value by less than twenty-five cents per share. Simply receiving an option with an "in-the-money" backdated exercise price does not guarantee that the option will be of any value before it expires. Where a company's stock option grant is fixed based on the number of options to be issued, the value of the backdated option is typically much less than its discounted exercise price. However, where companies determine the value of the options that should be issued before applying the Black-Scholes pricing model to determine the number of options to issue each employee, backdating typically allows a greater number of options to be issued, which in turn makes the issue grant more valuable.

As the SEC and DOJ investigations continue, companies also face civil lawsuits. As many of the alleged wrongful acts took place prior to 2001, many claims are barred by the statute of limitations applicable to securities class actions, which was extended by SOX to the earlier of two years after the discovery of the facts constituting the violation or five years after the violation. Attorneys are filing greater numbers of derivative lawsuits against companies' directors and officers because the derivative actions may be subject to longer state-law statutes of limitations and are not subject to the same loss causation and lead plaintiff requirements as securities class actions. As such, over 80 companies have been targeted with derivative suits as of October 2006, while only about 20 companies face class action lawsuits. The shareholder complaints seek damages allegedly attributable to the decline in a companies' stock price after the backdating investigations were disclosed, along with the disgorgement of profits earned by recipients of backdated stock options. Derivative suits are less popular with the plaintiffs' bar than securities class action lawsuits because settlements are paid to the company itself, not to its shareholders, and settlements in derivative actions often consist of corporate governance changes and result in lower fees to the plaintiffs' attorneys.

While plaintiffs must show that shareholders lost money as a result of backdating to prevail in a class action suit, Melvyn Weiss, a founding partner of Milberg Weiss Bershad & Schulman, a major shareholder class action firm, stated that "a lot of these stocks aren't reacting with big drops in price... or, if they drop initially, they come back over a short period of time." In the Brocade action, as discussed above, four plaintiffs and their lawyers reached a settlement on behalf of Brocade in which the company's directors agreed to enact corporate governance changes and to make a payment of \$525,000 for plaintiffs' attorney fees. While this settlement has not yet been approved by the court, it shows that the main objective of a derivative suit should be to enact changes of corporate governance, not to obtain substantial monetary damages.

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### The Ongoing Nature of the Investigations

While it remains unclear how the backdating of stock options became so widespread, the SEC is investigating whether directors sitting on more than one company board may have spread the practice of backdating stock option grants to the various boards in which they sat. Of the approximately 160 companies being investigated, at least 51 have director-based links, according to a study by The Corporate Library. Three companies were found to have six directors who sat on more than one implicated company board, and the overall number of companies implicated with common board members was found to be much higher than would be expected from a randomly selected sample. Regulators are also looking into whether companies that engaged in backdating had common advisors, as many of the companies under investigation are headquartered in the Silicon Valley and may have been advised by the same group of attorneys.

In an effort to avoid the improper timing of stock options, or even the appearance of impropriety, companies should consider adopting fixed stock option grant dates, such that the company routinely grants options on a particular day each year. Companies should also adopt mandatory blackout periods, to prevent stock option grants when company insiders have access to material non-disclosed information, and companies should keep shareholders apprised with regard to the rationale behind each stock option grants. Companies should file their Form 4s with the SEC immediately upon granting an option and should review their stock option plan compliance procedures to ensure that protections are in place to prevent any future improprieties. Companies must also rigorously defend civil lawsuits to ensure that derivative actions serve their designed purpose, to effect changes in corporate governance, not to provide profits to plaintiffs' attorneys.

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<sup>1</sup> Julie Creswell, *One Route Seems Closed, So Lawyers Try Different Lawsuit in Stock-Option Scandal*, N.Y. Times, September 5, 2006, at C4.

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### SECOND CIRCUIT: PLAINTIFFS HAVE "NO CLASS" IN IPO SECURITIES LITIGATION

A three judge panel of the Second U.S. Circuit Court of Appeals issued a decision on Tuesday, December 5, 2006 holding that six designated test cases asserting claims for federal securities law violations arising out of the pricing and sales practices for initial public offerings issued during the late 1990's and 2000 could not proceed as class actions. The Court of Appeals held that plaintiffs' individual claims were not sufficiently similar to group all of the cases together, precluding class action status. The IPO cases were filed on behalf of investors against 55 underwriters, 310 issuers and hundreds of individual officers alleging that the defendants engaged in a scheme to defraud the investing public by requiring, among other things, that individuals and entities who received prized IPO allocations to purchase additional shares in the aftermarket, ensuring stock price increases once the IPO was launched. The practice is alleged to have artificially inflated the share prices of the 310-issuer companies while costing investors billions of dollars in losses. The decision may threaten the previously announced issuer settlement which had essentially guaranteed a \$1 billion recovery to the plaintiffs as well as a tentative \$425 million settlement by one of the underwriter defendants, J.P. Morgan Chase & Co.

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## SECOND CIRCUIT: PLAINTIFFS HAVE “NO CLASS”

While the lower court had concluded that plaintiffs, who have the burden of proof at class certification, must make “*some showing*” that they met Rule 23 requirements of numerosity, commonality, typicality, and adequacy of representation, along with the two additional requirements for a (b)(3) class action of predominance and superiority, the Court of Appeals concluded that use of the lower “*some showing*” standard was in error. The Court of Appeals held that: (1) a district judge may certify a class only after making determinations that each of the Rule 23 requirements has been met; (2) such determinations can be made only if the judge resolves factual disputes relevant to each Rule 23 requirement and finds that whatever underlying facts are relevant to a particular Rule 23 requirement have been established and is persuaded to rule that the requirement is met; (3) the obligation to make such determinations is not lessened by overlap between a Rule 23 requirement and a merits issue; (4) in making such determinations, a district judge should not assess any aspect of the merits unrelated to a Rule 23 requirement; and (5) a district judge has ample discretion to circumscribe both the extent of discovery concerning Rule 23 requirements and the extent of a hearing to determine whether such requirements are met in order to assure that a class certification motion does not become a pretext for a partial trial of the merits.

The chairman of the plaintiffs’ executive committee, Melvyn Weiss of Milberg Weiss Bershad & Shulman LLP, states that plaintiffs plan to appeal the decision, but the ruling is a decisive loss for both the firm and the entire plaintiffs’ securities bar. Plaintiffs’ lawyers, who have invested an estimated \$250 million in time and expenses prosecuting the IPO action to date, face the possibility of having to file thousands of lawsuits on behalf of individual investors alleged to have suffered harm. While certain wealthy individuals and institutional investors may be able to demonstrate substantial losses, Christine Hurt, a law professor at the University of Illinois, estimates that most retail plaintiffs suffered less than \$20,000.00 in losses. Without the economies of scale provided by class action status, it is unlikely that attorneys will be willing to pursue lawsuits on behalf of typical investors.

The Court of Appeals ruling raises questions regarding the status of several settlements relating to the IPO litigation. In 2003, plaintiffs negotiated a settlement with approximately 300 IPO issuers and their D&O insurers whereby they agreed to guarantee recovery of no less than \$1 billion, which recovery was to be offset by settlement payments from underwriter banks. While the issuer settlement was approved by the parties, U.S. District Court Judge Shira Scheindlin has not yet granted final approval of the settlement and it is unclear whether it will be approved following the December 5 Court of Appeals decision. Further, J.P. Morgan Chase & Co. reached a settlement with plaintiffs in April 2006 whereby the bank agreed to pay plaintiffs \$425 million to settle all charges brought against it arising from the IPO action. Similarly, the J.P. Morgan settlement has not yet received final approval and it remains unclear whether the parties will proceed now that the lawsuits may not proceed as class actions.

Barring success on appeal, or overcoming substantial burdens to re-plead and proceed as a class action, retail plaintiffs will need to analyze losses to decide whether it is worthwhile to file an individual action prior to the expiration of the statute of limitations. Because a substantial number of investors will be unable to show sufficient losses to justify bringing an individual action, or will otherwise fail to protect their rights prior to the expiration of the statute of limitations, the Court of Appeals ruling appears to have substantially reduced the prospect of a multi-billion recovery by the plaintiffs in the last remaining and most wide-ranging securities litigation to arise out of the stock market boom of the late 1990s.



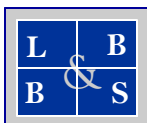
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# Directors & Officers Department

This quarterly newsletter is prepared by the Directors & Officers Practice Group of Lewis Brisbois Bisgaard & Smith LLP. The D&O Group routinely represents some of the largest underwriters of directors and officers liability insurance as coverage, litigation and transactional counsel. We pride ourselves on our ability to find creative and innovative solutions to complex and potentially catastrophic lawsuits on a cost-efficient basis for our clients. We also work with insurance companies in drafting policy forms and endorsements that address the rapidly changing and volatile risks presented by today's financial markets and regulatory environment. The members of the group draw upon their collective backgrounds in insurance, corporate transactional and securities work, commercial litigation, employment law and bankruptcy to forge a unit that is uniquely qualified to meet the changing needs of its clients.

This issue discusses the background of the stock option backdating scandal and the attendant civil litigation as well as a very recent Second Circuit Court decision reversing the district court's grant of class certification to six test cases in the massive IPO Securities Litigation pending in the Southern District of New York. Brent Pelton, an associate in our New York office, authored both articles.

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