

Stock option backdating imbroglio

The SEC steps up the stakes with criminal charges.

The recent issuance of criminal indictments against certain former officers of Brocade Communications Systems (California) and of Converse Technology (New York) signaled the seriousness of the Securities & Exchange Commission (SEC) and the Justice Department in dealing with the growing number of public companies that are reportedly under investigation for what has generically been labeled “stock option backdating.”

To understand the local impact of this latest SEC and prosecutorial focus, *Smart Business* interviewed Bruce Udolf, a leading local white-collar criminal defense lawyer and former assistant United States attorney.

Why all the publicity on stock option backdating?

Almost daily, we are seeing yet another public company publicly announce that it is conducting an internal investigation with regard to the manner in which stock options were granted and exercised. At issue is whether aspects of options have been manipulated so as to benefit certain executives in ways other than knowingly contemplated and disclosed by the company. So far, in what has become public, one alleged method has been to backdate the option grant date so as to effectively guarantee that the option had immediate value, as opposed to being an incentive for future performance.

Is that tactic another bureaucratic focus on paperwork?

Yes and no. Yes, the issue involves legal documentation and the corresponding issue of accuracy of public disclosures that have been made. But the SEC's concern appears to be that some individuals may have benefited in a manner inconsistent with the general notion of stock options most often being an incentive for future performance and that actual grant processes are at odds with a company's public disclosures. From the SEC's perspective, there is much more at stake than mere paperwork.



Bruce Udolf
Attorney
Berger Singerman

I want to emphasize that this entire area is emerging and evolving very quickly. Presently, there is a lot more speculation than facts on the breadth of the SEC focus and all of the resulting nuances. But that being said, the criminal indictments in the Brocade and Converse situations and recent public statements clearly demonstrate that the SEC is taking this area very seriously.

How broad-based is this situation?

To date, approximately 80 public companies have publicly acknowledged that they have varying degrees of potential problems. Although the highest industry concentration has been in the high-tech arena and in the Silicon Valley, a wide variety of industries are represented in the companies that have publicly acknowledged an ‘options issue.’

The initial 80 companies are located from coast to coast, including in Florida.

Based solely on the rate at which companies are being added to the list, it is reasonable to expect that hundreds of entities will eventually be involved. That is not to suggest that all of them will ultimately be found to have significant problems. But the investigatory focus will likely be widespread.

What is at stake for senior management, directors and the company itself?

In a post-Enron, post-Sarbanes-Oxley era, any time criminal indictments start to flow from a target-rich scenario like this area, the stakes are significant.

In recent years, prosecutors have demonstrated that they are more willing to pursue criminal charges against both the company and involved officers and/or directors. Once, companies and the officers and directors often defended themselves together. Today, companies are much more inclined to part ways with involved officers and directors in an effort to stave off a criminal indictment of the company itself.

Most importantly, juries in Enron and other recent white-collar criminal cases have shown that they are not averse to finding executives criminally responsible. As such, the stakes for any officer or director involved in manipulating options are very high.

What final words of advice on this subject would you give to a business executive?

The recent filing of criminal charges against executives in Brocade and Converse dramatically lifts the stakes for executives of public companies. Prudent executives will want to get counsel on this issue as soon as possible.

With your company's interest and your personal interest potentially being adverse, it is important that you get competent, independent counsel if you have any reason to believe that you have either knowingly — or even innocently — been involved in what the government might conclude was a manipulation of options in a manner for your personal benefit, whether or not such benefit was direct.

It is also important that you engage counsel on a timely basis so that you and your counsel can be pro-active in dealing with any potential exposure that you might personally have.

BRUCE UDOLF is a white-collar criminal defense attorney who focuses on economic and business matters involving federal and state charges and investigations. Read more about how Berger Singerman online at www.bergersingerman.com.

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