The Emerging Stock Options Backdating Scandal and Strategic Approach to Claims for Coverage

By: Kevin T. Coughlin, Suzanne C. Midlige, Robert J. Re, William J. Hoffman

November 6, 2006

In recent months, another corporate scandal in American business has become the subject of increasing media scrutiny and investigations by federal prosecutors' offices and government regulators — the improper and undisclosed "backdating" of executive stock options.

Needless to say, both shareholders and plaintiffs' securities lawyers have taken notice and the first wave of lawsuits arising out of the backdating scandal has already hit the courts. New York — a frequent venue for securities lawsuits and home to an aggressive and experienced plaintiffs' bar — is likely to be a target venue for backdating lawsuits. In fact, two of the earliest backdating lawsuits have been filed in the United States District Court for the Southern District of New York, located in Manhattan, and the United States District Court for the Eastern District of New York, located in Brooklyn.

The genesis of the scandal stems from the award of executive stock options. A stock option is a right to purchase stock at a fixed price, or "exercise" price, which is typically determined by the stock's price at 4 p.m. on the date of the stock option grant. An options holder usually has to wait at least one year before exercising his or her stock options at the exercise price. Naturally, an options holder benefits only when the company's stock price is above the exercise price at the time he or she exercises the option. Hence, the lower the exercise price is, the greater the potential value of the option.

Backdating occurs when stock options are granted on a particular date but the exercise price is intentionally backdated to the stock's price on an earlier date, when the price of the stock was lower than on its actual grant date. While backdating in and of itself is not illegal, failing to disclose backdating is. The companies under scrutiny are being investigated for, among other things, failing to disclose the backdating to their shareholders; failing to reflect the expenses resulting from backdating in the company's earnings and financial statements; and failing to report the backdating to the IRS.

First brought to light by academic studies and to the public's attention by the Wall Street Journal, the backdating scandal has the potential of unleashing a new torrent of criminal and civil litigation against companies and their individual directors and officers alleged to have engaged in improper backdating of stock options. Federal prosecutors' offices in Manhattan, Brooklyn and San Francisco, as well as the Securities and Exchange Commission (SEC) and the Federal Bureau of Investigation (FBI), have launched investigations into executive stock option grants at dozens of companies. In recent months, at least sixty-five corporations have disclosed that they are under investigation for past stock option grants alleged to have been improperly backdated. The SEC states that it has at least eighty companies under scrutiny, while the FBI is reportedly investigating over fifty companies that may have illegally backdated stock options. Among the companies under investigation are some of the most well-known names in American business, including Apple Computer, Barnes & Noble, Home Depot and Microsoft. A significant number of companies under the microscope are in the technology sector, where, beginning in the mid-1990s, stock options became an increasingly popular vehicle by which to attract executives and other high-level employees and, equally important, to keep those executives and employees from jumping to a competitor.

The statistics tell a troubling story — time after time stock options were awarded to corporate executives on dates when the price of the company's stock was at it lowest or near its lowest point of the quarter or fiscal year. Time after time the stock's price rose soon after the stock option grant, sometimes to record levels, resulting in millions of dollars in income gains to many of the recipients of these grants. Looking at these seemingly fortuitous grants of lucrative stock options, academics first speculated that corporations were granting their executives stock options just before the release of favorable news anticipated to result in a rise in stock prices. While it was troubling enough to think that executives were exerting their influence on corporate boards of directors for personal gain through what was essentially inside information, further studies revealed an even more troubling reality — corporations appeared to be deliberately and surreptitiously backdating stock option grants to coincide with low points in the company's stock price. The good fortune experienced by many executives seemed to defy the law of averages, and for good reason: one has a greater chance of winning the lottery than consistently being awarded stock options when a stock is trading at or near its low point, as was the case with many corporate executives during the 1990s and the early part of this decade.

According to academic investigations into the practice of backdating, the incidence of backdating significantly decreased after August 29, 2002, when new reporting requirements came into effect under the Sarbanes-Oxley Act, the well-known corporate reform law enacted by Congress amid the corporate scandals of earlier this decade. Under Sarbanes-Oxley, the time within which a company is required to report stock option grants was dramatically reduced to two business days from the issuance of the grant, down from forty-five days after the end of the fiscal year during which the options were awarded. Although this new reporting provision significantly narrowed the window within which backdating could occur, the practice has not altogether disappeared.

Many companies that have come under scrutiny have launched internal investigations into the practice of backdating. As a result of their findings, some companies have admitted to backdating and have begun to restate earnings to the tune of hundreds of millions of dollars. Apple Computer, for example, announced on August 3, 2006, that it anticipates restating its financials to reflect compensation expenses related to past option grants. In addition, the emerging scandal and the ongoing investigations have already resulted in the resignation of senior officers at companies where backdating is alleged to have occurred.

Shareholders have taken notice and have begun taking action against the executives and directors implicated in the backdating scandal, typically in the form of shareholder derivative actions. In a shareholder derivative action, the nominal plaintiff shareholder sues on a right derived from the corporation — hence, the term "derivative" action. In a successful derivative action, damages are paid to the corporation, not the shareholders. Defendants in derivative actions typically include a company's directors, officers and controlling shareholders. Although derivative actions assert corporate rights, the corporation is normally aligned as a nominal party defendant because the suit is generally prosecuted over the opposition of company management. Derivative actions thereby differ from class actions, where plaintiff shareholders file suit on their own behalf seeking recovery of personal investment losses allegedly resulting from misleading disclosures or other actions taken by the company and its directors and officers in violation of federal securities laws. Although some securities class action claims have been filed in connection with the backdating scandal, they are not expected to be as common as derivative claims given the fact that options backdating generally did not result in investment losses to individual shareholders. However, if earnings restatements result in diminished stock prices — as has been the case at some companies that have announced restatements — shareholder class actions may yet emerge as another by-product of the backdating scandal.

On July 20, 2006, the United States Attorney for the Northern District of California filed the first criminal complaint in the backdating scandal against two former officers of Brocade Communication Systems, Inc., a data storage equipment maker headquartered in San Jose, California. The United States Attorney for the Eastern District of New York followed suit on August 9, 2006, when it filed criminal charges against three former executives of Comverse Technology, Inc., a New York based telecom software manufacturer.

Only time will tell how big this scandal will grow and what impact it will have on the insurance industry. Directors and officers of companies caught up in the backdating scandal may not be the only persons in the cross-hairs of prosecutors and plaintiffs — accountants and attorneys who provided advice concerning backdating, actively participated in the practice, or helped cover it up after the fact may also be implicated. In fact, one of the defendants in the Brooklyn U.S. Attorney's Office's criminal complaint is Comverse Technology's former general counsel. It has also been reported that a prominent California attorney served as outside counsel to Brocade Communications and approximately 50% of the Silicon Valley companies currently under investigation for improper backdating and rendered advice to those companies on compensation issues, including options practices. Until the full extent of the backdating problem becomes known, insurers should brace for a potential firestorm of claims not only under D&O policies, but under lawyers and accountants professional liability policies as well.

Read More