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## Stock Option Backdating and the Independent Director: An Analysis of Litigation Trends

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### Introduction

Over the last two years, allegations of stock option pricing manipulation at a number of public companies have generated a wave of private securities lawsuits and regulatory investigations. This litigation has enhanced scrutiny of executive compensation practices, and the roles of outside directors and management who oversee them. In March 2006, the *Wall Street Journal* published ''The Perfect Payday,'' an article theorizing that a practice of deliberate backdating could be responsible for unusually fortuitous timing of executive stock option grants. By June 2007, 15 months later, the *Journal* identified announcements at over 120 companies of government investigations, departures of senior management or directors, or financial restatements related to options issues.[1] By August 2008, 14 months later, one legal observer had tallied the number of derivative actions nationwide based on alleged stock option backdating or timing issues at 166 and the number of securities class actions at 39.[2]

The U.S. Department of Justice also pursued high-profile criminal prosecutions in several cases involving CEO's and other senior executives at companies like Brocade, Comverse, and Broadcom, and some matters may still remain under investigation. In separate investigations or enforcement actions, the Securities and Exchange Commission announced significant civil settlements with a number of companies and individual defendants, including Brocade, the former CEO of United Health, the former general counsels of Apple and Monster Worldwide, and the former CEO of Take-Two Interactive Software, Inc.

Outside, independent directors, especially directors who serve on compensation committees, play an integral role in supervising corporate decisions on executive pay and their conformity with internal governance requirements. Civil litigation in the stock option backdating area has renewed focus on the fiduciary standards to which courts hold such corporate directors accountable when they oversee executive compensation practices. While most of the law in this context has been generated at the fairly early pleading stage, it nonetheless has provided useful insight into the analyses used by courts to judge directors' accountability for compensation-related misconduct occurring on their watch.

In addition, while directors have not been the focus of criminal prosecutions pursued in the backdating area, such prosecutions demonstrate the willingness of law enforcement authorities to step in where they perceive an elevated degree of intentional misconduct. This article will discuss several of the important themes reflected in recent backdating litigation and draw conclusions regarding the implications for independent directors and companies.

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[1] Charles Forelle and James Bandler, ''The Perfect Payday,'' *Wall St. J.*, March 18, 2006, at A1; ''Options Scorecard,'' *Wall St. J.*, June 2007, available at http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html (last updated September 2007).

[2] ''Counting the Options Backdating Lawsuits,'' *The D&O Diary*, *available at* http://www.dandodiary.com/2006/07/articles/options-backdating/counting-the-options-backdating-lawsuits/index.html.

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## Stock Option Backdating and Potential Consequences

Stock option grants have traditionally served as an important component of corporate executive pay packages, providing both rewards for past performance and, theoretically, an incentive for future positive performance. Under accounting rules in use prior to 2005, a company did not need to recognize a compensation expense for an option grant if the exercise price of an option granted in company stock was at least equal to the stock price on the date of the grant. Generally Accepted Accounting Principles (GAAP) permitted companies to measure expense for stock-based awards using either Accounting Principles Board (APB) Opinion No. 25, which utilized an "intrinsic value" method, or Statement of Financial Accounting Standards (Statement) No. 123, which utilized a "fair value" method. Most corporations followed the APB No. 25 accounting rules for purposes of "intrinsic value" expense recognition and included pro forma financial statement footnote disclosures of what net income and earnings per share would have been had Statement No. 123's "fair value" method been used.[3]

Under APB No. 25,[4] compensation expense is determined based on an award's intrinsic value on the "measurement date," the first date on which both the number of shares an employee will receive and the exercise price are known.[5] Thus, a stock option granted at the prevailing market price for the stock on the measurement date of the grant had no intrinsic value under APB No. 25 and did not trigger a compensation expense at the time of the grant. A stock option granted *below* the prevailing market price at the time of the measurement date had an intrinsic value equal to the difference between the exercise price and the market price, which value constituted a compensation expense to be recognized by the company.

Option backdating typically involves a practice of using hindsight when making an option grant to select from prior dates' stock prices an exercise price lower than the fair market value existing on the measurement date, while failing to disclose that the date being used to price the grant is not in fact the date on which the pricing decision was made – the true measurement date. Where a backdated option has intrinsic value under APB No. 25, it triggers a compensation expense. When charted in the context of surrounding historical stock prices, such option exercise prices can often be found at or near the bottom of V-shape or "trough" patterns.

In May 2005, Erik Lie at the University of Iowa published a study analyzing stock price patterns surrounding option grants at certain companies, theorizing that in some cases the timing of grants appeared opportunistic rather than fortuitous because of the unusually low stock prices on dates when options were granted to CEO's and other executives.[6] On March 18, 2006, the *Wall Street Journal* published "The Perfect Payday," which described a "striking pattern" of corporate option grants dated just prior to an increase in the stock price and often just after a steep drop, with the odds of this being the result of a random occurrence described as "wildly improbable."[7] Following growing attention from the media and Wall Street analysts, civil litigation and regulatory action over alleged manipulative option pricing practices ensued.

Backdating of stock options granted to management creates a number of potential consequences. Numerous companies have faced claims that a practice of backdating options, while admittedly not illegal *per se*, raises corporate governance issues where, for example, shareholder-approved stock plans prohibited any pricing of options at less than the prevailing fair market value, or where the backdating resulted from a delegation of key option decisions to management despite requirements in the stock plans that directors retain exclusive discretion over the pricing of option awards.

More significantly, however, backdating activity could lead to incorrect accounting for expenses, creating potential securities law and disclosure issues. Companies whose publicly filed financial statements were based on improper accounting or stated that APB No. 25's "intrinsic value" method would be used for options accounting might have a basis to consider restatements, and proxy statement disclosures could also be implicated if they contained incorrect representations about the terms of option grants. In addition, failure to disclose backdating could arguably affect executives' entitlement to an exemption from the short swing profits rule of Rule 16b-3(d) of the Securities Exchange Act of 1934 (Exchange Act) under the terms of that rule requiring disclosure to shareholders.[8]

Adverse tax implications could also follow from a practice of backdating. Internal Revenue Code § 162(m) and related regulations, for example, require fair-market-value pricing of options by a compensation committee of the board in order to qualify an issuer for a deduction for performance-based compensation paid to the issuer's CEO and certain highly compensated executive officers, to the extent that any such individual's aggregate compensation exceeds $1 million.[9] Below-market pricing or control of option decisionmaking by management, as opposed to a compensation committee of outside directors, would raise issues of disqualification under § 162(m).[10] Further, Internal Revenue Code § 409A imposes interest penalties and a 20 percent additional tax (over and above ordinary income taxes) on a recipient of nonqualified deferred compensation, and Treasury guidance indicates that below-fair-market-value pricing may cause an option to lose its exempt status.[11]

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[3] Thomas J. St. Ville, *Stock Options and Other Equity-Based Compensation Arrangements*, 75 C.P.S. (BNA) at A-49.

[4] APB No. 25 has been superseded by Statement of Financial Accounting Standards No. 123R, which now requires use of the fair value method for stock option grant accounting.

[5] St. Ville, *Stock Options and Other Equity-Based Compensation Arrangements*, 75 C.P.S. at A-49.

[6] Erik Lie, "On the Timing of CEO Stock Option Awards," *Management Science*, May 2005, http://biz.uiowa.edu/faculty/elie/Grants-MS.pdf.

[7] Charles Forelle and James Bandler, "The Perfect Payday," *Wall St. J.*, March 18, 2006 at A1.

[8] *See* 17 C.F.R. § 240.16b-3(d).

[9] 26 U.S.C. § 162(m); Gold, "Stock Option Backdating – What Boards Should Consider" Practising Law Institute, November 2006, 502-504.

[10] 26 U.S.C. § 162(m); 26 C.F.R. § 1.162-27(e)(2)(vi).

[11] 26 U.S.C. § 409A; 26 C.F.R. § 1.409A-1(b)(5)(i).

  

Because oversight of executive compensation practices is typically assigned to compensation committees composed of outside directors under a company's compensation committee charter or shareholder-approved stock plan, allegations of improper grant practices may subject the role of such directors to scrutiny. In some cases, stock plans may require that exclusive authority for setting terms and prices for all company options rest with the compensation committee or the full board. In other cases, the board or a committee may be permitted to delegate discretion over certain non-senior or non-executive level option terms to management or a subcommittee. Questions may be raised about whether directors are responsible for the mechanics of grant decisions, or merely ratify proposals submitted by management. Backdating practices may also raise questions about directors' roles with respect to supervision of company accounting processes and public disclosures.

## Director Liability Standards

Delaware law provides a useful starting point for understanding the contours of director liability primarily because of the large number of corporations incorporated in Delaware and the resulting deference of other jurisdictions to Delaware law as a result of the "internal affairs" doctrine recognized by most courts, which requires application of the state law of incorporation in adjudication of intracorporate claims (including derivative claims for breach of fiduciary duties).[12] Under Delaware law standards, directors can be held liable under fiduciary duty standards for affirmative actions that breach the duties of care and loyalty where the action is not otherwise entitled to the protections of the business judgment rule, which presumes that directors have acted on an informed basis, in good faith, and in what they honestly believed was the best interests of the company.[13] In cases where directors at most failed to detect and prevent misconduct, however, a derivative plaintiff cannot typically make out a fiduciary duty claim against a director without pleading facts to suggest that the director exhibited more than gross negligence, i.e., an intentional and bad faith refusal to exercise oversight by utterly failing to ensure that reasonable internal reporting and controls system existed.[14] Facts showing the directors ignored specific "red flags," for example, would be required to show liability.[15]

## Demand Futility and Fiduciary Duty Standards

Motions to dismiss derivative complaints alleging backdating or other options-related misconduct have given courts occasion to analyze the fiduciary duties of directors as applied to supervision of executive compensation practices. Under federal law and the law of most state jurisdictions, shareholders seeking to pursue derivative claims against directors and officers on behalf of the corporation without first making a formal demand on the board of directors are required to plead particularized facts showing that such a demand would have been futile based either on a risk of director partiality – "interestedness" or "dependence"– or a risk that the director decisionmaking will ultimately fall outside of the protections of the business judgment rule where affirmative board action is at issue. In either case, courts assess this question by judging preliminarily whether the plaintiff has adequately pleaded what is in essence a claim for breach of fiduciary duty.[16]

Intentional backdating of stock options can implicate the fiduciary duties of good faith and loyalty where it is done in knowing contravention of shareholder-approved stock plans and concealed from shareholders.[17] Given that the intended effect of backdating is presumably to reward executives while avoiding accurate reporting of company expenses, courts view the conduct as violative of fiduciary duties because it advances the interests of management above those of the company and its shareholders.[18] A related option timing practice alleged in some cases, "springloading," involves intentionally setting the grant date and exercise price of an option just prior to the release of material nonpublic information that is expected to cause a sharp increase in the company's stock price. While springloading does not involve the same accounting issues as backdating, some Delaware caselaw recognizes that springloading may breach the fiduciary duty of loyalty where it involves the surreptitious use of nonpublic information for management's benefit to the exclusion of shareholders' interests, primarily because of the recognition that shareholders are entitled to full disclosure in the area of executive compensation.[19]

While several Delaware option timing decisions have suggested a critical view of director accountability in the context of alleged backdating or other problematic pricing practices, other Delaware and federal caselaw have reflected a more nuanced view. Three Delaware Chancery Court cases – *Ryan v. Gifford*, *In re Tyson Foods*, and *Conrad v. Blank*[20] – declined to dismiss breach of fiduciary duty claims against directors for failure to plead demand futility based on allegations of options backdating or springloading. In the *Ryan* and *Conrad* backdating decisions, the courts did so where plaintiffs alleged that grant exercise prices consistently hit monthly or yearly lows and company stock plans re-

[12] *See First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983) ("internal affairs" doctrine); *Ryan v. Gifford*, 918 A.2d 341, 356-58, 5 EXC 11 (Del. Ch. 2007) (noting that "Delaware law directly controls and affects many of the option backdating cases" where sister courts in other jurisdictions are adjudicating issues relating to Delaware corporations); *In re Sagent Technology, Inc. Deriv. Litig.*, 278 F. Supp. 2d 1079, 1086-87, 1090-93 (N.D. Cal. 2003).

[13] *Ryan*, 918 A.2d at 356-58.

[14] *See Stone v. Ritter (AmSouth Bancorporation)*, 911 A.2d 362, 369-71, 5 EXC 3 (Del. 2006).

[15] *See Guttman v. Huang*, 823 A.2d 492, 506-07 (Del. Ch. 2003) (discussing *Caremark* standard for director liability); *see also In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (recognizing that pleading director liability based on failure to detect wrongdoing is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment").

[16] *See In re Tyson Foods Consolidated S'holder Litig.*, 919 A.2d 563, 582, 5 EXC 12 (Del. Ch. 2007); *Guttman*, 823 A.2d at 500-01 & n. 15.

[17] *See Ryan*, 918 A.2d at 357-58; *Edmonds v. Getty,* 524 F. Supp. 2d 1267, 1276, 6 EXC 5 (W.D. Wash. 2007).

[18] *See Ryan*, 918 A.2d at 357.

[19] *See Weiss v. Swanson*, 948 A.2d 433, 441-443, 6 EXC 15 (Del. Ch. 2008); *In re Tyson Foods*, 919 A.2d at 593.

[20] *Ryan*, 918 A.2d 341; *Conrad v. Blank*, 940 A.2d 28, 6 EXC 34 (Del. Ch. 2007); *In re Tyson Foods*, 919 A.2d 563.

quired pricing of options at fair market value on the date of the grant.[21]

A number of federal cases, however, while acknowledging this Delaware jurisprudence, have nonetheless declined to assume such liability without a greater pleading of actual director involvement in the mechanics of pricing decisions.[22] A fourth Delaware case involving Sycamore Networks, *Desimone v. Barrows*,[23] also appears to diverge somewhat from the *Ryan/Tyson/Conrad* approach by holding that compensation committee membership itself does not presumptively generate a likelihood of liability for alleged backdating without greater specificity as to what directors actually did. Thus, *Desimone* and these federal decisions appear to suggest a judicial awareness that at many companies management may in fact control proposals for grant allocations, recipients, and timing, and the role of the board may be limited to mere ratification (or less) of some or all of these proposals.

There are several ways to rationalize the divergence in caselaw between the stricter view of director liability evidenced by the *Ryan/Tyson/Conrad* line and the more lenient and fact-dependent view followed by *Desimone* and numerous federal courts. First, the flexibility afforded by internal corporate guidelines covering executive compensation practices appears to play a role. In cases where stockholder-approved plans provide strict guidance regarding the terms under which options may be granted, e.g., that discounting or repricing are not permitted, courts seem more likely to conclude that options manipulation would not have occurred without knowing director involvement.[24] In *Desimone*, on the other hand, the stock plan at issue for option grants to officers and employees did not contain a fair value pricing requirement.[25] Thus, where company stock plans removed discretion to award discounted, i.e., ''in-the-money'' options, courts appeared somewhat more inclined (although not certain) to find that the occurrence of backdating would threaten director liability and remove the protections of the business judgment rule.[26]

As noted above, the mechanics of a company's particular option grant process may also in some cases influence whether directors can avail themselves of the relatively lenient *Caremark* standard of liability. In cases where company stock plans allow for significant delegation to management of the mechanics of options granting, the argument that directors were not responsible for improper dating and pricing practices, or for the failure to prevent them, has met with some success. In *Desimone*, for example, the company's stock plans permitted delegation of the power to grant stock options, and thus contemplated that Sycamore's directors ''might have a very limited role in making certain option grants by permitting the board to delegate its authority under the Plan to Sycamore's executive officers.''[27] As a result, under the *Caremark* standard Sycamore's directors could not be deemed presumptively liable for failing to prevent improper option grant practices to certain categories of employees because ''the board itself might play a very minimal role in the option granting process'' and there was no pleading of conscious directorial abdication of oversight responsibilities.[28] In *Ryan* and *Conrad*, however, the courts found either that the directors had exercised direct responsibility over the grants or were required to do so under applicable stock plans.[29] Thus, in cases where stock plans allowed for some flexibility for delegation to management to effect options grants, courts have been more likely to accord directors the benefit of the doubt regarding responsibility for options misconduct occurring at the company.[30]

Second, the results in cases like *Ryan*, *Conrad*, and *Edmonds v. Getty* [31] (a federal derivative case following *Ryan's* reasoning) can also be rationalized as a judicial attempt to balance the protections afforded to directors under Delaware laws with the compelling allegations of fortuitous options pricing in those particular cases. In *Ryan*, for example, the court scrutinized the strength of the complaint's allegations and noted that they pointed to a highly unusual pattern of nine option grants, every single one of which hit the lowest price of the month or year in which it was granted, as well as a Merrill Lynch analysis showing disproportionate returns to option recipients as contrasted with the market in general.[32] *Conrad* involved what the court viewed as similar allegations of implausibly fortuitous pricing.[33] In *Edmonds*, the plaintiff alleged that eight of the challenged grants were made at or near the lowest price of the fiscal year and the remainder were made at or near the lowest price of the fiscal quarter.[34]

In cases where the option pricing allegations did not point to an extremely improbable pattern or were not supported by a thorough statistical analysis, courts were more circumspect in inferring directorial liability for alleged compensation-related misconduct. As one federal court put it, a ''less convincing and compelling picture as it relates to option backdating . . . presents a lower risk of liability to [directors] for the backdating.''[35] A number of federal courts have therefore declined to adopt plaintiffs' theories of liability based on backdating allegations found to be less than persuasive.[36]

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[21] *Ryan*, 918 A.2d at 357-58; *Conrad*, 940 A.2d 28.

[22] *See, e.g., In re CNET Networks, Inc. Deriv. Litig.*, 483 F. Supp. 2d 947, 963-66 (N.D. Cal. 2007); *In re Linear Technology Corp. Deriv. Litig.*, 2006 WL 3533024 * 3, 6 EXC 49 (N.D. Cal. 2006); *In re F5 Networks, Inc.*, 2007 U.S. Dist. LEXIS 57464, at *40-41 (W.D. Wash. 2007); *In re Finisar Corp. Deriv. Litig.*, 542 F. Supp. 2d 980, 995 (N.D. Cal. 2008); *In re MIPS Technologies, Inc. Deriv. Litig.*, 542 F. Supp. 2d 968, 977-78 (N.D. Cal. 2008).

[23] *Desimone v. Barrows*, 924 A.2d 908, 5 EXC 66 (Del. Ch. 2007).

[24] *See Ryan*, 918 A.2d at 357-58; *Conrad*, 940 A.2d at 33; *Edmonds*, 524 F. Supp. 2d at 1272-74.

[25] *Desimone*, 924 A.2d at 920-21, 930-31.

[26] *But see In re CNET Networks*, 483 F. Supp. 2d at 965-66 (dismissing claims against compensation committee directors despite fair-value-pricing requirement in stock plans).

[27] *Desimone*, 924 A.2d at 920-21.

[28] *Desimone*, 924 A.2d at 938-40.

[29] *See Ryan*, 918 A.2d at 356 n. 38.

[30] *In re CNET Networks*, 483 F. Supp. 2d at 965; *Desimone*, 924 A.2d at 920-21.

[31] *Edmonds*, 524 F. Supp. 2d at 1273.

[32] *Ryan*, 918 A.2d at 354.

[33] *See Conrad*, 940 A.2d at 39-40.

[34] *Edmonds*, 524 F. Supp. 2d at 1273.

[35] *See In re Computer Sciences Corp. Deriv. Litig.*, 2007 U.S. Dist. LEXIS 25414, at *45-46 (C.D. Cal. 2007).

[36] *See In re CNET Networks*, 483 F. Supp. 2d at 965 (rejecting year-by-year allegations of backdating and noting that ''the issue is whether plaintiffs have alleged circumstances from which we may reasonably infer backdating as opposed to in-

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The weight of demand futility cases in the backdating area suggest, therefore, that courts will not reflexively view outside directors, even those serving on compensation committees, as presumptively responsible for options-related misconduct occurring on their watch. To the extent that courts can assess the ground rules under which directors operate, as well as the mechanics of a company's options grant process and the roles of other parties, i.e., management, courts may rely on such factors in declining to adopt plaintiffs' theories of liability. The strength of circumstantial allegations of backdating themselves may also play a role.

## Director Liability for Disclosure Violations Under Federal Securities Laws

As with fiduciary liability, director liability under the federal securities laws in backdating cases has generally depended upon the clarity of director's roles and knowledge regarding problematic compensation practices. As the type of acts triggering a violation under federal securities laws – specific fraud, or misrepresentations or omissions – is a narrower subset of the more generalized activities that might compromise the duties of care and loyalty for fiduciary liability purposes, courts appear willing to apply the same rigorous scrutiny to allegations of director involvement in options-related misconduct and to dismiss securities claims, especially where specifics are not pleaded in accordance with the requirements of the Private Securities Litigation Reform Act (PSLRA).

For example, in a securities class action involving Hansen Natural Corporation, the court held that the scienter, i.e., actual knowledge or deliberate recklessness, of individual management and director defendants for purposes of a claim under § 10(b) of the Exchange Act could not be pleaded without specific facts showing their roles and knowledge regarding alleged backdating at the company.[37] In two other backdating decisions, federal courts dismissed complaints alleging director liability under § 10(b) even though the occurrence of backdating had all but been established.[38] In a fourth case, the court found that scienter had not been adequately pleaded because the allegations showed that backdating had not consistently benefited option recipients.[39] While the state of mind required for § 14(a) claims based on false proxy statements is negligence, as opposed to knowledge or deliberate recklessness, courts have nonetheless also recognized the need for greater pleading specificity for such claims where backdating is alleged.[40]

As in the fiduciary liability context, however, when the discretion afforded to directors regarding permissible option pricing under the terms of stock plans is restricted, courts may be more receptive to allegations of knowledge and participation in option backdating if such restrictions were not followed. Courts have, on occasion, declined to dismiss § 10(b) claims against compensation committee directors in backdating cases where stock plans required fair-market-value pricing for options, on the theory that the stock plan terms implied greater responsibility and opportunity to monitor exercise dates of options.[41] One flaw in the analysis of such decisions is the assumption that directors are necessarily in a position to know or verify the ultimate pricing of options where management controls the mechanics of options awards. Given that directors are typically entitled to rely in good faith upon records and representations of management in performing their duties,[42] an argument could be made that outside directors should not be presumptively charged with knowledge of backdating on option awards carried out by company management unless specific facts show that the practice was made apparent from discussion or records presented to the board or compensation committee.[43]

Moreover, under recent Supreme Court authority, allegations that directors were part of a backdating scheme should not be sufficient in themselves to plead liability under § 10(b). In *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*,[44] the Supreme Court held that liability under § 10(b) requires a specific false or misleading statement or omission attributable to each defendant. Thus, arguably under *Stoneridge*, directors who are merely alleged to have participated in backdating by virtue of compensation committee membership, but who did not exercise specific control over financial statements or accounting, should not face liability under § 10(b). As a result, plaintiffs' attempts to utilize the fact of directors' compensation committee membership in itself as a basis for pleading actionable conduct under § 10(b) should be foreclosed by *Stoneridge*.

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nocent bookkeeping error''); *In re Linear*, 2006 WL 3533024, at *3 (holding that plaintiffs had not adequately pleaded demand futility based on weak allegations of backdating); *In re F5 Networks*, 2007 U.S. Dist. LEXIS 57464, at *20-42 (demand futility not pleaded because no particularized facts supporting plaintiffs' assertion that options were in fact backdated); *In re Openwave Sys., Inc. S'holder Deriv. Litig.*, 503 F. Supp. 2d 1341 (N.D. Cal. 2007) (rejecting allegations that numerous reported stock option grant dates fell at suspiciously low prices without any statistical analysis that would support an inference of backdating); *In re PMC-Sierra, Inc. Deriv. Litig.*, 2007 WL 2427980 * 4-5 (N.D. Cal. 2007) (rejecting allegations of backdating based merely on subsequent rise in stock price and without adequate statistical analysis).

[37] *See In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1157 (C.D. Cal. 2007).

[38] *See In re Mercury Interactive Corp. Sec. Litig.*, 2007 WL 2209278 at * 10 (N.D. Cal. 2007) (dismissing claims against compensation committee members based on inadequate scienter pleading despite company's admission that options had been backdated); *In re Atmel Corp. Deriv. Litig.* 2007 U.S. Dist. LEXIS 54058 at * 18 (N.D. Cal. 2007) (dismissal required even where backdating is ''almost certain'' where complaint fails to provide adequate detail regarding the role and knowledge of defendants).

[39] *See Rudolph v. UTStarcom, et al.*, Case No. 07-04578 SI (N.D. Cal. 2008) (despite defendants' responsibility for approving option grants, allegations did not negate inference that backdating had occurred through innocent bookkeeping error).

[40] *See, e.g., In re Atmel Corp. Deriv. Litig.*, 2007 U.S. Dist. LEXIS 54058 at * 23-24 (N.D. Cal. 2007).

[41] *See, e.g., In re Comverse Tech., Inc. Sec. Litig.*, 543 F. Supp. 2d 142-43 (E.D.N.Y. 2008).

[42] *See, e.g.*, Del. Code Ann. Tit. 8 § 141(e); *In re CNET Networks*, 483 F. Supp. 2d at 963-64.

[43] *See In re CNET Networks*, 483 F. Supp. 2d at 965 (holding that compensation committee directors might not have known dates on which management finalized the grants where stock plans permitted some delegation).

[44] *Stoneridge Inv. Partners LLC v. Scientific-Atlanta Inc.,* 128 S. Ct. 761, 6 EXC 62 (2008).

## Effect of Internal Investigations on Judicial Perceptions of Director Liability

Internal company investigations and resulting remedial efforts can be a critical component of a company's case for cooperation and lenience vis-à-vis the Department of Justice, SEC, and other regulators when accounting irregularities are at issue. In some cases, securities plaintiffs have sought to take advantage of corporate self-remediation efforts in the face of what are believed to be improper executive compensation practices to bolster claims of intentional wrongdoing. Such strategies have created a risk that any admissions of faulty practices resulting from such remedial efforts could strengthen the hand of litigation adversaries.

The stock option backdating caselaw provides examples of judicial reaction to such strategies. In the wake of options-related allegations or regulatory inquiries, numerous companies proactively commissioned internal board-supervised investigations (often assisted by outside counsel) to ascertain whether improper options pricing or accounting had occurred. Some of these investigations led companies to publicly disclose irregularities in their options accounting or past disclosures, or even to issue restatements. As a result, in some derivative actions, plaintiffs seized upon disclosures of options irregularities following such board-supervised investigations to bolster their claims of director liability.

Despite attempts by shareholder plaintiffs to paint such disclosures as admissions of impropriety, judicial receptivity to such arguments has been mixed. In *Conrad*, the court suggested that it considered adverse or ambiguous disclosures following the company's internal investigation to be probative indicators of possible wrongdoing even where no admission of intentional wrongdoing had been made.[45] In the majority of cases, however, courts have declined to draw such an inference and thereby create a disincentive for companies to self-report and disclose accounting irregularities or weaknesses in internal controls. In a number of cases, courts have expressly rejected plaintiffs' attempts to seize upon companies' remediation and disclosure of options-related accounting errors as a basis for inferring director liability.[46] In others, courts have rejected arguments that a failure to identify wrongdoing after an internal investigation could support allegations of liability.[47] Courts have moreover expressly acknowledged that erroneous accounting in the stock option area cannot in itself be regarded as indicative of intentional misconduct.[48] Given that internal efforts to address problematic practices benefit both corporate governance and regulatory interests, the sophisticated perspective of courts on this question is desirable in that it tends to encourage, rather than inhibit, these efforts. Such decisions help avoid creating a disincentive for good corporate citizenry and implicitly reinforce company efforts to proactively resolve issues with compensation practices.

## Criminal Prosecutions Involving Stock Option Backdating

Where alleged backdating conduct is perceived by regulatory authorities to be tied to serious weaknesses in management integrity, egregious misstatements to the market or auditors, or substantial personal gains as a result of intentional wrongdoing, the Department of Justice has demonstrated that it will take action notwithstanding the potential for civil liability. In a number of criminal prosecutions of company executives for stock option backdating-related conduct, the government has generally alleged wrongdoing falling into several categories: management-directed falsification of records documenting options practices or other deceptive acts, extreme overstatement of income or underreporting of expenses, or substantial financial gains resulting from what is believed to be deliberate misconduct.

A review of recent indictments indicates that the government has chosen to select for criminal prosecution cases suggesting a higher degree of alleged intentional wrongdoing on the part of management than most in the civil arena. In August 2006, for example, the Department of Justice indicted the former CEO, CFO, and General Counsel of Comverse Technology for conspiracy to commit securities fraud and other crimes based on an alleged scheme to backdate options involving falsification of records and deception of the company's compensation committee by use of fictitious option recipients, resulting in gains in the millions.[49] In February 2007, the former General Counsel of McAfee, Inc. was indicted on mail and wire fraud and false SEC filing charges based on an alleged scheme to direct false entries in company books and records to backdate options resulting in gains to himself and others.[50] In August 2007, former Brocade CEO Gregory Reyes was convicted on charges relating to a backdating scheme, and in December 2007, Brocade's former human resources director was also convicted of similar charges, as part of which federal authorities alleged that she had

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[45] *E.g., Conrad*, 940 A.2d at 37-38 & n. 22.

[46] *See In re PMC-Sierra*, 2007 WL 2427980 *5 (rejecting plaintiffs' inference of backdating arising from PMC's admission that its internal investigation had found that some options had been incorrectly dated); *Nach v. Baldwin (Peet's Coffee & Tea)*, 2008 WL 410261, 6 EXC 46 (N.D. Cal. 2008) (declining to accept plaintiffs' argument that acknowledgment of incorrect dates as a result of internal company investigation established backdating).

[47] *Finisar*, 2008 U.S. Dist. LEXIS 4590 * 38-39 (rejecting allegation that results of investigation and lack of remedial actions demonstrated demand futility); *In re CNET Networks*, 2007 WL 1089690 (N.D. Cal. 2007) (rejecting allegations impugning outcome of special committee investigation because while plaintiffs are entitled to inferences in their favor at the pleading stage, ''those inferences must be reasonable'').

[48] *See, e.g., In re Zoran Corp. Deriv. Litig.*, 2007 WL 1650948 * 21, 6 EXC 52 (N.D. Cal. 2007) (recognizing that ''[u]se of an incorrect measurement date for stock options could be the result of innocent but sloppy accounting practices rather than a fraudulent effort to retrospectively change the grant dates'' and noting that the SEC Chief Accountant is in accord).

[49] U.S. Department of Justice Press Release, ''Former Executives of Comverse Technology, Inc. Charged With Backdating Millions of Stock Options and Creating a Secret Stock Options Slush Fund,'' Aug. 9, 2006, *available at* http://www.usdoj.gov/usao/nye/pr/2006/2006Aug09.html.

[50] U.S. Department of Justice Press Release, ''Former McAfee General Counsel Indicted For Stock Options Backdating,'' Feb. 27, 2007, *available at* http://www.usdoj.gov/usao/can/press/2007/2007_02_27_roberts.indictment.press.html.

  

falsified Brocade's books and records to conceal backdating.[51]

A number of prosecutions alleged schemes with extreme accounting ramifications. In January 2008, the former CEO of Monster Worldwide, Inc. pleaded guilty as part of a deferred prosecution arrangement to conspiracy and securities fraud charges arising from a backdating investigation in which the government claims the company's net income was overstated by more than ''1,900 percent.''[52] In April 2008, the DOJ also indicted the former COO of Monster for securities fraud and conspiracy based on the same alleged scheme. In its press release, the DOJ contended that the former COO had received gains of approximately $13.5 million based on the in-the-money portion of backdated grants.[53] And in June 2008, the DOJ indicted the former CEO and CFO of Broadcom Corp. on conspiracy and securities fraud charges relating to an alleged backdating scheme that supposedly required Broadcom to write down $2.2 billion in profits.[54] Thus, a number of the prosecutions alleged conduct by management involving acts of deception, substantial personal gain, and unusually significant accounting consequences.

The dearth of backdating prosecutions involving independent directors could be understood as an acknowledgment of the same realities often recognized by courts in the civil backdating context: management in many cases is much closer to the day-to-day aspects of compensation practices than outside directors, even compensation committee directors, directors' compensation incentives are different from those of management, and management has much more direct control over the accounting practices and statements used to report on executive pay than directors do. For these reasons, it is not surprising that it has been management, not boards, that have been the focus of government prosecution efforts in backdating cases.

## Conclusion

Civil and criminal developments in the option backdating area have highlighted and clarified the standards of independent director liability where executive compensation practices are at issue. In the fiduciary liability context, courts have shown care in recognizing the limitations on director accountability for options-related misconduct occurring at companies, although the more narrowly defined the parameters of their authority and the more egregious the alleged misconduct, the less likely directors are to receive the benefit of the doubt when irregularities occur. In the criminal arena, the lack of prosecutions involving outside directors appears to reflect a similar recognition that it is management, not directors, that control day-to-day company affairs, of which executive compensation is simply one component. As the law in this area continues to develop, it seems clear that courts will continue to be called upon to rationalize normative ideals of director behavior with the positive realities within which directors must operate in the corporate world.

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[51] U.S. Department of Justice Press Release, ''Brocade Vice President Stephanie Jensen Sentenced to 4 Months in Prison and a $1.25 Million Fine,'' March 19, 2008, *available at* http://sanfrancisco.fbi.gov/dojpressrel/2008/sf031908a.htm; Henry Lee, ''A Second Brocade Ex-Officer Convicted In Backdating Case,'' *San Francisco Chronicle*, Dec. 6, 2007, *available at* www.sfgate.com.

[52] Leslie Gevirtz, ''Monster Backdating Options Criminal Probe Not Over,'' *Reuters Online*, April 23, 2008, *available at* http://www.reuters.com/; U.S. Department of Justice Press Release, ''Former Chief Executive Officer of Monster Worldwide, Inc. Charged With Stock Options Backdating,'' Jan. 23, 2007, *available at* http://www.usdoj.gov/usao/nys/pressreleases/January08/mckelveydppr.pdf..

[53] U.S. Department of Justice Press Release, ''Former Chief Operating Officer and President of Monster Worldwide, Inc. Charged With Securities Fraud and Conspiracy in Connection With Backdating Of Stock Options,'' April 30, 2008, *available at* http://www.usdoj.gov/usao/nys/pressreleases/April08/treacymonsterindictmentpr.pdf..

[54] U.S. Department of Justice Press Release, ''Former Broadcom CEO Henry Nicholas and Former CFO Indicted in Massive Stock-Options Backdating Case,'' June 5, 2008, *available at* http://losangeles.fbi.gov/dojpressrel/pressrel08/la060508usa.htm.