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REPORT

STOCK OPTIONS

Private Civil Litigation: The Other Side of Stock Option Backdating

BY LEE G. DUNST

Since stock option backdating exploded in the public consciousness (and in the legal field) after a series of articles in *The Wall Street Journal* in March 2006, the public focus has been on the numerous governmental investigations and prosecutions of alleged improper activity.[1] Specifically, at least 160 companies to date have announced they are the subject of investigation by the Securities and Exchange Commission and/or the Department of Justice concerning stock option practices. In fact, these inquiries have resulted in the SEC filing civil charges against various corporate executives, while the United States Attorney's Offices in the Northern District of California, Southern District of New York and the Eastern District of New York and the Manhattan District Attorney's Office have brought high-profile criminal prosecutions against many of these same corporate officials. Moreover, many other corporate employees have been caught up in these inquiries and have been forced to resign or have been fired for their roles in their company's stock option practices. Finally, a significant number of companies have conducted internal investigations and uncovered issues with their stock option practices, resulting in the companies now taking substantial charges for these expenses and, in many cases, actually restating their financial statements.[2]

While details of the governmental investigations have been highly publicized (and detailed on various Internet websites), there has been less public coverage of the private civil litigation that has been filed since stock option backdating became the latest "scandal du jour" for the class action bar. According to one of the few websites focusing on such civil litigation involving allegations of stock option backdating, approximately 160 companies have been sued in shareholder derivative

[1] As at least one court has recognized, "it is helpful to define some of the new jargon that has entered the corporation law lexicon as a result of the ongoing stock option backdating controversy," as detailed below:

Stock option "backdating" is a practice whereby a public company issues options on a particular date while falsely recording that the options were issued on an earlier date when the company's stock was trading at a lower price. The options are purportedly issued with an exercise price equal to the market price on the date of the option grant. But, in fact, because the grant dates were falsified, the options were "in the money" when granted.

Desimone v. Barrows, No. 2210-VCS, 2007 WL 1670255, at *6 (Del. Ch. Ct. June 7, 2007).

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[2] "Options Scorecard," *The Wall Street Journal Online* (http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html).

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lawsuits, while at least 31 securities fraud actions and at least five ERISA/401k(k) complaints have been filed.[3] However, unlike the famed ''Options Scorecard'' on website of *The Wall Street Journal* (which tracks the latest news on the progress of the SEC and DOJ inquiries, as well as internal investigations, restatements and company personnel decisions), the news about the progress of these numerous private civil actions has been more haphazard and much quieter. The intention of this article is to shed some light on what has been going on on this other side of alleged stock option backdating and, when possible, to draw some themes from court decisions and what they may mean for the future of these actions.

When the onslaught of the inevitable private civil litigation began in spring 2006 and rumbled on through 2006 and into 2007, there was skepticism by many legal commentators about whether these cases would be able to survive dismissal in light of several significant challenges, such as the possibility that backdating was coincidental, as well as obstacles such as minimal damages and statute of limitations issues.[4]

As it turned out, many of these commentators were prescient about the prospects of the private civil suits concerning allegedly improper stock option backdating. As these civil cases have made their way through motion practice, many of them have been unable to survive dismissal due to many of the defects spotted by commentators at the outset, as well as due to some unforeseen obstacles, which have made these cases difficult for the private bar to successfully prosecute.

A review of several recent federal and state court rulings on dismissal motions in stock option backdating cases reveals that many of these cases are very fact specific and, as a result, it is hard to draw from them useful points which can be extended to other cases. At least one court has noted the importance of a focus on the specific details of alleged stock option backdating in order to determine whether there is a viable basis for a civil action:

> Not each and every instance where a company has chosen the wrong measurement date is necessarily a case of backdating. Use 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. The Office of the Chief Accountant [of the Securities and Exchange Commission] recognized that determining the measurement date is a fact-specific endeavor. So too is pleading with specificity that stock options are backdated.[5]

However, these cases still have revealed several interesting themes which extend beyond the specific facts of each case and which may prove relevant to other courts confronting similar issues in the many civil cases which are still pending in courts across the country.

Adequacy of Scienter Allegations for Federal Securities Fraud Claims. Many of the civil complaints include allegations that improper statements concerning the company's stock option practices resulted in violations of Section 10(b) and Rule 10(b)(5). However, many of these 10(b) claims have failed to survive dismissal due to inadequate allegations of the required scienter element.

For example, courts have held that generic allegations that an individual defendant is a member of a company's board of directors or compensation committee—which may have approved backdated stock options—is insufficient on its own to satisfy the scienter requirement.[6] Similarly, courts have concluded that even the ''high rank'' of executives within a company does not support an allegation that ''each individual defendant had knowledge or acted with reckless disregard of the truth.''[7] Also, courts have rejected attempts to lump individual defendants together and, thus, failing to provide sufficient detail regarding each individual's role and knowledge of alleged backdating, even when the court acknowledges that ''it appears almost certain that some of the options at issue here were backdated.''[8] Thus, ''[s]imply pleading that defendants surely would have known that the statements were false by virtue of their positions at the company is not automatically sufficient to show a strong inference of deliberate recklessness.''[9]

However, plaintiffs have been successful in some cases of making sufficient scienter allegations to survive dismissal. For example, in the derivative complaint involving Zoran Corporation (a digital entertainment technology company based in Northern California), plaintiffs alleged that the company's Chief Executive Officer and Chief Financial Officer both received backdated options and later had sold some of them for substantial profits in the millions of dollars.[10] Further, plaintiffs contended that the CEO and CFO were responsible for review and certification of Zoran's financial statements and that they were ''intimately involved in deciding when and to whom options would be granted'' and that the CEO ''allegedly exercised final approval over options grants.''[11] On the basis of these more detailed allegations, the court concluded that the CEO and CFO ''would have either known, or been deliberately reckless in not knowing, that stock options were not being issued at fair market value on the date

[3] ''Counting the Options Backdating Lawsuits,'' *The D&O Diary* (http://dandodiary.blogspot.com/2006/07/counting-options-backdating-lawsuits.html#).

[4] Amanda Bronstad, ''Next Step in Stock Option Probes: 'Backdate' Lawsuits,'' *The National Law Journal* (June 9, 2006).

[5] *In re Zoran Corp. Derivative Litigation*, No. C-06-05503, 2007 WL 1650948, at * 9 (N.D. Cal. June 5, 2007).

[6] *See, e.g., In re Ditech Networks, Inc. Derivative Litigation*, No. C 06-5157, 2007 WL 2070300 (N.D. Cal. July 16, 2007).

[7] *Id.* at *6.

[8] *In re Atmel Corp. Derivative Litigation*, No. C 06-4592, 2007 U.S. Dist LEXIS 54058 at *18 (N.D. Cal. July 16, 2007).

[9] *Zoran*, 2007 WL 1650948 at *20.

[10] *Id.* at *4-5.

[11] *Id.* at *20.

Note to Readers

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of the grant.''[12] Accordingly, the court held that plaintiffs' scienter allegations were sufficient and declined to dismiss the federal fraud claims in the *Zoran* case.[13]

On the other hand, in a recent case in Delaware, the Chancery Court dismissed a derivative complaint, noting the plaintiff has pleaded ''no facts to suggest even the hint of a culpable state of mind on the part of any director.''[14] This Delaware decision also reinforces an important point about stock option cases:

> The absence of pled facts of these kinds underscores the utility of a cautious, non-generic approach to addressing the various option practices under challenge in many lawsuits. The various practices have jurisdictional implications that are also diverse, not identical, and the policy purposes of different bodies of related law (corporate, securities, and tax) could be lost if court do not proceed with prudence.[15]

Thus, it again bears repeating that the differences in the fact patterns in these cases limits the ability to draw too many overarching themes from these various stock option backdating cases.

Impact of the Statute of Limitations. When the stock option backdating frenzy emerged in spring 2006, it became apparent that this was in many ways a historical footnote because many of the alleged improper grants of options had occurred before the enactment of new rules under the Sarbanes-Oxley Act of 2002. As a result, much of the allegedly actionable conduct concerning stock option grants occurred in the late 1990s or the early 2000s and possibly outside the statute of limitations periods of the federal securities laws. As it turned out, some of the courts which have addressed this issue have agreed that much of the conduct is outside the statute of limitations of the federal securities laws and have limited how far back in time the private civil complaints can reach.

A federal securities fraud claim must be brought no later than the earlier of ''(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.''[16] As the practice of alleged backdating of stock options at various companies generally did not come to light until sometime in 2006, courts have held that the 2-year discovery period is not applicable and look instead to the 5-year limitations period as controlling how far these cases can go.[17] Thus, as many of these complaints were filed in the spring and summer of 2006, the serious question facing courts is whether plaintiffs' securities fraud claims regarding stock option conduct prior to 2001 are time barred.

In addressing this key question, many courts have concluded that such fraud claims concerning alleged backdating preceding 2001 are barred by the 5-year statute of limitations. For example, in a case from the United States District Court for the Northern District of California, one court held that ''the period of repose starts on the date that the option was made . . . [and] because the initial complaint was filed on August 23, 2006, any improper transaction under Section 10(b) must have occurred after August 23, 2001.''[18]

The courts also appear to be holding to a hard line in not allowing plaintiffs to get around the five-year statute of limitations on federal securities fraud claims, noting that ''[t]he statute of limitations is not subject to equitable tolling.''[19] Similarly, judges have indicated they are ''highly skeptical of a continuing wrong theory that would allow the revival of a time-barred claim under Section 10(b) upon the issuance of a further financial statement that failed to correct the prior false statement.''[20] Thus, at least one court had held that plaintiffs ''may not avoid the effect of the statute of limitations by combining allegations of recent financial statements and time-barred option back-dating.''[21]

While many of these civil cases are still making their way through the judicial system, the fact that the alleged backdating conduct supporting these complaints may be limited to those options issued in 2001 and later may severely limit the scope and impact of these cases because much of apparent backdating of stock options occurred prior to 2001.[22]

Impact of Admissions of Backdating and Restatements. As detailed at length on the ''Options Scorecard'' on *The Wall Street Journal* website, many companies have investigated their stock option practices and have admitted that certain options had been backdated and, as a result, many companies have taken a hit on their financial statements and, in some cases, even restated historical financial statements. Nonetheless, it is interesting to note that, notwithstanding these admissions, many civil plaintiffs have failed to successfully use such concessions of backdating to keep their claims alive.

For example, in one case, the court noted that the company had issued a press release conceding that ''the actual measurement dates for certain stock options differed from the measurement dates for such stock options'' and that ''the Company's prior financial statements could not be relied upon.''[23] Despite that admission, the court still dismissed much of the case and this admission of backdated options appeared to play little or no role in the judge's decision-making process.[24]

Similarly, Sycamore Networks, Inc. (an optical switching technology company based in Massachu-

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[12] *Id.*

[13] *Id.*

[14] *Desimone,* 2007 WL 1670255, at *16.

[15] *Id.*

[16] 28 U.S.C. § 1658(b).

[17] *See, e.g., Ditech,* 2007 WL 2070300 at *7; *Zoran,* 2007 WL 1650948 at *21 (''Outsiders like plaintiff did not have superpowers to detect secret backdating inside the company.'').

[18] *Ditech,* 2007 WL 2070300 at *7.

[19] *Id.*; *see Atmel,* 2007 U.S. Dist LEXIS 54058 at *20.

[20] *Ditech,* 2007 WL 2070300 at *8.

[21] *Atmel,* 2007 U.S. Dist LEXIS 54058 at *22; *see Zoran,* 2007 WL 1650948 at *21 (''Although plaintiff does plead that defendants kept making false statements about their past options grants, that simply does not connect nine years of option grants. Accordingly, the five-year statute of repose applies, and any claims alleging events before September 7, 2001, are time-barred, at least at the pleading stage.'').

[22] The courts' hard line on the limitations period is not limited just to Section 10(b) cases, but also extends to other federal securities law claims, such as Section 14(a) claims (with a shorter period of three years following publication of a false statement) and Section 20(a) claims (which follow the Section 10(b) period). *See, e.g., Ditech,* 2007 WL 2070300 at *8-9; *Atmel,* 2007 U.S. Dist LEXIS 54058 at *23-26.

[23] *Atmel,* 2007 U.S. Dist LEXIS 54058 at *9-10.

[24] *Id.* at *39; *see In re CNET Networks, Inc. Shareholder Derivative Litigation*, 483 F. Supp.2d 947 (N.D. Cal. 2007) (dismissal of case despite restatement and additional expenses of nearly $106 million resulting from mispricing of stock options for accounting purposes).

setts) publicly disclosed that a number of options between 1999 and 2001 were incorrectly accounted for under generally accepted accounting principles and, subsequently, restated its earnings for several years and took an additional charge of nearly $30 million as a result of the incorrect accounting.[25] Despite Sycamore's admissions of backdating of stock options, the derivative complaint was dismissed in its entirety in a detailed and thoughtful opinion by the Delaware Chancery Court, which clearly was not swayed by these admissions.[26]

Thus, in referring to restated financial statements due to discovery of improper accounting for stock options, at least one court noted that ''plaintiffs may not rely on them as an automatic admission of fraud.''[27]

While many of the civil complaints discussed above have failed to survive dismissal motions, other cases have been able to move forward, such as the *Zoran* case. One of the most notable cases to survive a dismissal motion involves United Health Group (a major health care services company based in Minnesota), which was one of the companies featured in the initial article in *The Wall Street Journal* which helped set off the regulatory and litigation focus on stock option backdating.[28]

In ruling on defendants' motion to dismiss the federal securities law claims involving United Health, the district court made its intentions clear when noting at the outset of the opinion that, ''[n]otwithstanding counsel's siren's song, the Court persists in its belief that two plus two equals four.''[29] The district court's decision in *United Health* did not get any better for the defendants:

> The Court wishes to be explicit: it expresses—and harbors—no opinion as to the ultimate merits of this case. But it has eyes to see, as well as a mind to perceive, the nature of plaintiffs' claims. Plaintiffs' claims are nowhere as complex as defense counsel suggest. If plaintiffs are correct, this case is incredibly simple. Plaintiffs claim defendants were playing a game with a stacked deck. When awarded options, with deliberately selected grant dates which were already in the money, defendants were playing a game they knew they could not lose; and, unsurprisingly, defendants won.

If the Minnesota district judge did not make his feelings sufficiently obvious, he concluded his decision with a detailed reference to a famed movie from the 1970s —which made his views abundantly clear:

> Interestingly, plaintiffs' theory has been examined in the public media for years. Indeed, it has won several Academy Awards. Plaintiffs' theory lies at the core of the plot of one of Hollywood's most entertaining and honored films. In *The Sting*, the bad guy is ultimately brought down by utterly charming con men, played by Paul Newman and Robert Redford. *The Sting* (Universal Pictures, 1973). They gain their revenge through a scheme involving ''past-posting,'' or betting on horse races after the results are known. The Court expresses not the slightest opinion as to whether such shenanigans occurred here, but such is the essence of plaintiffs' theory. It is a poker axiom that if a payer has his knees under the table and cannot tell who the sucker is, he's it. In this game, according to plaintiffs, the patsy was either the hapless corporation, which in varying ways the defendants controlled, or the corporation's shareholders, whose equity provided the game's antes and bloated pot. That's it. A claim has been stated.[30]

And with those pithy references, the district court rejected the dismissal motions and permitted the United Health class action to proceed.

Not only have some stock option backdating class actions survived dismissal, but at least one such case has actually settled with payments to members of the class. On April 13, 2007, Newpark Resources, a Texas-based oil and gas exploration services company, announced the settlement of shareholder class action and derivative litigation. According to the press release announcing the settlement, these lawsuits were filed after Newpark disclosed an internal investigation into various potential irregularities, including ''alleged improper granting, recording and accounting of backdated grants of stock options to executives.''[31] Pursuant to the preliminary settlement (subject to court approval), the company and the directors and officers' liability insurance carrier together would pay nearly $10 million to settle all claims with the class. Interestingly, the company's press release noted that ''the Company is preserving certain claims that it may have against its former CEO and CFO for matters arising from . . . the backdating of options.''[32]

While there have been a few notable successes in the civil arena, many of the private class actions involving allegations of improper stock option backdating have been dismissed or failed to gain much traction in the courts.[33] As noted at the outset, it is difficult to draw too many general themes from these decisions because the stock option practices of each company are highly fact-specific. Nevertheless, many of the problems with these cases originally noted when these complaints were first being filed in the spring of 2006, in fact, have emerged as significant obstacles to many of the private civil lawsuits alleging improper backdating of stock options. Time will only tell whether these first few decisions dismissing these complaints are outliers to be ignored or a sign of further things to come.

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[25] *Desimone,* 2007 WL 1670255, at *10.

[26] *Id.* at *33.

[27] *CNET,* 483 F. Supp.2d at 963.

[28] *In re United Health Group PSLRA Litigation*, No. 06-CV-1691, slip op. (D. Minn. June 4, 2007).

[29] *Id.* at p. 1.

[30] *Id.* at pp. 3-4.

[31] ''New Park Resources Announces Settlement of All Outstanding Shareholder Litigation,'' April 13, 2007 (http://www2.newpark.com/phoenix.zhtml?c=107117&p=irol-newsArticle&ID=984679&highlight=).

[32] *Id.* It also is interesting to note that several other stock option backdating cases have settled with the nominal payment of attorneys' fees and no additional payments. *See, e.g.,* Jaime S. Jordan, ''Dean Foods cleared of backdating stock options,'' *Dallas Business Journal* (May 11, 2007).

[33] *See, e.g., In re Mercury Interactive Corp. Derivative Litigation,* No. C-05-3395, 2007 WL 2209278 (N.D. Cal. July 30, 2007); *In re Computer Sciences Corporation Derivative Litigation*, Nos. CV 06-05356 & 06-06512, 2007 WL 2274951 (C.D Cal. July 24, 2007); *In re Openwave Systems Inc. Derivative Litigation*, No. C 06-03468, 2007 WL 1456039 (N.D. Cal. May 17, 2007); *Wandel v. Eisenberg*, No. 603665/06, slip op. (N.Y. Sup. Ct. May 3, 2007) (dismissal of claims against members of the board of directors of Bed Bath and Beyond).

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