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STOCK OPTION BACKDATING: THE SCANDAL, THE MISCONCEPTION & THE LEGAL CONSEQUENCES

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With the barrage of recent corporate scandals, including the well-publicized fall of Enron,[1] a recent closer scrutiny of corporate executive practices has brought to light additional corporate malfeasance in the form of stock option backdating.[2] This paper will familiarize and clarify which corporate practices regarding backdating are legal versus those that are illegal, thereby subjecting companies and individuals to violations of state and federal law.

I. WHAT IS A STOCK OPTION AND HOW CAN IT BE BACKDATED TO CREATE AN ADVANTAGE?

A stock option gives the recipient of the grant the right to buy a company's stock at a certain exercise or "strike" price.[3] There

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[1] *See* Edward Iwata, *Are Firms' Internal Inquiries Too Cozy?*, USA TODAY, May 24, 2007, at 1B (mentioning the Enron accounting scandal); *see also* Joann S. Lublin & William M. Bulkeley, *IBM Ends Director Stock Options, Spotlighting Popular Perk's Decline*, WALL ST. J., Dec. 21, 2006, at A1 (acknowledging the heavy backlash after big corporate scandal such as the accounting frauds at Enron Corp and WorldCom Inc).

[2] *See* Adams v. Amdahl, No. C06-0873RSL, slip op. at *3 (W.D. Wash. Sept. 12, 2006) ("When plaintiff complains of the 'backdating' of options, the alleged illicit practice is more thoroughly described as the granting of below-market options to purchase stock and the failure to report those options as compensation"); *see also* Patrick Richard et al., Commentary, *Backdating is Not Always Fraudulent: How to Distinguish Between Lawful and Fraudulent Ratification*, 22 No. 5 ANDREWS CORP. OFF. & DIRECTORS LIAB. LITIG. REP. 2 (2006) (stating that the "'backdating scandal' . . . [is] about certain directors and officers who secretly manipulated an otherwise appropriate corporate-governance technique to hide their true compensation levels from stockholders, regulators and the Internal Revenue Service").

[3] *See* Charles Forelle & James Bandler, *The Perfect Payday---Some CEO's Reap Millions By Landing Stock Options When They Are Most Valuable; Luck---Or Something Else?*, WALL ST. J., Mar. 18, 2006 at A1 (hereinafter *Perfect Payday*) (discussing how

are two types of option grants given to executives, those termed "at the money"[4] and those termed "in the money."[5] "At the money" options are those in which the fair market value of the stock is assigned to the option on the date the option is granted to the recipient.[6] The recipient can then only profit if the stock increases following the grant.[7] "In the money" options are those that have an exercise price below the fair market value at the time of the grant, and therefore, already have value at the time of the grant.[8] Typically options are granted at the money, with the value of the stock being set at the current fair market value[9]

CEO's use stock options effectively); *see also* Charles Forelle & James Bandler, *Dating Game---Stock-Options Criminal Charge: Slush Fund and Fake Employees --- U.S. Accuses 3 Ex-Executives at Comverse Technology of Long-Running Scheme--- Scrambling to Avoid Detection*, WALL ST. J., Aug. 10, 2006 at A1 (hereinafter *Slush Fund and Fake Employees*) (noting that stock options "have become the primary form of compensation for many top executives").

[4] *See* Charles Forelle, *KLA Finds Options-Dating Problem --- Internal Probe May Lead to an Accounting Charge, Restatement of Earnings*, WALL ST. J., Jul. 1, 2006 at A3 (describing "at the money" options); *see also* Erik Lie, Backdating of Executive Stock Option (ESO) Grants, http://www.biz.uiowa.edu/faculty/elie/backdating.htm (last visited May 26, 2007) (defining that "at the money options" as those usually granted for executive stocks).

[5] Charles Forelle & James Bandler, *Backdating Probe Widens as 2 Quit Silicon Valley Firm --- Power Integrations Officials Leave Amid Options Scandal; 10 Companies Involved So Far*, WALL ST. J., May 6, 2006 at A1 (discussing "in the money" options); William B. Mateja & Lezlie B. Willis, *Backdating Stock Options: In the Money and Under Investigation: What the Government is Doing and What You Should Do in Response*, 22 No. 5 ANDREWS CORP. OFF.. & DIRECTORS LIAB. LITIG. REP. 4 (2006) ("To be completely free from scrutiny, an option's exercise price should be the same as the fair market value on the day of the grant.").

[6] *See* Forelle, *supra* note 4, at A3 (noting that these options were formerly accorded preferential treatment); *see also* Lie, *supra* note 4 (stating that stock options are granted at the money when "the exercise price of the options is set to equal the market price of the underlying stock on the grant date.").

[7] *See* Forelle, *supra* note 4, at A3 (explaining that an "at the money" option only has value if the fortunes of shareholders improve); *see also* Mateja & Willis, *supra* note 5 (positing that the option does not have any inherent value when granted if the exercise price is "the same as the fair market value on the day of the grant").

[8] *See* Forelle & Bandler, *supra* note 5, at A1 ("'[I]n the money' options [are] those that carry an exercise price below the market price at the time of the grant."); *see also* Mateja & Willis, *supra* note 5 ("[W]hen options are granted at an exercise price that is lower than the fair market value of the option at the time of the grant, the option already has some intrinsic value and is, consequently, 'in the money' . . . ").

[9] *See* Forelle, *supra* note 4, at A3 ("Options entitle the recipient to profit when shares rise above the 'strike price,' normally set to equal the market value on the grant date."); *see also* Lie, *supra* note 4 (explaining that the executive stock options are "usually granted-at-the money").

Stock options have been the primary form of compensation for executives since the early 1990s,[10] and were originally instituted to align executives' interests with those of the shareholders.[11] The theory was that, by giving executives a stake in the company's future success, the executives would have additional incentive to improve the health and value of the company.[12] Proponents of stock options, such as Frederic W. Cook, a New York compensation consultant, call the stock option "the most perfect equity derivative that's ever been invented: It's simple, elegant, easily understood, and it gives you a little piece of the action."[13] However, critics advocate the banning of stock options, calling them the "gold mine that has enriched the world's executive class by untold billions over the past few decades."[14] The proponents may have a point when it comes to "at the money" options, as corporations have wide latitude when it comes to executive compensation.[15] However, with "in the money" options, the executive made money on paper when he received the grant and, therefore, the incentive to improve company performance is vastly diminished.[16]

[10] *See Slush Fund and Fake Employees*, *supra* note 3, at A1 ("Stock options . . . have become the primary form of compensation for many top executives"); *see also* Steve Stecklow, *Options Study Becomes Required Reading*, WALL ST. J., May 30, 2006 at B1 ("Companies routinely issue stock options . . .").

[11] *See* Lublin & Bulkeley, *supra* note 1, at A1 ("Stock options [were] long touted by many companies as a vital tool for rewarding board members and aligning their interests with those of shareholders."); *see also* Mark Maremont & Charles Forelle, *Open Spigot: Bosses' Pay: How Stock Options Became Part of the Problem --- Once Seen as a Reform, They Grew Into Font of Riches And System to Be Gamed --- Reload, Reprice, Backdate*, WALL ST. J., Dec. 27, 2006 at A1 ("[Stock options] were the ideal carrot, an incentive for good work that aligned executives' interests with those of shareholders.").

[12] *See Slush Fund and Fake Employees*, *supra* note 3, at A1 (explaining that stock options gave "recipients an incentive to make the stock rise and profiting them only if it does"); *see also* Stecklow, *supra* note 10, at B1 (stating that "stock options [were issued] as an incentive for executives to improve their firms' performance and share prices.").

[13] Maremont & Forelle, *supra* note 11, at A1 (quoting one of the numerous defenders of stock options who say options "shouldn't be judged by a few giant packages").

[14] Steve Maich, *Why Stock Options Should Be Banned*, 37 MACLEAN'S 31, Jan. 1-8, 2007, at 31 (citing author who advocates a complete ban of stock options).

[15] *See* Forelle & Bandler, *supra* note 3, at A1 ("Companies have a right to give executives lavish compensation if they choose to . . ."); *see also* Richard et al., *supra* note 2, at 2 ("Directors have a great deal of discretion over their company's compensation structure . . .").

[16] *See Slush Fund and Fake Employees*, *supra* note 3, at A1 (describing backdated stock options as giving the recipient a paper gain right from the start); *see also* Lublin & Bulkeley, *supra* note 1, at A1 (stating that "IBM also believes options tend to make recipients

"Backdating" occurs when "in the money" options are reported as "at the money" options; that is, options are actually approved after the listed grant date, and backdated so it appears that the options were granted earlier.[17] In other words, the date stamped on the options grant, or strike price, is not actually the date the options were approved and signed, but an earlier date that was picked for its low closing stock price.[18] Therefore, when the options are actually approved, usually by the compensation committee, they are already in-the-money because they have been purposely backdated to a date with a lower stock price.

II. IS BACKDATING ILLEGAL?

The real confusion in the scandal stems from the fact that backdating in and of itself is not illegal.[19] Executives are allowed to backdate stock options, or any type of resolution, through a process called ratification, which gives retroactive effect to resolutions passed by the directors' or the board as part of regular corporate governance.[20] However, the government only allows directors to retroactively authorize when "proper procedures are followed and the necessary disclosures are made."[21] This is where a plethora of executives have gotten themselves, and their companies, into major trouble.

more oriented toward short term results than they are with other forms of compensation.").

[17] *See* Mateja & Willis, *supra* note 5 (elaborating on in-the-money options and backdating); *see also* Lie, *supra* note 4 (describing backdating).

[18] *See* Adams v. Amdahl, No. C06-0873RSL, slip op. at *8 (W.D. Wash. Sept. 12, 2006) (discussing how backdated option grants "give an executive the option to purchase stock in the company at a cost equal to the price of the stock at some arbitrary date in the past, such as a date during which the price of the stock was low"); *see also Slush Fund and Fake Employees, supra* note 3, at A1 (describing the strike price set for stock options).

[19] *See* Mateja & Willis, *supra* note 5 (explaining that "backdated options that have been *properly* reported and accounted for are neither illegal nor improper."); *see also* Corilyn Shropshire, *Black Box Stock Option Backdating Controversy Sheds Light on Practice,* PITTSBURGH POST-GAZETTE, Dec. 3, 2006 (revealing that backdating is not illegal and is defended by advocates).

[20] *See* Kalageorgi v. Kamkin, 750 A.2d. 531, 539 (Del. Ch. 1999) (referring to ratification as a legal device); *see also* Richard et al., *supra* note 2, at 2 (stating that backdating has "long been a common and useful corporate-housekeeping tool").

[21] Richard et al., *supra* note 2 (citing Kalageorgi v. Victor Kamin, Inc., 750 A.2d 531, 539–40 (Del. Ch. 1999)) (indicating that the "court permitted a board to use the ratification device to retroactively authorize a grant of stock shares to the directors themselves, even though that ratification effectively backdated the directors' stock grants by almost 10 years.").

In order for backdating to be legal, it must be clearly communicated to shareholders as it creates instant in-the-money profits for the executive granted the options, and it is the shareholders who are paying the extra compensation.[22] In order to be communicated to shareholders, this extra compensation must be properly reflected as a negative in the earnings expenses under the accounting rule in effect until 2005.[23] Under this rule, at-the-money options did not have to be reported, unlike in-the-money options.[24] This requirement was frequently not met when companies failed to report in-the-money options, in effect, pretending they were at-the-money. As a result, many of the companies under investigation have had to reduce their earnings in restatements to the SEC for past years in order to account for the additional compensation to executives.[25] This means that shareholders were buying/selling stock using reported company earnings numbers that were higher than what the company actually earned. This resulted because the earnings numbers were not downwardly adjusted for the additional executive compensation attributed to the unreported in-the-money options. This, in effect, perpetuated a fraud on the shareholders.[26] It also caused

[22] *See Slush Fund and Fake Employees*, *supra* note 3, at A1 (quoting the Deputy attorney general as saying that "without honest disclosure, those options are simply theft from shareholders"); Shropshire, *supra* note 19 (revealing the SEC's concern about the failure to disclose backdating to shareholders); Lie, *supra* note 4 (listing requirements for backdating legality).

[23] *See* Forelle & Bandler, *supra* note 5, at A1 (stating that under accounting rules, companies need to report an expense for grants of in the money options which would include any options backdated to a day when the stock was lower); *see also* Lie, *supra* note 4 (outlining the in the money options and the corresponding accounting rule).

[24] *See* Erik Lie, Testimony of Erik Lie Before the U.S. Senate Comm. on Banking, Hous., & Urban Affairs, Sept. 6, 2006 (noting that the Accounting Principles Board (APB) opinion No. 25, which was phased out in 2005, had the effect that companies did not have to expense at the money options, only ones that were in the money); *see also* Lie, *supra* note 4 ("Under APB 25, the accounting rule that was in effect until 2005, firms did not have to expense options at all unless they were in-the-money.").

[25] *See* Maich, *supra* note 14, at 31 (positing that Monster understated its options costs by $339.6 million over 6 years and Home Depot, $200 million over 25 years); *see also* James Bandler & Robert Tomsho, *KLA-Tencor Officials Depart Over Options Dating*, WALL ST. J., Oct. 17, 2006, at A2 (explaining that Altera Corporation, as a result of faulty accounting, will restate its earnings downward by $35.2 million from 1996-2005); Lie, *supra* note 4 (noting that the new FAS 123R has changed the APB 25 accounting rule as of 2005, so that even at-the-money options need to be expensed).

[26] *See* Mike Rogoway, *Feds Plan Backdating Inquiry in Oregon*, THE OREGONIAN, Oct. 26, 2006 (stating that "if companies backdate grants without shareholders' permission, the companies may be committing fraud."); *see also Bay Area Federal Task Force Targets Stock-Option Backdating*, 12 No. 20 ANDREWS DERIVATIVES LITIG. REP. 3 (2006) [hereinaf-

damage to companies, as these executives are paying less to the company for the stock than they should have.[27]

Secondly, legal backdating must be reflected in taxes by both individual executives and the company.[28] For the company, in-the-money options can cause an excess of allowable limits on deductions for the compensation of its executives.[29] Therefore, if the company treated in-the-money options as being at-the-money (probably as a result of some type of improper backdating), it is guilty of violating the tax laws.[30] This behavior can subject the company to an audit, followed by the revocation of large past deductions with interest and penalties added to the totals.[31] For individual executives, having in-the-money instead of at-the-money

ter *Bay Area Task Force*]. (quoting the San Francisco US Attorney as stating that "[f]alsification or backdating of financial documents . . . can constitute fraud on the company, shareholders and the market.").

[27] *See Bay Area Task Force*, *supra* note 26 (providing that backdating is a "windfall for the insider but shortchanges the company itself, which gets paid less for its stock"); *see also Analog Devices Seeks Dismissal of Suit Over Stock-Option Backdating*, 22 No. 4 ANDREWS CORP. OFF. & DIRECTORS LIAB. LITIG. REP. 6 (2006) (outlining the suit by shareholders claiming that when "the recipient pays less to acquire the stock and receives compensation he or she is not entitled to . . . the company also receives less money than it should.").

[28] *See* Edward Kirk, *The Options Backdating Scandal; Did Officers Profit From "Blind Luck" or A Rigged System?*, PROF'L LIAB. UNDERWRITING SOC'Y JOURNAL (2006), *available at* http://www.sdma.com/files/Publication/ e522581f-c91e-4cad-b73d-021c732a328a /Presentation/ PublicationAttachment/4333f591-e194-4478-bf18-074277aae599 /EKirk%20Reprint.pdf ("Backdating of ESOs is not necessarily illegal if the practice is clearly communicated to shareholders and properly reflected in earnings and taxes."); *see also* Lie, *supra* note 4 (asserting that backdating must be "properly reflected in taxes").

[29] *See* Mateja & Willis, *supra* note 5. In the money options may cause the company to exceed the limits on deducting expenses for executive compensation. Under Section 162(m) of the Internal Revenue Code, a public company is allowed to make a tax deduction up to one million dollars for compensation paid to its CEO and 4 highest-paid officers other than the CEO with the exception to this if the compensation is "performance based." In short, at-the-money options are performance based and can be deducted even if they exceed one million. However, in-the-money options are not exempt from the one million dollar limit. *See also* Lie, *supra* note 4. Section 162(m) of the Internal Revenue Code that results in at-the-money options being "considered performance-based compensation, and can be deducted for tax purposes even if executives are paid in excess of $1 million." *Id.* "However, if the options were effectively in-the-money on the decision date, they might not qualify for such tax deductions." *Id.*

[30] *See* Forelle & Bandler, *supra* note 5, at A1 (noting that companies may be subject to past income taxes as a result of backdating); *see also* Mateja & Willis, *supra* note 5 (pointing to the risk of audits, tax disallowance, and potential interest and penalties).

[31] *See* David Cay Johnston, *Tech Company Settled Tax Case Without an Audit*, N.Y. TIMES, Aug. 10, 2004, at C1 (stating that Micrel Inc., of San Jose, California, had a backdated stock options tax bill calculated to be as much as $58 million from just 3 years); *see also* Mateja & Willis, *supra* note 5 (citing the tax ramifications to companies who have improperly reported stock options).

options can also drastically affect their tax bills.[32] Therefore, as a result of unreported backdated options, both the company and individuals are guilty of tax fraud, prosecutable by the Internal Revenue Service,[33] and subject to lawsuits from the SEC and individual shareholders.[34]

III. UNVEILING THE SCANDAL

The first to recognize the problem of improper backdating was David Yermack, a researcher from New York University, who, in 1997, found that stock prices tend to increase following the issuance of stock option grants.[35] However, no alarms sounded, as the first company did not come under attack for the practice until August 2004.[36] The business community first took notice of the backdating problem when Erik Lie, a University of Iowa researcher released a study in May 2005 of unscheduled executive

[32] *See* Mateja & Willis, *supra* note 5 (pointing out that Section 409A of the Internal Revenue Code classifies in-the-money options as "nonqualified deferred compensation" and subjects the recipient to "significant taxes, penalties, and interest from the date of the option vesting," and suggesting that since the original options were likely characterized as being at-the-money, the executive likely never paid the required taxes under 409A); *see also* Lie, *supra* note 4 (commenting that the exercise price affects individual option recipients).

[33] *See* Eric Dash, *Dodging Taxes Is a New Wrinkle in the Stock Options Game*, N.Y. TIMES, Oct. 30, 2006, at C1 (positing that "backdating an exercise date can result in tax fraud"); *see also*, Lie, *supra* note 4 (discussing how treating an in-the-money decision as at-the-money would violate Section 162(m) of the Internal Revenue Code).

[34] *See* Mateja & Willis, *supra* note 5 (commenting that companies have to face the consequences, including civil lawsuits brought by the government and individuals); *see also* Shropshire, *supra* note 19 (stating that "failing to disclose backdating to shareholders or reporting for tax purposes" opens the company up to lawsuits).

[35] *See* Mark Maremont, *Authorities Probe Improper Backdating of Options---Practice Allows Executives to Bolster Their Stock Gains; A Highly Beneficial Pattern*, WALL ST. J., Nov. 11, 2005 (commenting that Yermack is credited with the earliest research on option-grant timing); *see also* Lie, *supra* note 4 ("He attributed most of this pattern to grant timing, whereby executives would be granted options before predicted price increases. This pioneering study was published in the *Journal of Finance* in 1997."); Stecklow, *supra* note 10, at B1 ("For years, academics who study corporate finance were aware of a statistical pattern that showed share prices often rose quickly after options were granted--a paper by David Yermack, an associate professor of finance at New York University's Stern School of Business, documented the phenomenon about a decade ago. He and other researchers speculated the rise might be due to corporate executives who knew that good news was on the horizon and made sure options were granted beforehand.").

[36] *See* Johnston, *supra* note 31, at C1 (discussing how Micrel came under fire only because an IRS whistleblower opened herself up to criminal charges); *see also* Lie, *supra* note 4, (noting IRS auditor turned down a secret deal).

stock option awards.[37] Lie found that stock prices fell just before unscheduled option awards, and stock prices increased afterward, suggesting they had been manipulated.[38] The SEC began to investigate, and the Wall Street Journal picked up the scent and published its first article highlighting the backdating scandal in November 2005.[39] The scandal then grew exponentially in the years that followed.[40]

From November 2005 to early 2006, the Securities and Exchange Commission investigated only about a dozen companies.[41] By the end of 2006, the number of companies under suspicion ballooned to one hundred thirty,[42] and either by resignation or ousting, over thirty top executives have met their departure as a result.[43] This, however, is by no means the end according to some experts.[44] In a study released in December 2006, researchers at

[37] *See* Geoffrey Colvin, *A Study in CEO Greed; How one intrepid academic exposed the latest stock option scandal*, FORTUNE, May 30, 2006, at 53 (highlighting Lie's massive study of 5,977 option grants between 1992 and 2002); *see also* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005).

[38] *See Perfect Payday*, *supra* note 3, at A1 (noting that Lie's study "found that share prices generally fell before option grants and rose afterward," and that grants were given at favorable times with grant dates filed retroactively); *see also* Lie, *supra* note 37, at 810 (concluding "abnormal stock returns are negative" before unscheduled executive option awards and positive afterward).

[39] *See* Maremont, *supra* note 35 (outlining the scandal and the misdeeds of Mercury Interactive Corp.); *see also* Lie, *supra* note 4 ("Prompted by the Mercury case and other SEC investigations, the *Wall Street Journal* (WSJ) ran a big story on the issue of backdating on November 11, 2005.").

[40] *See* Colvin, *supra* note 37, at 53 (referring to the backdating problem as a "mushrooming scandal"); *see also* Forelle & Bandler, *supra* note 5, at A1 (discussing how "[t]he stock-options backdating scandal continued to intensify" and noting that the resignations of the Chairman and CFO of Power Integrations, Inc. were just two of numerous resignations related to the stock-options-dating matter).

[41] *See Perfect Payday*, *supra* note 3, at A1 (indicating that the SEC is investigating "a dozen companies' option grants . . ."); *see also* Maremont, *supra* note 35, at A1 (stating Mercury Interactive Corporation is "one of about a dozen companies" being investigated by SEC).

[42] *See* Maremont & Forelle, *supra* note 11, at A1 (stating "[a]t least 130 U.S. corporations" were being investigated for backdating option grants); *see also* News Release, California State Senator, Phil Angelides, California Treasurer Angelides Urges Calpers and Calstrs to Take Tough Action Against KB Home Executives (Nov. 15, 2006), *available at* http://www.treasurer.ca.gov/news/releases/2006/20061115_kbhomes.pdf (highlighting that news reports indicate more than 130 companies were under investigation for improperly dating option grants).

[43] *See* Dash, *supra* note 33, at C1 (highlighting as investigation progressed at least 46 executives and directors lost jobs); *see also* Bandler & Thomsho, *supra* note 25, at A2 (indicating that by October 2006, more than 30 executives and directors lost their jobs).

[44] *See generally* Lucian Bebchuk et al., *Lucky CEOs* (John M. Olin Ctr. For Law, & Econ., & Bus., Discussion Paper No. 566, 2006), *available at* http://www.law.harvard.edu

Harvard Law School found that about 460 firms (seven percent of all publicly traded companies), and 1400 outside directors were associated with events produced by fraudulent backdating of stock options.[45] While not all of these options were fraudulently granted, with estimates in the hundreds, the amount of companies under investigation is likely to extend well beyond a mere one hundred thirty. At least one research professor needs to back pedal; in 2006, David Aboody was quoted as stating that "backdating would be such a 'brazen' attempt to line one's pockets that he'd be surprised if it was widespread."[46] He was "shocked" that CEOs would steal money from their own companies and engage in "criminal activity."[47] At this point, however, this type of cock-eyed corporate confidence has no doubt been dispelled.

According to reports, companies under suspicion have already been subjected to charges amounting to over $5 billion dollars.[48] Experts predict this figure "is going to get a lot higher."[49] This is no doubt an unsettling fact for most investors, especially since CFO.com reported that companies caught up in the backdating

/programs/olin_center/papers/pdf/Bebchuk_et%20al_566.pdf (highlighting use of stock option manipulation was not limited); *see also* Lucian Bebchuk, et. al., *Lucky Directors*, at 2 (John M. Olin Ctr. For Law, & Econ., & Bus., Discussion Paper No. 573, 2006), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_et%20al _573.pdf (noting 9% of all director stock option grants given on days when stock price equal to monthly low); *see also* Angelides, *supra* note 42, at 4 (asserting 130 investigations in progress "may only be the tip of the iceberg").

[45] *See* Bebchuk, *supra* note 44 at 2; Eric Dash, *Study Finds Outside Directors Also Got Backdated Options*, N.Y. TIMES, Dec. 18, 2006, at C2 (mentioning study concluded board members of about 460 companies probably received manipulated options); *see also* Lublin & Bulkley, *supra* note 1, at A1 (discussing academic study found as many as 1,400 outside board members received questionable option grants).

[46] Forelle & Bandler, *supra* note 5, at A1 (quoting David Aboody, associate professor at the Anderson School of Management of University of California).

[47] *See* Maremont, *supra* note 35, at A1 (highlighting skepticism of researcher David Aboody, that "hundreds of companies" were engaged in "criminal activity"); *see also* Charles Forelle, *How the Journal Analyzed Stock Option Grants*, WALL ST. J., Mar. 18, 2006, at A5 (asserting David Yermack's view that numbers in stock manipulation study should not be thought of as "precise figures").

[48] *See* Dash, *supra* note 33, at C1. "Companies have taken charges totaling $5.3 billion to account for the impact of improper grants, according to Glass Lewis & Company, a research firm that advises big investors on shareholder issues." *Id.* Similarly, the *San Francisco Chronicle* reported companies were charged 5.2 billion to correct backdating. *See* Stephen Taub, *The Mounting Costs of Backdating Options* (Oct. 26, 2006), http://www.cfo.com/article.cfm/8097059?f=search.

[49] Taub, *supra* note 48 (quoting Todd Fernandez, senior research analyst at Glass Lewis).

scandal have seen their "collective market capitalizations drop by $5.1 billion the day after each company announced its exposure to the problems."[50]

IV. THE SCANDAL'S MAJOR PLAYERS

There are a variety of schemes attributed to the backdating scandal, and a number of very prominent companies caught up in the malfeasance. Among the most prominent has been UnitedHealth Systems, one of the nation's two largest health insurers with market capitalization in the billions.[51] It was also one of the first to be investigated for improper stock option grants.[52] The major red flag for this company was the opportunistic timing of a grant to its CEO, William McGuire, who received what the Wall Street Journal describes as "one of the most lucrative stock-option grants ever."[53] The entire package included 14.6 million options that, if completely exercised today, would be worth about $756 million.[54] Luckily for McGuire, this grant was dated on the day UnitedHealth hit its lowest stock price of the year.[55] As an even bigger stroke of luck, options granted to McGuire in 1997 and 2000 were given the price of the stock on the lowest closing date for those years.[56] Statistics reviewed by a professor of fi-

[50] *Id.* (reporting further findings of Glass Lewis).

[51] *See* Eric Dash & Milt Freudenheim, *Chief Executive at Health Insurer Is Forced Out in Options Inquiry*, N.Y. TIMES, Oct. 16, 2006 at A1 (citing market capitalization for UnitedHealth of $66 billion in October 2006); *see also* Iwata, *supra* note 1, at 1B (mentioning large market capitalization of UnitedHealth).

[52] *See Perfect Payday*, *supra* note 3, at A1 (outlining advantageous nature of stock option grants to UnitedHealth CEO William McGuire); *see also* Lie, *supra* note 4 (suggesting March 18, 2006 Wall Street Journal Article identified UnitedHealth Group as company that likely backdated options).

[53] *Perfect Payday*, *supra* note 3, at A1.

[54] *See id.* ("So far, he has exercised about 5% of them, for a profit of about $39 million. As of late February he had 13.87 million unexercised options left from the October 1999 tranche. His profit on those, if he exercised them today, would be about $717 million more."); *see also* Bill McClellan, *Journal Story Builds Case for Crackdown on Stock Options*, ST. LOUIS POST-DISPATCH, Mar. 20, 2006, at B1 (describing McGuire's executive compensation).

[55] *See* Dash & Freudenheim, *supra* note 51, at A1 (mentioning that 3 of McGuire's option grants issued were "priced at the stock's lowest price that year"); *see also Perfect Payday*, *supra* note 3, at A1 ("The 1999 grant was dated the very day UnitedHealth stock hit its low for the year.").

[56] *See* Dash & Freudenheim, *supra* note 51, at A1 (stating that "among the most substantial and egregious" options "were those awarded to Dr. McGuire"); *see also Perfect Payday*, *supra* note 3, at A1 (highlighting gratuitous grants given to McGuire).

nance put the odds of such gratuitous timing as exceeding one in 200 million.[57] In addition, as a result of the SEC's investigations, McGuire was forced to resign in October 2006 and dismantle part of his $1.1 billion dollar stock portfolio.[58] The company has been forced to restate its earnings in an amount estimated by reports as ranging from $286 million to $1.6 billion.[59] The company's internal investigation claims that "inadequate internal controls" are to blame and that executives were entitled to rely on accounting statements.[60]

The executives at Comverse Technology had a different idea about what to do with their stock options; they created a slush fund of compensation in the form of board-approved backdated options handed out at will to employees.[61] Employees were created out of thin air, and granted options, which were then placed into the slush fund account.[62] When the SEC began to investigate, executives attempted to conceal this fund.[63] This was only

[57] *See* Forelle, *supra* note 47, at A1 (detailing David Yermack's findings); *see also* David Phelps, *SEC Looks at Option Plans like that of UnitedHealth; Fortuitously Timed Stock Grants Have Drawn Federal Scrutiny*, STAR TRIB., Mar. 21, 2006, at 1D ("A finance professor at New York University, David Yermack, said the odds of picking those days when the stock was that depressed were 'astronomical.'").

[58] *See* Dash & Freudenheim, *supra* note 51, at A1 (discussing McGuire's portfolio and forced resignation); *see also* James P. Miller, *Arrow from the Heartland Wounds Corporate America*, CHI. TRIB., Dec. 3, 2006, at 1 (commenting on McGuire's resignation).

[59] *See* Dash & Freudenheim, *supra* note 51, at A1 ("UnitedHealth said in May that restating could cut as much as $286 million from profits for 2003, 2004 and last year."); *see also* Iwata, *supra* note 1, at 1B (reporting that "UnitedHealth announced a $1.6 billion restatement"); *see also* Maremont & Forelle, *supra* note 11, at A1 (stating that UnitedHealth "said it will have to restate past earnings by as much as $1.7 billion.").

[60] *See* Dash & Freudenheim, *supra* note 51, at A1 (describing internal investigative findings); *see also* Forelle & Bandler, *supra* note 5, at A1 (mentioning UnitedHealth's statement of their internal probe).

[61] *See Slush Fund and Fake Employees, supra* note 3, at A1 (detailing Comverse's slush fund and how it was "populated"); *see also Law Firms Fight for Lead Role in Comverse Backdating Suits*, 22 No. 5 ANDREWS CORP. OFF. & DIRECTORS LIAB. LITIG. REP. 12 (2006) (stating shareholders' claims that "the defendants knowingly made material misstatements and omissions regarding the actual dates of stock-option grants").

[62] *See Slush Fund and Fake Employees, supra* note 3, at A1 (describing "the slush fund" and how "dozens of phony employee names" were created that allowed for "[h]undreds of thousands of options" to be "approved with no real recipient"); *see also* Edward Iwata, *Lawyer to Pay $3.1M over Comverse Stock Options*, USA TODAY, Jan. 10, 2007, at 5B (outlining Comverse's slush fund scheme).

[63] According to the FBI, Comverse omitted the page about the slush fund options when submitting documentation to auditors. In addition, an executive also attempted to change the date when the slush fund was closed, and cover it up by trying to reverse it and making minor changes to "every account record, to cover up his tampering." *Slush Fund and Fake Employees, supra* note 3, at A1. "According to court filings, Alexander and Kreinberg

the tip of the iceberg when it came to company's founder, Kobi Alexander, and the backdating scam at Comverse. Executives were also personally receiving millions in backdated options as compensation.[64] The FBI proceeded to file charges against Alexander for the scheme after the SEC calculated the extra profits (and cost to the company) on one option grant was $130 million for recipients.[65] Charges were also filed against the company's lawyer, William Sorin, and its CFO, David Kreinberg.[66]

The scam apparently worked with Alexander initially deciding to grant options, next choosing a favorable grant date at a low stock price, and then, inciting other executives to trick the compensation committee into signing the approval documents for the backdated grants.[67] In the FBI's investigation, the compensation committee claimed they "did not intend to grant in-the-money op-

manufactured evidence to defend the options grants and deceived Comverse directors and auditors. Prosecutors alleged that Comverse set up a roster of phony grant recipients labeled 'I.M. Fanton' after a secretary saw *The Phantom of the Opera*." Iwata, *supra* note 62, at 5B.

[64] *See Slush Fund and Fake Employees, supra* note 3, at A1 ("The SEC said options were distributed 'company-wide.'"); *see also* News Release, U.S. Dep't of Just., *Former Executives of Comverse Technology Inc. Charged with Backdating Millions of Stock Options and Creating a Secret Stock Options Slush Fund,* 2006 WL 2377912 at *1–3 (Aug. 9, 2006) [hereinafter U.S. Dep't of Just. On Comverse Backdating] (describing how Comverse fraudulently backdated options).

[65] *See Slush Fund and Fake Employees, supra* note 3, at A1 (mentioning that charges were filed against in-house counsel William Sorin, company founder Kobi Alexander and CFO David Kreinberg); *see also* Frank Reynolds, *Comverse Ex-Execs Second to Face Criminal Backdating Charges,* 12 No. 20 ANDREWS DERIVATIVES LITIG. REP. 4 (2006) ("[P]rosecutors charge that Alexander alone reaped a $138 million profit from his options and that $6.4 million of that profit came from backdating . . .").

[66] *See* Press Release, *Sec. & Exch. Comm'n, SEC Charges Former Comverse Technology, Inc. CEO, CFO, and General Counsel in Stock Option Backdating Scheme* (Aug. 9, 2006), http://www.sec.gov/news/press/2006/2006-137.htm [hereinafter *SEC Charges Former Comverse CEO*] (reporting charges and allegations against Jacob Alexander, William F. Sorin, and David Kreinberg); *see also* U.S. Dep't of Just. On Comverse Backdating, *supra* note 64, at *1 (stating that there were charges filed against three Comverse executives for "fraudulently backdating options and operating a secret stock options slush fund").

[67]*See Slush Fund and Fake Employees, supra* note 3, at A1 (noting that after Alexander decided it was time to grant options, Sorin, the company attorney, would call the compensation committee to say that "options-granting paperwork was on its way," however, there was no place for the members to date their signatures, and the FBI said in some cases, "directors didn't sign the forms until weeks or months after the purported grant date"); *see also* Press Release, *Sec. & Exch. Comm'n, SEC Settles Options Backdating Case Against William Sorin, Former General Counsel of Comverse Technology, Inc.* (Jan. 10, 2007), http://www.sec.gov/news/press/2007/2007-4.htm (last visited May 24, 2007) [hereinafter *SEC Settles Options Backdating Case*](delineating the SEC's charges that allege that Sorin falsified records in order to perpetuate the backdating scheme).

tions."[68] The FBI maintains that the backdating scheme at the company ran over a decade from 1991 to 2002, with the company consequentially materially overstating its net income and earnings during that time.[69] During those years, Alexander personally gained over $6 million from the backdated grants alone.[70] Alexander initially denied the backdating and any wrongdoing, but by the Wall Street Journal's analysis, denial is fruitless as the "odds of the grant dates falling as they did purely by chance [were] around one in six billion."[71] According to the FBI, Alexander changed his tune, and tried to justify his actions by claiming that everyone was "doing it."[72] The company is now forced to restate its earnings.[73]

The FBI and SEC have not hesitated to follow through in the Comverse case. Kreinberg was the first in the backdating scandal to reach a civil/criminal plea and SEC settlement in October 2006 in which he agreed to pay almost $2.4 million in disgorgement, and pled guilty to criminal charges including securities fraud.[74] William Sorin was sentenced to a year and day in prison

[68] *Slush Fund and Fake Employees, supra* note 3, at A1 (citing an FBI affidavit where two committee members insisted that "they didn't realize the grant carried a lower trading price").

[69] *See Slush Fund and Fake Employees, supra* note 3, at A1 (stating that "at least 26 stock-option grants" were improperly backdated from 1991-2001); *see also SEC Charges Former Comverse CEO, supra* note 66 (citing Comverse's material financial overstatements); *see also Nightly Business Report* (Cmty. Television Found. Of S. Florida television broadcast Aug. 9, 2006), *available at* http://www.pbs.org/nbr/site/onair/transcripts /060809b/ (indicating the charge of prosecutors for backdating between 1991 and 2005).

[70] *See SEC Charges Former Comverse CEO,* supra note 66 (putting Alexander's actual gains from stock options at $138 million); *see also Nightly Business Report,* supra note 69 (reporting Alexander's fraudulent profits).

[71] *Slush Fund and Fake Employees, supra* note 3, at A1 (noting that all but one of Alexander's grants between 1994 and 2001 were dated just before a "sharp run-up in company shares").

[72] *See Slush Fund and Fake Employees, supra* note 3, at A1 (stating Alexander defending the backdating "on the ground that everyone in high technology was 'doing it'"); *see also* Reynolds, *supra* note 65, at 4 (quoting Alexander as saying "everyone in the Silicon Valley was doing it [backdating]").

[73] *See Law Firms Fight for Lead Role in Comverse Backdating Suits,* supra note 61, at 12 (describing a civil lawsuit that alleges defendants "knowingly violated federal securities laws by overstating the company's financial situation from 2001 through 2006"); *see also SEC Charges Former Comverse CEO, supra* note 67 (stating that earnings were materially overstated between 1991-2002).

[74] *See* Press Release, Sec. & Exch. Comm'n, *David Kreinberg, Former CFO of Comverse Technology, Inc., Agrees to Settle SEC Charges in options Backdating Case* (Oct. 24, 2006), *available at* http://www.sec.gov/news/press/2006/2006-180.htm. The settlement also included a permanent injunction, a permanent officer and director's bar, and suspension from appearing or practicing before the SEC as an accountant. Kreinberg, in a deal with

for his role in the scandal, and ordered to pay $3.1 million in disgorgement to the SEC.[75] The company's founder took the high road in taking responsibility for his involvement and fled to Namibia, Africa, and attempted to conceal funds by transferring more than $57 million to accounts in Israel.[76] The U.S. is currently seeking to extradite him, as Alexander has already been indicted on charges of fraud and conspiracy, among other things.[77] Collectively, the backdating scandal has cost Comverse $51.8 million dollars, an amount that must be paid back to the company according to a judicial order.[78]

Other players in the stock options backdating scam were the top executives at Brocade Communications, a telecommunications company based in California.[79] Former CEO, Gregory Reyes, and former VP of human resources, Stephanie Jensen, have been federally indicted for defrauding Brocade, its Board,

the US Attorney's Office in New York, pled guilty to "one criminal count of conspiracy to commit securities fraud, mail fraud, and wire fraud, and one criminal count of securities fraud." *See* Martha Graybow, *Ex-Comverse lawyer gets prison time for backdating*, REUTERS, May 12, 2007, *available at* http://www.reuters.com/article/technology-media-telco-SP/idUSN1043112520070511. This article mentions Kreinberg's guilty plea to conspiracy and securities fraud.

[75] *See* Bloomberg News, *Wall Street Roundup; Prison sentence in backdating scandal*, L.A. TIMES, May 11, 2007 (reporting Sorin's prison sentence and SEC settlement); *see also Comverse Exec Sentenced in Options Case*, BOSTON GLOBE, May 10, 2007, *available at* http://www.boston.com/business/technology/articles/2007/05/10/comverse_exec_sentenced_in_options_case/ (citing Sorin's guilty plea to conspiracy and his prison sentence).

[76] *See* Graybow, *supra* note 74 (stating that Alexander is considered a fugitive); *see also Slush Fund and Fake Employees*, *supra* note 3, at A1 (describing the allegations of concealing $57 million in funds); *see also* U.S. Dep't of Just., *supra* note 64 (describing the American government's seizure of $45 million for Alexander's participation in fraudulent stock options and "money laundering scheme involving the secret transfer of more than $57 million to accounts in Israel in an effort to conceal the funds from US authorities).

[77] *See Comverse Exec Sentenced in Options Case*, *supra* note 75. Alexander has currently "been indicted on charges of conspiracy, securities fraud, making false filings with the SEC, mail fraud, wire fraud, money laundering and engaging in unlawful monetary transactions." Graybow, *supra* note 74. Alexander is located in Namibia pending a U.S. extradition request.

[78] *See Comverse Exec Sentenced in Options Case*, *supra* note 75 (indicating that while Sorin is joint and severally liable for the $51.8 million cost to the company, the implementation of the order has been stayed); *see also* Graybow, *supra* note 74 (citing the judge's order of restitution).

[79] *See* Nicholas Rummell, *Feds Get New Life in Brocade Backdating*, WORKFORCE MGMT., May 22, 2007 (describing the case against telecom company Brocade); *see also* Ed Sutherland, *Former Brocade Execs Charged in Stock Scandal* (July 21, 2006), *available at* http://www.internetnews.com/bus-news/print.php/3621681 (stating that Brocade manufactures computer gear).

shareholders, auditors and the public.[80] The allegations are that Reyes and Jensen backdated $100 million in stock options between 2000 and 2004.[81] Although Reyes and Jensen didn't personally profit from any of the options,[82] the court has refused to dismiss their indictments.[83] The pair of executives backdated the dates of board meeting minutes so that on paper it showed that options were granted on dates with low stock prices, when in reality there were no meetings or grants on those dates.[84] The pair also backdated employment offer letters so new employees could be granted options before they were even hired.[85] The real fraud occurred when Reyes and Jensen perpetuated this scheme on

[80] *See* Patrice Hill, *Brocade Officers Hit With Fraud Complaint; SEC Probe Finds Mishandling of Stock Options*, WASH. TIMES, Jul. 21, 2006, at C08 (discussing the indictments of Brocade executives for securities fraud). *See generally* Sec. & Exch. Comm'n v. Reyes, 2006 U.S. Dist. Ct. Pleadings 4435 (2006) (outlining the criminal complaint against Brocade executives).

[81] *See* Howard Mintz, *Judge Rejects Bid To Toss Out Charges*, SAN JOSE MERCURY NEWS, May 11, 2007 (indicating the number of backdated options to be over $100 million); *see also* Howard Mintz, *Novel Options Defense Falls Flat, Brocade Ex-CEO's Lawyer: Backdating Is Not 'Material,'* SAN JOSE MERCURY NEWS, May 12, 2007, at 1C (mentioning the systematic backdating of options totaling more than $100 million).

[82] *See* Jessica Guynn, *U.S. Attorney Not Letting Up On Backdating: Interim S.F. Leader Says He Will Maintain Task Force That Is Investigating Stock Options*, S.F. CHRON., Apr. 5, 2007, at C1 (explaining that attorneys for Reyes and Jensen argue that they did not personally profit from backdating options); *see also* Howard Mintz, *Novel Options Defense Falls Flat, Brocade Ex-CEO's Lawyer: Backdating Is Not 'Material,'* SAN JOSE MERCURY NEWS, May 12, 2007, at 1C (reporting that even though Reyes and Jensen were not accused of any personal profit from the backdated options, the "government maintains their alleged efforts to conceal the backdating demonstrate they were aware they were breaking the law and accounting rules").

[83] *See* Mintz, *supra* note 81 (discussing Federal Judge Charles Breyer's refusal to dismiss the indictments against Reyes and Jensen just because they didn't personally profit from the backdated stock options, and further refusal to uphold the argument that backdating is not material and "investors do not consider backdating and concealing the practice from auditors an important factor in assessing a company's performance"); *see also* Mintz, *supra* note 82 at C1 (noting the federal judge's rejection of the materiality argument and the SEC's fear that its success could "undercut government efforts to press charges related to backdating in other cases.").

[84] *See generally* PRACTISING LAW INSTITUTE, *Stock Option Pricing Practice: What you Need to Know*, 1574 PLI/Corp 247 (2006) (outlining the sly behavior of Brocade executives); Frank Reynolds, *Brocade Execs Plead Not Guilty to Backdating Charges*, 22 No. 5 ANDREWS CORP. OFF. & DIRECTORS LIAB. LITIG. REP. 5 (2006) (explaining the indictment's allegations that Reyes allegedly instructed Jensen to prepare false documents to show that options were granted at specific committee meetings of a given date).

[85] *See* PRACTISING LAW INSTITUTE, *supra* note 84, at 257 (noting that Brocade backdated offer letters to potential employees); *see also* Reynolds, *supra* note 84 (discussing that Brocade went so far as to backdate employment letters to grant options to people who were not yet employed).

outside auditors, thus creating misleading SEC statements.[86] The executives plead "not guilty" to the charges.[87] As a result of the scandal, Brocade has been forced to restate its financial statements from 1999 through 2004.[88]

One of the most high profile incidents of backdating involved Apple Computers and its CEO, Steve Jobs. An initial internal investigation cleared Jobs of any wrongdoing, but the findings released were not exactly complete.[89] The company failed to report that Jobs was the recipient of 7.5 million backdated options in 2002, which constituted two percent of the entire number of outstanding shares at that time.[90] Company records were falsified to cover up that options had been backdated by two months, and left unreported in company documentation.[91] Although Apple proclaims Job's accomplishments for the company, and he is widely known as a "visionary,"[92] he is far from the ideal executive most investors are seeking.[93]

[86] *See* Mateja & Willis, *supra* note 5 (mentioning the conscious violation of laws and accounting rules by Reyes and Jensen); *see also* PRACTISING LAW INSTITUTE, *supra* note 84, at 258–59 (citing the false and misleading statements to auditors and to the SEC).

[87] *See* Reynolds, *supra* note 84 (reporting that Reyes' attorney stated that his client is innocent and "the government made a mistake by seeking an indictment of Mr. Reyes."); *see also* Chris Williams, *Ex-Brocade pair plead not guilty*, THE REGISTER, Aug., 31, 2006, *available at* http://www.theregister.co.uk/2006/08/31/reyes_pleads/print.html (documenting the not guilty pleas of Jensen and Reyes to mail and securities fraud charges).

[88] *See* Sutherland, *supra* note 79 (explaining that Brocade had to revise its financial statements for the years 1999 through 2004); *see also* Williams, *supra* note 87 (outlining the accusations against Brocade that include misleading the market).

[89] *See* Lucian Bebchuk, *Inside Jobs*, WALL ST. J., Jan. 6, 2007, at A6 (reporting that Apple's internal report says little about what executives knew about backdating); *see also* Gene Munster, *What Counts Are iPod Sales*, ONLINE REPORTER (USA), Jan. 6, 2007 at 24 (noting that an internal report from Apple cleared Jobs against allegations of backdating).

[90] *See* John Heilemann, *Steve Jobs's Halo*, N.Y. MAG., Jan. 8, 2007, *available at* http://www.nymag.com/news/politics/powergrid/26302 (indicating that that Apple company records were falsified to cover up backdating); *see also* Colleen Taylor, *SEC Backdating Charges Against Former Apple CFO, General Counsel*, ELECTRONIC NEWS, Apr. 30, 2007 (explaining that there was a grant of 7.5 million options to Jobs, who altered company records to disguise fraud).

[91] *See* Heilemann, *supra* note 90 (adding that another grant to Jobs' was backdated 6 days in 2000 and that was "greatly to his advantage"); *see also* Arik Hesseldahl, *Apple's Options Overdose*, BUS. WEEK, Aug. 18, 2006, *available at* http://www.businessweek.com /technology/content/aug2006/tc20060817_404045.htm?chan=search (noting that Apple's "irregularities" in reporting options coincided with Jobs' return to the company).

[92] *See* Lev Grossman, *Steve Jobs.*, TIME MAG., May 14, 2007, at 160 (referring to Steve Jobs as the "visionary founder . . . at Apple and Pixar").

[93] *See* Editorial, *Fallen Icons: Low-Brow High-Tech*, L.A. TIMES, Oct. 7, 2006, at 16. "All the same, the practice of secretly backdating options is antithetical to public companies because it cheats investors . . . Jobs need only look a few miles up the freeway to HP and

Other companies wrapped up in the scandal include Mercury Communications and Affiliated Computer Services. Mercury's Chief Executive and other top officials were forced to resign after an internal investigation found that they personally benefited from "widespread manipulation of stock-option grant[s]," and the company will be forced to restate it's past earnings results to at least 2002.[94] Affiliated's CEO, Jeffrey Rich, made good on his name when he reaped the benefits of timely dated stock options.[95] In a pattern of stock option grants calculated by the Wall Street Journal, Rich received six stock option grants between 1995 and 2002 that were all dated before a large rise in Affiliated stock.[96] Rich calls this "blind luck," but a conservative estimation by the Wall Street Journal puts the odds of this happening at one in 300 billion.[97] According to company estimates, Affiliated needs to report $51 million in additional compensation expenses relating to the backdating scheme.[98]

see that, when scandal comes, the corporation is more likely to survive than its chief." *Id; see* Jim Pavia, *The Options' Buck Stops at the SEC*, INV. NEWS, Jun. 18, 2007, at 10. "Let the recent settlements deliver a clear message: The SEC will not tolerate corporate executives who cheat investors and undermine public confidence in the capital markets. *Id.*

[94] *See* Maremont, *supra* note 35, at A1 (citing problems plaguing Mercury Interactive Corporation due to executive manipulation of stock-grant options and stating "Mercury has said it will need to restate its past results back to at least 2002 due to the options-timing problems"); *see also* Eric Dash, *Who Signed Off On Those Options?*, N.Y. TIMES, Aug. 27, 2006, at 1 (discussing how Mercury's directors kept "backdating ball rolling" rather than keeping such practices in check and further emphasizing that "[a]ll three executives resigned abruptly last fall").

[95] *See Perfect Payday*, *supra* note 3, at A1 (noting impeccable timing of Rich's stock option grants); *see also* Katie Dean, *Affiliated Computer Executives Exit*, TheStreet.com (Nov. 27, 2006), http://www.thestreet.com/newsanalysis/techsoftware/10324356.html (stating that Rich frequently "used hindsight to select favorable grant dates").

[96] *See Perfect Payday*, *supra* note 3, at A. Article notes the "striking pattern" of Rich's stock option grants. *Id. See also* Dean, *supra* note 95. The scheme of Rich and other executives was designed so that grants were "intentionally misdated . . . to make it appear as if the memoranda had been created at or about the time of the chosen grant date, when in fact, they had been created afterwards." *Id.* Affiliated then "effectively granted 'in the money' options without recording the appropriate compensation expense." *Id.*

[97] *See* Gerard Baker, *Five Years After Enron, Culture of Greed is Back; American View*, TIMES (U.K.), Jun. 20, 2006, at 45. "When Mr. Rich was asked to explain the suspiciously good timing of his company's options issuance, he told The Wall Street Journal that it had been 'blind luck'". *Id.*; *see also Perfect Payday*, *supra* note 3, at A1. To put these odds in perspective, the article compares them with odds of winning multistate Powerball lottery, about one in 146 million. *Perfect Payday*, *supra* note 3, at A1.

[98] *See* Markets, *Wall St. Roundup*, L.A. TIMES, Nov. 28, 2006, at 4 (describing resignations of chief officers due to violations of ethics rules regarding granting of stock options and declaring that Affiliated would record " . . . about $51 million in additional compensation expenses to correct the accounting of misdated option grants"); *see also* Dean, *supra*

This brief sampling of companies is barely the icing on the cake. Nevertheless, the widespread and disturbing nature of the problem is glaringly evident.

V. LEGAL IMPLICATIONS OF BACKDATING

A. Fiduciary Duty of Loyalty

With the barrage of companies and executives subjected to numerous investigations surrounding millions of stock options, the legal implications of the executives' participation and fault are likely significant. When a corporate director assumes his leadership position, he is required to fulfill certain duties, namely, a strict duty of loyalty to the company.[99] The duty of loyalty consists of the director's requirement to put the interests of the company before his own interests and to avoid situations where any potential self-interest conflicts with the interests of the company.[100] According to Bruce Marks, "[a] director or officer

note 95 (stating further that "[t]he company has not yet determined the impact of these accounting adjustments on its historical and current period consolidated financial statements . . . nor whether it will be required to restate its consolidated financial statements as a result of these adjustments . . .").

[99] *See generally* DEL. CODE ANN. tit. 8, § 102(b)(7)(i) (2007). "A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director . . . : (i) For any breach of the director's duty of loyalty to the corporation or its stockholders . . . " *Id.* However, for purposes of this article, since personal liability for breaches of this duty, in many states, can be released by provisions in a company's charter, it will not be analyzed. *See, e.g.*, Bernard S. Black, Stanford Law Sch. Professor, *The Principal Fiduciary Duties of Boards of Directors*, Presentation at Third Asian Roundtable on Corporate Governance, Singapore, Apr. 4, 2001, *available at* http://www.oecd.org/dataoecd/50/53/1872746.pdf. The directors also owe the company a fiduciary duty of care to "pay attention and to try to make good decisions." *Id.* If the duty of care is met, a court will not interfere in decisions of directors and officers because the business judgment rule prevents courts from second-guessing decisions that turn out poorly. *Id; see* Mark R. High, *Dickinson Wright PLLC-Attorneys, Disney and the 140 Million Dollar Man*, (October 2005), *available at* http://www.dickinsonwright.com/news2.asp?id=136&action_flag=edit. The author describes Delaware General Corporation Law, which allows company charters to release executives "from personal liability for breaches of the duty of care." *See* Nat'l Assoc. of Veterans' Research and Educ. Found., *Duty of Care, Loyalty and Obedience*, http://www.navref.org/bestpractices/gov_bod_responsibilities_duties.htm (last visited Oct. 31, 2007). Duty of care is a "standard that requires a board member to exercise the same care that an ordinary prudent person would exercise in a like position or under similar circumstances." *Id.*

[100] *See, e.g.*, Bayer v. Beran, 49 N.Y.S.2d 2, 5 (N.Y. Spec. Term 1944) ("The fiduciary must subordinate his individual and private interests to his duty to the corporation

has the fiduciary obligation to work for the benefit of the corporation and any activity to the detriment of the corporation by a director is contrary to this duty."[101] A simple way to comply is to not engage in any "self-dealing transactions".[102] In most states, if there is a director conflict-of-interest, the decision of the board must be ratified by disinterested directors or by shareholders in order for it not to be a void or voidable transaction.[103]

If it is established that there is no director conflict of interest, directors and officers can still be held liable for breaches of the duty of loyalty if they acted in bad faith, as the duty of loyalty requires actions by directors and board members to be in good faith.[104] *In re* the Walt Disney Company Derivative Litigation, and in a recent decision in *Stone v. Ritter*, the Delaware Supreme Court clarified the duty of good faith as not rising to the level of

whenever the two conflict."); *see also* Julius J. Brecht, *Directors have a 'Duty of Loyalty'*, ALASKA J. COMM., Jun. 30, 2002, *available at* http://alaskajournal.com/stories/063002/wea_loyalty_duty.shtml (defining duty of loyalty as "basic to corporate governance"); *see* Nat'l Assoc. of Veterans' Research and Educ. Found., *supra* note 99 (requiring directors to put interests of organization above self-interest). *See generally* Black, *supra* note 99 (stating that the same fiduciary duties apply to both corporate directors and officers).

[101] Bruce D. Marks, *When to Go For It: The Duty of Loyalty*, (2001), *available at* http://www.lawworldwide.com/Duty%20of%20Loyalty.htm (last visited October 31, 2007). "This ties directly to the concept that a director of the corporation has an obligation to not compete against the corporation to the detriment of the corporation." *Id.*

[102] *See* Peter C. Kostant, *Exit, Voice and Loyalty in the Course of Corporate Governance and Counsel's Changing Role*, 28 J. SOCIO-ECON. 203 (1999) (defining board of directors as having virtually absolute power " . . . as long as directors do not violate their duty of loyalty to the entity by engaging in tainted self-dealing"); *see also* Black, *supra* note 99 (explaining that steering clear of "'self-dealing' transactions" is the "easiest way to comply with this duty [of loyalty]").

[103] *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (2007) (mandating disclosure of material facts as to conflict of interest); *see also* N.J. STAT. ANN. § 14A:6-8 (West 2007) (allowing corporations to void transactions that contain conflict of interest if transaction wasn't fair, or if there was failure to appropriately disclose information to disinterested directors or shareholders); N.Y. BUS. CORP. LAW § 713 (McKinney 2007) (requiring good faith disclosure of facts relating to conflict of interest, and if lacking, corporation may void the contract unless the party can affirmatively establish that contract or transaction was fair and reasonable to corporation when it was approved by the board, committee or shareholders).

[104] *See* Posting of Stephen M. Bainbridge to Law and Business blog, http://www.businessassociationsblog.com/lawandbusiness/comments/ryan_v_gifford_chandler_tackles_stock_options/ (Feb. 7, 2007) (defining bad faith where "the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation" or where "the fiduciary acts with intent to violate applicable positive law" or where "the fiduciary intentionally fails to act in the face of known duty to act, demonstrating a conscious disregard for his duties"). *See generally* Kostant, *supra* note 102, at 203 (highlighting that directors are immune from liability as long as they are not acting in self-interest or in bad faith).

the duty of loyalty, but as a subordinate element of the duty.[105] The court, in *Stone*, states that bad faith can be shown where, "the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the fact of known duty to act, demonstrating a conscious disregard for his duties."[106] While failure to act in good faith is not "ipso facto" a breach of the duty of loyalty, bad faith can demonstrate a "conscious disregard" of responsibilities and breach the duty of loyalty.[107]

In *Stone*, the Delaware Supreme Court found that the standard established in *Caremark* is the applicable standard for "assessing director oversight liability."[108] This standard outlines the "necessary conditions predicate" to such liability including: "a) the directors utterly failed to implement any reporting or information system or controls; *or* b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[109] For either to be established, the officer must have had knowledge that they were breaking

[105] *See* High, *supra* note 99 (analyzing whether duty of good faith "is a separate duty owed by directors or is an integral part of the duties of loyalty and care"); *see also* Peter Golden, Fried Frank, LLP, *Delaware Supreme Court Finds No Basis for Personal Liability of Directors for Alleged Failure to Supervise Employees and Addresses Duty of Good Faith* (Nov. 14, 2006), http://www.ffhsj.com/siteFiles/ffFiles/061114_del_supreme_ct_liability.pdf (describing good faith as "subsidiary element" of duty of loyalty); *see also* Andrew M. Johnston et al., Morris, Nichols, Arsht & Tunnell, *Delaware Supreme Court Addresses Director Oversight Liability, Clarifies the Obligation to Act in Good Faith* (Nov. 13, 2006), http://www.mnat.com/assets/attachments/94.pdf (discussing "interplay" between good faith and duty of loyalty).

[106] Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006).

[107] *Id.* at 369–70 (explaining that acting in good faith is not a separate fiduciary duty, but an element of the duty of loyalty); *see* Golden, *supra* note 105 (commenting that under *Stone* breach of duty of good faith may indirectly lead to a finding of fiduciary liability if such conduct results in breach of duty of loyalty); *see also* Johnston et al., *supra* note 105 (citing *Stone* court's explanation of the interplay between good faith and duty of loyalty and warning directors that, while good faith may not be considered a separate fiduciary duty, courts consider it linked to the duty of loyalty).

[108] Johnston, *supra* note 105 (quoting *Stone* that '*Caremark* articulates the necessary conditions for assessing director oversight liability.'); *see also* Golden, *supra* note 105 (observing that Delaware Supreme Court in *Stone* approved *Caremark* standard after reviewing case law on director liability for ignorance of conduct which created corporate liability and loss).

[109] *Stone*, 911 A.2d at 370 (articulating the standard set forth in *Caremark* for the imposition of director oversight liability).

their fiduciary duties by "failing to discharge that fiduciary obligation in good faith."[110]

Once the fiduciary duty of loyalty is breached, executives become personally liable for any harm to the company that resulted from such a breach.[111] Even if they have an insurance policy covering their liability, coverage does not extend to the damages that result from the directors' breach of the duty of loyalty, including "intentionally dishonest or criminal acts, willful violations of law, or profit gained by a person who is not legally entitled to receive it."[112] In addition, insurance companies can cancel policies if the company or applicant director made any misrepresentations in any applications.[113] This would include, according to Mark High, "inaccurate financial statements, even if believed to be accurate when submitted."[114]

In addition, under ordinary circumstances, directors are usually entitled to indemnification by the company for costs incurred in litigation and damages awarded while at the helm.[115] However, indemnification provisions under DGCL §145 allow indemnity only "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best in-

[110] *Id.* (explaining that a director breaches a duty of loyalty by not acting where there is a known duty to act, because such conduct demonstrates blatant disregard for responsibilities and lack of good faith).

[111] *See* High, *supra* note 99 (stating that under Delaware General Corporation Law ("DGCL") Sec. 102(b)(7) the "release from personal liability is not available for breaches of a director's duty of loyalty . . . nor for acts or omissions not performed in good faith"); *see also* Johnston, *supra* note 105 (noting that under DGCL §102(b)(7) "[d]irectors cannot be exculpated under a limitation on liability provision . . . for breaches of the duty of loyalty.").

[112] High, *supra* note 99 (generalizing traditional director and officer insurance policies); *see also* Law of Corp. Officers & Dir.: Idemn. & Ins. §8.10 (Nov. 2007) (noting that there is some variation in way director and officer policies treat claims against directors and officers for alleged acts of bad faith, dishonesty, knowing violations of law, or acts for illegitimate personal gain, but generally these types of acts are not covered).

[113] *See* High, *supra* 99 (noting that if insurer finds a misrepresentation was made in director's liability insurance application, policy can be rescinded); *see also* Emily A. Moseley et al., Kilpatrick Stockton LLP, *Directors and Officers' Liability Insurance* (June 2001), http://www.kilpatrickstockton.com/publications/article_detail.aspx?ID=940 (commenting that most states require, by statute, that insurance policies be voided if misrepresentations, even innocent ones, were made on insurance application).

[114] High, *supra* note 99.

[115] *See* 18B AM. JUR. 2D *Corporations* §1645 (2007). Most states allow corporations to indemnify any person who is sued for conduct pursuant to their position as director or officer of the corporation. *See* High, *supra* 99. Under Delaware law, directors of Disney Corporation could have been denied indemnification if court found they had failed to act in good faith.

terests of the corporation . . . "[116] Therefore, any breach of the duty of loyalty would prevent indemnification of the directors, potentially resulting in significant personal liability.

Whether or not there is a conflict of interest, when stock options are backdated without proper disclosure, regardless of whether the failure to disclose was in accounting, or in taxes, there is a breach of the executives' fiduciary duty of loyalty.[117] However, the case for breach of the duty of loyalty is strongest when executives personally benefited from backdated grants. When an executive is the recipient of self-manipulated, undisclosed, backdated stock option grants, there is a clear conflict of interest and obvious self-dealing. The executive instantly and personally profits from setting earlier grant dates at the expense of the company, as the company receives less for the stock than it should, and dilutes the amount of stock on the market.[118] To avoid breaching his duty of loyalty, the executive must make full disclosure and get the approval of disinterested directors.[119] In most cases, however, the disclosures were never made and the options were, in fact, manipulated on paper to look like at-the-money grants.[120]

This is the case with companies such as UnitedHealth, Comverse Technology and Apple Computers.[121] The CEO at United Health received a stock option plan worth millions with the

[116] DEL. CODE ANN. tit. 8, § 145 (2007); *see* High, *supra* note 99 (noting that DGCL §145 limits director indemnification to acts taken in good faith).

[117] *See supra* notes 21, 23, & 28 and corresponding text (explaining that backdating of options becomes an issue, and potentially illegal, when the backdating is not disclosed to shareholders, in accounting reports, or in tax reports).

[118] *See American Tower Corp. Execs Face Suit Over Options Backdating*, 22 No. 5 ANDREWS CORP. OFF. & DIRECTORS LIAB. LITIG. REP. (2006) (referring to the immediate gain realized by recipients of backdated options as "paper profit[s]"); *see also Analog Devices Seeks Dismissal of Suit Over Stock-Option Backdating*, *supra* note 27, at 6 (inferring that the company receives less for its stock when options are backdated); *Bay Area Federal Task Force Targets Stock-Option Backdating*, *supra* note 26, at 3 (stating that the company gets short-changed by being paid less).

[119] *See supra* note 103 and corresponding text for discussion of state law in this area of the finance industry; *see also* Dash, *supra* note 45, at C2. According to a study done by Harvard Law School program on corporate governance, 1400 outside directors themselves may have received manipulated grants over the past decade. This suggests that many of the boards may not have had any disinterested directors in many cases, if even the outside directors were conflicted. Therefore, ratification may have been impossible for some boards, even if full disclosure was made.

[120] *See supra* note 18 and accompanying text (describing backdating manipulation).

[121] *See supra* notes 49–91 and accompanying text (describing the exploits of these companies).

chances of it occurring by accident, that is, not manipulated, calculated to exceed one in 200 million or greater.[122] The company was forced to make restatements with some reports reaching $1.6 billion.[123] The fact of the restatements alone suggests a breach of the fiduciary duty. The CEO clearly failed to put the corporation's interests first when he effectively stole from the company in the form of gratuitously granted options which were unreported to the SEC until the scandal was uncovered.

Comverse Technology was an even more egregious example when executives created a slush fund of options that the founder tried to conceal by changing its closing date.[124] Executives at the company also personally benefited from backdated options, again creating a clear conflict of interest amongst the slue of illegal activity.[125] Alexander, the company's founder and chief executive, received 100,000 options with the extra backdated earning potential of $10.7 million, and $130 million company-wide.[126] These numbers are staggering, and it is no wonder Alexander attempted to conceal his activity when the company went under investigation.[127]

[122] *See supra* notes 53–57 (describing the lucrative payout of McGuire's grants).

[123] *See supra* note 57 (explaining the unlikelihood of the stock option grants falling, by mere chance, on the specified dates); *see also* Iwata, *supra* note 1, at 1B ("UnitedHealth's senior officers, directors and legal and accounting experts 'never raised concerns at the time' about the options, Brodsky says. He says the board compensation committee was advised by attorneys and human-resource professionals, yet routinely backdated grants.").

[124] *See supra* note 63 (describing Alexander's illegal activities); *see also* Jonathan Peterson, *Ex-Comverse CEO Arrested in Namibia; The Fugitive Faces Extradition to the U.S. to Answer Charges of Stock Option Fraud at the Tech Company*, L.A. TIMES, Sept. 28, 2006, at C3 ("Stock options give their holders the right to buy stock at a set price within a certain time limit. Typically, that price is the same as the price on the day the option was granted. But at Comverse and other companies, insiders may have improperly cherry-picked dates from the past that had lower stock prices.").

[125] *See supra* note 62 and accompanying text (discussing the stock option backdating offenses of Comverse Technology); *see also Slush Fund and Fake Employees*, *supra* note 3, at A1 (stating that the SEC reported that options were distributed "company-wide").

[126] *See Slush Fund and Fake Employees*, *supra* note 3, at A1 (reporting the egregious amount of personal profits for Comverse's founder who received nearly a quarter of the total options granted inside the company); *see also* Peterson, *supra* note 124, at C3 (describing Comverse CEO Kobi Alexander's flight from the country, subsequent arrest, and the stock fraud charges he faced in 2006).

[127] *See Slush Fund and Fake Employees*, *supra* note 3, at A1. Alexander was the master manipulator of the scheme. He, in effect, tricked the compensation committee by instructing his secretary to create dozens of phony names to mix in with "real people on the list of options presented to directors for approval." He would then dole out the options as he pleased, including one grant to an Israeli executive who was not pleased with his pay, and even directed that the options vesting date for this gift be changed so that the executive

Apple Computers executive Steve Jobs tried to mislead the public by allowing the initial internal investigation to be released clearing him of any wrongdoing, without disclosing the fact that he received $7.5 million in backdated options in 2002.[128] This is a clear conflict of interest for the well-touted executive, one that was cleverly left undisclosed to the public until the investigation commenced.[129]

Even when there is no conflict of interest for the directors, there is still a breach of the duty of loyalty because many of the executives' decisions were made in bad faith. The directors failed to work for the benefit of the corporation when they allowed anyone to receive undisclosed backdated stock options, as it subjected the company to liability for both securities and tax fraud, even if they themselves did not benefit from the options.[130] Executives, even when holding the health of the company above their own personal practices, whether or not it was done for good reason,[131] are not permitted to blatantly break established rules. Surely no executive could have thought that any type of deception to the company about grant dates would coincide with his strict duty of loyalty owed to the company.

The Delaware court has even articulated, in *Ryan v. Gifford*, that "[b]ackdating options qualifies as one of those 'rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.'"[132] And while the court presumably limited its holding to the "unique

could cash them out immediately. *See also* Peterson, *supra* note 124, at C3. Mark J. Mershon, then-assistant director in charge of the FBI's New York field office, noted that "Alexander's alleged role in options backdating victimized Comverse shareholders and deceived prospective investors."

[128] *See supra* notes 89–93 and accompanying text (noting the internal investigation into Apple's chief executive, Steve Jobs, and the company's failure to report significant data).

[129] *See supra* notes 89–93 and accompanying text.

[130] *See supra* notes 79–88 and corresponding text (detailing another options backdating scandal regarding executives at Brocade Communications, a telecommunications company based on California).

[131] *See Brocade Execs Indicted Over Backdating of Stock Options*, 12 No. 20 ANDREWS DERIVATIVES LITIG. REP. 5 (2006) (describing the backdating of hiring letters and grants to retain talent in the competitive high-tech industry); *see also* Reynolds, *supra* note 65, at 4 (citing CEO Alexander's defense of backdating when stating "everyone in the Silicon Valley was doing it").

[132] Ryan v. Gifford, 918 A.2d 341, 355-56 (Del. Ch. 2007) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

facts" of the case, this holding likely has staggering implications.[133]

The facts of *Ryan* coincide with those of other current backdating scandals.[134] Maxim Integrated Products had a stock option plan that was blatantly broken by its founder, chairman, and CEO, Gifford.[135] The court found that the directors' "[deliberate attempt] to circumvent their duty to price the shares at no less than market value on the option grant dates" by backdating the grants, combined with the fact that the directors failed to disclose the conduct by "making false representations" of grant dates was enough to overcome the business judgment rule.[136] The plaintiffs did not need to provide facts that proved grants were backdated; studies suggesting that the grant dates were not the result of pure chance were enough for the court to infer manipulation.[137] The Chancery also commented that he was "unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith."[138]

[133] *See Ryan*, 918 A.2d at 350 (asserting that the case "address[es] novel issues," but is also one that "encompasses numerous issues"); *see also* Duane Morris, U.S.: Delaware Court Issues Two Rulings in Options Backdating and Spring-loading Cases (Mar. 14, 2007), http://www.duanemorris.com/alerts/alert2451.html (claiming that this "decision addresses many issues likely to recur in other stock options backdating cases, though the [c]ourt limited its holding to the 'unique facts' of the case.").

[134] *See, e.g., supra* notes 49–76 (describing the current backdating scandals).

[135] *See Ryan*, 918 A.2d at 346, 347, 357–58 (explaining Gifford's relation with Maxim and basic terms of Maxim's stock option plan, concluding the plan was intentionally violated); *see also* Morris, *supra* note 133 (noting that "it was the combined actions of the directors [in *Ryan v. Gifford*] that entailed an effort to deceive Maxim's shareholders in order to lead the shareholders to believe that the stock options were granted in accordance with the terms of the stock options plans.").

[136] *See Ryan*, 918 A.2d at 358.

[137] *See id.* at 354. Plaintiff pointed to "highly suspicious timing" and other "empirical evidence suggesting that backdating occurred." *Id.* The empirical evidence was a Merrill Lynch analysis which "measured the extent to which stock price performance subsequent to options pricing events diverged from stock price performance over a longer period of time." *Id.* The Merrill Lynch analysis revealed that "Maxim's average annualized return of 243% on option grants to management was almost ten times higher than the 29% annualized market returns in the same period." *Id.*

[138] *Id.* at 358.

Companies are required to have a stock option plan on file with the SEC.[139] As a result, any of the executives that violated their company's stock option plans by backdating while failing to disclose this additional compensation are likely to be found to have acted in bad faith. This triggers personal liability of the executives because they will be precluded from seeking indemnification or collecting on insurance policies.[140]

This view is further reflected in the case of the executives at Brocade Communications, where former CEO, Gregory Reyes, and former VP of Human Resources, Stephanie Jensen, neither of whom had personally benefited from the stock option grants, were nonetheless federally indicted.[141] Because they did not stand to personally profit from the options, there was no conflict of interest. However, the executives acted with a reckless disregard for the law. The executives changed the dates of board meeting minutes in order to backdate options to days when meetings never took place, and backdated employment offer letters as incentives to new employees.[142] This activity was in clear violation of accounting rules, and the government maintains in their indictment that the pair's "alleged efforts to conceal the backdating demonstrate they were aware they were breaking the law and the accounting rules."[143] This activity clearly worked to the detriment of the corporation, as the company has been forced to restate five years of financial reports.[144] In light of *Ryan v. Gifford*, the court will likely find that these executives acted in bad faith, even if they did not explicitly break an existing stock option plan. They not only acted in ways that did not advance the best interest of the corporation, but also violated the law. They intentionally failed to report the backdated options, which is tantamount to "failing to act in the face of a known duty to act."[145]

[139] *See* 17 C.F.R. § 240.9b-1 (2007) (providing that companies shall file options disclosure documents that detail their option's plans with the SEC); *see also Perfect Payday*, *supra* note 3, at A1 (observing that "companies grant their options under a shareholder approved 'option plan' on file with the SEC").

[140] *See supra* notes 111–113 (outlining personal liability).

[141] *See supra* notes 80 & 82 and corresponding text.

[142] *See supra* notes 84–85 and corresponding text.

[143] *See* Mintz, *supra* note 81, at 1C.

[144] *See supra* note 88 and corresponding text.

[145] *See* Posting of Stephen M. Bainbridge to Law and Business blog, *supra* note 104 (defining bad faith).

Many executives initially tried to escape the duty of loyalty analysis completely by claiming that they had no knowledge of the alleged backdating, or that it just did not exist.[146] According to *Graham v. Allis*, "directors will not be liable for the illegal conduct of a corporation's employees if they do not have actual knowledge of the conduct or a cause for suspicion that improper conduct is occurring unless there is 'a sustained or systematic failure of the board to exercise oversight.'"[147] UnitedHealth attempted to release a report to clear executives of wrongdoing, blaming "inadequate" internal controls and the executives' entitlement to presume that "matters brought before them for action were procedurally proper and consistent with applicable legal and accounting standards."[148] The company clearly has not stood by this position, as it has forced William McGuire, its former Chief Executive, to resign.[149] Comverse Technology executive Kobi Alexander initially tried to claim he had no knowledge of the backdating, and blamed a former CEO for the problems.[150] Faced with evidence of his involvement, he tried to justify his actions by claiming "everyone was doing it."[151] Since the court in *Stone v. Ritter* recognized that the test for liability should be "quite high" and liability for employee failures is "possibly the most difficult theory in corporation law upon which a plaintiff

[146] *See, e.g.*, Dash & Freudenheim, *supra* note 51, at A1 (blaming "'inadequate' internal controls"); *see Slush Fund and Fake Employees*, *supra* note 3, at A1 (denying backdating).

[147] *See* Golden, *supra* note 105 (stating holding of *Graham*); *see also* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 131 (1963) (affirming ruling that individual director defendants are not liable merely because some employees violated anti-trust laws, subjecting corporation to loss).

[148] Dash & Freudenheim, *supra* note 51, at A1 (quoting the affidavit).

[149] *See id.* ("Dr. William W. McGuire, a medical entrepreneur who built the UnitedHealth Group into a colossus in its field, was forced to resign from the company yesterday and to give up a portion of the $1.1 billion he holds in harshly criticized stock options."); *see also* Editorial, *Channeling Sgt. Schultz*, ST. LOUIS POST-DISPATCH, Oct. 19, 2006, at D10 ("Four corporate CEOs have lost their jobs in recent weeks over such arrangements. The latest is Dr. William McGuire of UnitedHealth Group, one of the nation's largest health insurance companies. UnitedHealthcare, as it's known here, controls 13.5 percent of the group health market in Missouri and almost 16 percent of HMO coverage.").

[150] *See Slush Fund and Fake Employees*, *supra* note 3, at A1 (describing his attempted denial); *see also* Robert E. Kessler, *3 Comverse Ex-execs Indicted; Trio Charged With Manipulating Stock Options and Raking in Millions at Company with Woodbury Offices*, NEWSDAY, Aug. 10, 2006, at A44 (reporting indictments of three former top executives of Comverse Technology, Inc. including Kobi Alexander).

[151] *See* Reynolds, *supra* note 65, at 4 (stating explanation Alexander used for backdating scandal); *see also Slush Fund and Fake Employees*, *supra* note 3, at A1 (quoting Alexander in an affidavit).

might hope to win a judgment," it is no wonder the executives were so eager to deny wrongdoing.[152]

B. 10B5 Violations

Not only can undisclosed in-the-money options violate state law, but also federal securities laws, namely Rule 10B5 of the Securities Exchange Act of 1934. Rule 10B5 prohibits material misrepresentations or omissions in connection with the purchase and sale of securities.[153]

The improperly backdated grants can accurately be characterized as either a misrepresentation or an omission. When net earnings were under-reported in SEC financial statements and taxes, and true income exceeded the reported amount, there has been an affirmative misrepresentation of executive income. On the other hand, large amounts of actual executive compensation were omitted from the net earnings numbers.

In order to establish a 10B5 violation, certain requirements must be met. There must be: (1) misrepresentations in connection with the purchase and sale of a security;[154] (2) a breach of a fiduciary duty;[155] (3) a manipulative or deceptive device employed;[156] (4) a material misrepresentation;[157] (5) scienter;[158] (6) reliance;[159] and (7) causation.[160]

[152] Golden, *supra* note 105 (citing *Stone v. Ritter* decision).

[153] 17 C.F.R. §240.10b-5 (2007) ("It shall be unlawful for any person, directly or indirectly, by the use of any means of or instrumentality of interstate commerce, or of the mails or any facility of any national securities exchange, a) To employ any device, scheme, or artifice to defraud, b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."). *See generally* Sec. & Exch. Comm'n v. Zandford, 535 U.S. 813, 819 (2002) (stating the requirements of the Securities Exchange Act).

[154] *See* 17 C.F.R. §240.10b-5 (2007); *see also* Wharf (Holdings) Ltd v. United Int'l Holdings, Inc., 532 U.S. 588, 593 (2001) (indicating plaintiff must show defendant used one of four kinds of deception).

[155] *See* Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646, 654 (1983) (requiring manipulation or deception for a breach of duty under Rule 10b-5); *see also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473–74 (1977) (mentioning the fiduciary duty breach requirement).

[156] *See* Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988) (analyzing materiality requirement); *see also Santa Fe*, 430 U.S. at 472–73 (describing Congress' objective to prevent manipulative or deceptive devices).

[157] *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (setting the standard for materiality).

First, the misrepresentations must be in connection with the purchase and sale of a security.[161] This is a factual inquiry.[162] The Supreme Court held that the "in connection with" element is satisfied when the deception "touches" the purchase and sale of securities.[163] For purposes of 10B5, stock options are considered securities,[164] so when executives manipulated the grant dates on the stock options and caused misleading financial statements to which the public relied in purchasing stock, their actions were in direct connection to the purchase and sale of a security.[165]

There must also be a breach of fiduciary duty, which as described in the previous section, can likely be established in most stock options cases.[166] In addition, a manipulative or deceptive

[158] *See Basic*, 485 U.S. at 231–32 (affirming the materiality standard); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (outlining plaintiff's burden to show knowledge of fraud).

[159] *See Basic*, 485 U.S. at 243 (agreeing that "reliance is an element of a Rule 10b-5 cause of action"); *see also* Sec. & Exch. Comm'n v. C. Jones & Co., 312 F. Supp. 2d 1375, 1379 (D. Colo. 2004) (stating that reliance is required for private actions under Rule 10b-5).

[160] *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342 (2005) (stating that at Rule 10b-5 claim must state a casual connection between the material representation and the loss); *see also Basic*, 485 U.S. at 243 (noting the requirement for a "causal connection").

[161] *See* Securities Exchange Act of 1934, §10 (codified at 15 U.S.C.S. §78(j) (2007)); *see also* Pommer v. Medtest Corp., 961 F.2d 620, 623 (7th Cir. 1992) (reiterating the requirements of the Securities Exchange Act of 1934, §10).

[162] *See* Sec. & Exch. Comm'n v. Ginsburg, 362 F.3d 1292, 1302 (11th. Cir. 2004) (explaining that the jury's unique competence in ascertaining what a "reasonable" shareholder would have considered material under the circumstances usually precludes summary judgment in Rule 10B5 actions); *see also Pommer*, 961 F.2d at 623 (allowing the jury to decide whether there was a connection on a factual basis).

[163] Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12–13 (1971) (describing the balance between the government's desire to preserve state actions for fiduciary breaches and Congress' intent to "bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face").

[164] *See* Deutschman v. Beneficial Corp., 841 F.2d 502, 507–08 (3d Cir. 1988) (holding that a stock option trader has standing to sue as a purchaser of a security under Rule 10B5); *see also* Liebhard v. Square D Co., No. 91-C-1103, 1992 U.S. Dist. LEXIS 15582, at * 12 (E.D. Ill. 1992) (positing that because options traders affect the options market, they have standing to sue for alleged misrepresentations under Rule 10b-5).

[165] *See, e.g., supra* notes 55–57 & 61–66 (describing the backdating exploits of several executives); *see* Sec. & Exch. Comm'n v. C. Jones & Co., 312 F. Supp. 2d 1375, 1380 (D. Colo. 2004) (explaining that defendant provided and directed others to provide false information to a broker-dealer to hide his affiliations with a company).

[166] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977) (stating that a claim of fraud and fiduciary breach states a cause of action when combined with "manipulative or deception"). *See generally supra* notes 99–153 (discussing the fiduciary duty owed to stockholders); *see also* Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646, 654 (1983) (stating that plaintiff must also allege manipulation or deception under 10b-5).

device must have been employed.[167] This is required in order to ensure that this federal cause of action is based on more than just a state-regulated breach of fiduciary duty.[168] A device is manipulative when there was some type of "omission or misstatement" by the company.[169] When companies involved in the stock options scandal released accounting statements that omitted stock options, misrepresenting net profits and earnings, this was a violation of the federal standard, as these statements dictated the value of the corporation's stock.[170] Since this sometimes resulted in mass understatements of earnings for multiple years,[171] it is reasonable to infer that liability can be attached.[172]

The misrepresentations must also be material.[173] This standard was originally set forth in *TSC Industries v. Northway*, where the Supreme Court determined that misrepresentation or omission is material if there is a "substantial likelihood" that a reasonable investor might consider the information important in

[167] *See Santa Fe*, 430 U.S. at 472–73 (describing that a Rule 10b-5 claim is allowed only if it coincides with the intent of Congress, which was to prevent manipulation or deception, not just breaches of fiduciary duty); *see also* Advanced Laser Prod., Inc. v. Signature Stock Transfer, Inc., No. 98-CV-1624-D, 1999 U.S. Dist. LEXIS 5179, at *5 (N.D. Tex. 1999) (noting that deception is required to state a cause of action under Rule 10b or 10b-5).

[168] *See* Securities Exchange Act of 1934, §10 (codified at 15 U.S.C.S. §78(j) (2007)) (emphasizing that the purpose of the federal legislation is to ensure the protection of investors through fair transactions and full disclosure, and also to facilitate commerce by ensuring that issuers of stock are able to raise capital); *see also Santa Fe,* 430 U.S. at 476–77 (elaborating on part of the purpose of the 1934 Act to prevent the misleading of investors and promote a philosophy of full disclosure); *see also* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (stating the purpose of the Act is not "limited to preserving the integrity of the securities markets").

[169] *Santa Fe*, 430 U.S. at 474 (noting the lack of omission or misstatement in notice accompanying the merger document was not sufficient to state a cause of action under 10-b5); *see* Reeder v. Mastercraft Elec. Corp, 363 F. Supp. 574, 580 (S.D.N.Y. 1973) (stating that the plaintiff investors were entitled to full disclosure of all material business prospects).

[170] *See supra* notes 23–26 and accompanying text.

[171] *See, e.g.*, Dash & Freudenheim, *supra* note 51, at A1 (detailing the restatement of Comverse Technology summarizing the scandal); *see also* Williams, *supra* note 87 (stating the restatements of Brocade Communications).

[172] *See* Rekant v. Desser, 425 F.2d 872, 882 (5th Cir. 1970) (discussing case where corporate officers deceived shareholders by making affirmative misrepresentations in corporation's annual report and by failing to file same report following year). *See generally* Shell v. Hensley, 430 F.2d 819, 825 (5th Cir. 1970) (summarizing allegations that corporate officers used reports to deceive shareholders and concealed improper payments to the corporation's president).

[173] *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (setting standard for materiality under Rule 14a-9).

determining whether to buy or sell the security.[174] This prong would be tougher to prove when the number of stock options is insignificant compared to the total value and profits of the company.[175] If the percentage of the securities given to the executive was significant, the amount of executive compensation could still be considered material to investors. The large stock option granted to Steve Jobs that totaled almost two percent of the all outstanding shares of Apple is likely material because it is such a large misstatement of earnings.[176]

Scienter, or knowledge of the misrepresentation is also required.[177] Scienter is defined as an "intent to deceive, manipulate, or defraud."[178] The intent of many executives in these cases is clear: to manipulate the dates of stock options in order to receive them after they had already increased in value. The benefit is reporting them as if they were at-the-money so as to avoid adding them as compensation in accounting reports, and/or paying taxes on their true value.[179] This is exemplified in the case of Comverse Technology where there was direct evidence of executives changing grant dates and subsequently deceiving the compensation committee.[180]

While an executive might prove that he had no knowledge of the backdating, his naiveté is not necessarily dispositive.[181] Many

[174] *Id.*; *see* Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988) (affirming the rule 14a-9 materiality standard articulated by the Court in *TSC Indus.'s*).

[175] *See* In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 767–68 n.533 (Del. Ch. 2005) (comparing the ramifications of $ 734 million sale of subsidiary and hiring of employee to 1996 revenues of almost $ 19 billion).

[176] *See supra* notes 89–92 (referring to the misdeeds of the well-touted executive); *see also* Bebchuk, *supra* note 89, at A6 (describing the backdated grant of Steve Jobs of 7.5 million Apple shares, totaling roughly 2% of all outstanding shares); Joe Nocera, *Nice Phone, Mr. Jobs, But*, N.Y. TIMES, Jan. 13, 2007, at C1 (reporting that Apple grant to Jobs finalized in December 2001 but carried an October 2001 date).

[177] *See* Aaron v. Sec. & Exch. Comm'n, 446 U.S. 680, 692 (1999) (expanding the requirement of scienter regardless of plaintiff's identity or type of relief sought); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (concluding that scienter is required for a private cause of action under Rule 10b-5); McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979) (stating that scienter is a requisite element of the Securities Exchange Act of 1934).

[178] *Ernst*, 425 U.S. at 193 (defining scienter).

[179] *See generally supra* notes 19–34 (describing the scandal and executive activities).

[180] *See supra* notes 61–68 and accompanying text (outlining the wrongdoings at Comverse).

[181] *See, e.g.*, Dash & Freudenheim, *supra* note 51, at A1 (explaining UnitedHealth's claim that its executives were entitled to presume that "matters brought before them for action were procedurally proper and consistent with applicable legal and accounting stan-

circuit courts have found that recklessness satisfies the requirement of scienter.[182] Recklessness is conduct that can be defined as a "highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[183] Although the actual state of mind of the defendants will depend on a factual inquiry,[184] it is reasonable to assume that much of the large-scale backdating, even if direct executive knowledge cannot be proven, still warrants a finding of extreme recklessness and ignorance in failing to curtail the fraud, especially when some of the backdating practices exceeded a decade.[185]

For a 10B5 violation, reliance must also be established.[186] The purchasers of the securities must have relied on the misleading information when the securities were purchased.[187] If the information is non-public, then actual reliance must be shown.[188]

dards"); *see Slush Fund and Fake Employees, supra* note 3, at A1 (describing Comverse Executive Kobi Alexander's initial denial of having knowledge of the backdating).

[182] *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568–69 n.6 (9th Cir. 1990) (listing multiple circuits that have held recklessness satisfies scienter requirement).

[183] *Hollinger*, 914 F.2d at 1569 (defining recklessness); Howard v. Everex Sys., Inc., 228 F.3d 1057, 1063 (9th Cir. 2000) (citing *Hollinger* definition of recklessness).

[184] *See* Karen Schoen, Comment, *Insider Trading: The "Possession Versus Use" Debate*, 148 U. PA. L. REV. 239, 257 (1999) (highlighting that factual inquiries are required to obtain an understanding of "the state of mind and motivations of the trader."); *see also* Edward J. Yodowitz, *Does Recklessness Satisfy the Scienter Requirement?*, THE CPA JOURNAL ONLINE, Dec. 1989, *available at* http://www.nysscpa.org/cpajournal/old /08033856.htm (stating that whether a third party's reliance "is reasonably foreseeable in a specific case will likely depend on the particular facts involved").

[185] *See, e..g.*, *Nightly Business Report* (Cmty. Television Found. Of S. Florida television broadcast Aug. 9, 2006) (illustrating FBI claims of backdating at Comverse Technology that spanned over 10 years); *see Slush Fund and Fake Employees, supra* note 3, at A1 (revealing 26 improperly dated grants at Comverse between 1991 and 2001);

[186] *See Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (agreeing that reliance is an "element of a Rule 10b-5 cause of action"); *see also* Sec. & Exch. Comm'n v. C. Jones & Co., 312 F. Supp. 2d 1375, 1379 (D. Colo. 2004) (stating that reliance is required for private actions under 10b-5).

[187] *See Basic*, 485 U.S. at 241–47 (describing the reliance standard); *see also*, In re Gupta Corp. Sec. Litig., C 94-1517 FMS, 1995 U.S. Dist. LEXIS 22093, at *11 (N.D. Cal. Apr. 18, 1995) (stating that "[u]nder the fraud on the market theory, the plaintiff has the benefit of a presumption that he has indirectly relied on the alleged misstatement, by relying on the integrity of the stock price established by the market.").

[188] *See Basic*, 485 U.S. at 246 (commenting that since "most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a *Rule 10b-5* action."); *see also*

However, since statements are required to be filed with the SEC under accounting rules, and consequently made public, proving actual reliance will not be necessary.[189]

Alternatively, for backdating, reliance can be established through the fraud-on-the-market doctrine, which provides for presumed reliance if the misleading information was publicly disseminated.[190] This is a rebuttable presumption that is based on the economic theory that when a materially false statement or omission is made by a company, investors rely on the "integrity of the price set by the market."[191] Moreover, even though ordinary investors do not read complicated financial statements, the market is set by sophisticated stock analysts, who do read these statements and, therefore, ordinary investors indirectly rely on them.[192]

A defendant can rebut the presumption of reliance, which is based on the fraud-on-the-market doctrine, by "1) disproving materiality or by proving that, despite materiality, an insufficient number of traders relied to inflate the price; and 2) by proving

West v. Prudential Sec.,Inc., 282 F.3d 935, 938 (7th Cir. 2002) (holding that when misinformation is not available to the public, it cannot be the basis for a claim under the fraud on the market doctrine).

[189] *See* Lie, *supra* note 24. This is testimony on accounting rule APB opinion No. 25, which was phased out in 2005. It discusses the new accounting rule FAS 123R and the changes it has enacted. *See also* Lie, *supra* note 4. This provides additional discussion of the new accounting rule and its changes.

[190] *See Basic*, 485 U.S. at 242. "The Court of Appeals held that in order to invoke the presumption, a plaintiff must allege and prove: 1) that the defendant made public misrepresentations; 2) that the misrepresentations were material; 3) that the shares were traded on an efficient market; 4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and 5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed." *Id.* at 248. This paper highlights that "[i]n Basic, the Court concluded that 'misleading information will . . . defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.'" *Defending Securities Class Actions*, ALI-ABA COURSE OF STUDY MATERIALS (2003).

[191] *Basic*, 485, U.S. at 245 ("Requiring a plaintiff to show a speculative state of facts, i.e., how he would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made, would place an unnecessarily unrealistic evidentiary burden on the *Rule 10b-5* plaintiff who has traded on an impersonal market."); *see* Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975) (citing that a "speculative negative," that is, one that requires a "plaintiff prove directly that he would have acted differently had he known the true facts," is unnecessary and is thereby rejected by the court).

[192] *See Basic*, 485 U.S. at 242 (citing the district court that found "the presumption of reliance created by the fraud-on-the-market theory provided 'a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of FRCP 23"); *see also West*, 282 F.3d at 937 (describing *Basic* and the fraud-on-the-market doctrine).

that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he would have, had he known of it."[193]

Because all traders theoretically relied on the financial statements released to the SEC, the executives would have to disprove that their compensation was material to stock prices in order to invoke the first prong. This is unlikely as most investors would likely consider how much executives were raking in from the company for their own personal profit to be material to the health of the company, and consequently, to stock prices.

In addition, since the stock options were fraudulently hidden from released financial statements to the SEC, stock investors in the companies that participated in backdating would have had no way of knowing about the additional compensation, and the companies would therefore have difficulty rebutting the presumption of reliance based on the second prong. Thus, the fraud-on-the-market theory would create a presumption of reliance.

The final requirement of causation calls for a "causal connection between the defendant's misrepresentation and a plaintiff's injury."[194] In cases where there is an affirmative misrepresentation, there are multiple ways to establish the causal connection. First, reliance on the market may be used to prove causation.[195] One may also establish the "causal nexus" indirectly by "proof of materiality coupled with the common sense that a stock purchaser does not ordinarily seek to purchase a loss in the form of artificially inflated stock."[196] Under this standard, the plaintiffs in stock option backdating cases should not have a problem proving a causal connection between the fraudulent activities of executives and the consequential harm to the corporation or to their individual stock portfolios. The injuries to the corporation,

[193] *Blackie*, 524 F.2d at 906 (outlining how defendants can rebut the fraud-on-the-market doctrine).

[194] *Basic*, 485 U.S. at 243.

[195] *See id.* at 243 (highlighting that although reliance can be used to show "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury," there is "more than one way to demonstrate the causal connection."); *see also* Donald Eric Remensperger, *The Second Circuit Review—1981-1982 Term: Security: Causation in Fraud-on-the-Market Actions--Investors' Insurance in the Second Circuit?*, 49 BROOKLYN L. REV. 1291, 1323 (1983) (stating that "an action under 10b-5 requires a showing of reliance to establish this causation.").

[196] *See Basic*, 485 U.S. at 245 (quoting Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975).

including negative publicity, large market reductions, and the cost of accounting restatements and tax re-filings,[197] were all the direct result of the grant manipulations. Causation is a logical finding.

However, this is not the standard for causation in all circuits. In the recent case of *Oscar v. Allegiance Telecom, Inc.*, the Court adopted its own fraud-on-the-market rule that required "loss causation," which provides that "the plaintiff [may] recover under the fraud on the market theory if he [can] prove that the defendant's non-disclosure materially affected the market price of the security."[198] This new standard is set forth in *Basic v. Levinson*, which provides for the rebuttal of reliance when the causal connection between the misrepresentation and the plaintiff's injury are severed.[199] In cases such as Apple Computers, where shareholders actually bid up the stock by more than $5 per share at one point,[200] proving actual loss causation could be extremely difficult. However, even this rise might have been fraudulently induced, as it followed a company disclosure stating that its well-touted CEO, Steve Jobs, had received no benefit from or did not appreciate the accounting implications of any stock option grants.[201] According to later reports, Jobs received a fortuitous grant of 7.5 million Apple shares that were allegedly backdated by 2 months.[202] In addition, considering reports put the losses in market capitalization of companies the day after reported backdating announcements at around $5.1 billion,[203] most sharehold-

[197] *See, e.g.*, *Comverse Exec Sentenced in Options Case*, BOSTON GLOBE, May 10, 2007, *available at* http://www.boston.com/business/technology/articles/2007/05/10/comverse_exec_sentence (indicating that the cost to Comverse technology for backdating malfeasance was judicially calculated at $51.8 million); *see* Dash & Freudenheim, *supra* note 51, at A1 (describing UnitedHealth's accounting restatement).

[198] 487 F. 3d 261, 265 (5th Cir. 2007) (quoting Nathenson v. Zonagen Inc., 267 F. 3d 400, 414 (5th Cir. 2001)) (requiring loss causation).

[199] *See id.* (stating requirements were not "plucked from the air," but rather came from *Basic*).

[200] *See supra* notes 89–93 and accompanying text (describing the market reaction to Apple news).

[201] *See supra* notes 89–93 and accompanying test (detailing results of Apple backdating).

[202] *See* Bebchuk, *supra* note 89, at A6 (detailing the massive grant to Steve Jobs). *See generally* Karen Gullo & Connie Guglielmo, *Apple's Jobs Questioned in Options Probe, Lawyers Say (Update 3)*, BLOOMBERG, Jan. 23, 2007, http://www.bloomberg.com/apps/news?pid=20670001&refer=conews&sid.htm (detailing the involvement of Jobs in the governmental probe into backdated stock options granted).

[203] *See* Taub, *supra* note 48 (reporting the findings of Glass Lewis).

ers should not have a problem establishing causation, even with this potentially higher standard in some circuits.

Therefore, when company executives made inaccurate disclosures by omitting large portions of their compensation from the company's earnings as a result of fraudulent stock options to the SEC and, consequently, to the public, they can be found guilty of directly violating Section 10B5 of the Securities Exchange Act.[204]

C. Shareholder Litigation

i. Types of Suits

When a company has committed fraud by illegally backdating option grants and failing to properly disclose and report them, two types of actions can be brought by injured shareholders: a class action lawsuit or a derivative suit.[205] A class action civil suit is brought by "one or more people on behalf of themselves and others" who have been similarly and directly injured.[206] A derivative suit is a civil action brought by a shareholder on behalf of the corporation to enforce corporate rights against directors or other insiders.[207]

In the case of the stock option grant backdating, the type of action filed will likely depend on whether or not the plaintiff's stock took a dive and caused a direct harm on the shareholder when news of the backdating was disseminated, or when the costs of litigation, as well as accounting and tax restatements had a direct effect on the stock value. In these cases, a class action is a more appropriate remedy. For example, the shareholders of

[204] *See, e.g., supra* notes 25–26.

[205] *See* Mateja & Willis, *supra* note 5 ("Misstatements and accounting irregularities can lead to class actions and shareholder derivative lawsuits that claim damages arising from the misstatements on behalf of shareholders and the corporations themselves"); *see also* Francine McKenna, *Stock Options Backdating: An Update for Auditors*, The IIA Chicago Conference, Apr. 2, 2007, *available at* http://www.mckennapartners.com/downloads/MP_IIA-Chgo_0407.pdf (discussing the two types of suits available, a class action suit, where "the shareholder plaintiff is the allegedly injured party," and a derivative suit, where "the corporation, not the shareholder plaintiff, is the allegedly injured party.").

[206] *What is a Class Action Lawsuit*, FREEADVICE, http://law.freeadvice.com/financial_law/broker_disputes/class_action.htm.

[207] *See* MBCA §7.41(2). The named plaintiff in a derivative suit must be a fair and adequate representative for the corporation's interests. A derivative suit is also called a derivative action, and has been defined as "[a] suit by a beneficiary of a fiduciary to enforce a right belonging to the fiduciary." BLACK'S LAW DICTIONARY 203 (3d ed. 2003).

Comverse Technology filed a class action lawsuit against the executives, including the company's CEO, Kobi Alexander, alleging that "improperly backdated stock options produced a windfall for top officers of Comverse," "at the expense of the software company's shareholders."[208] The suit claims that "during the class period, the defendants knowingly made material misstatements and omissions regarding the actual dates of stock-option grants," and that, consequently, the Comverse stock dropped more than $6 per share.[209] Class actions have also been filed against a slue of other companies with similar allegations.[210]

If the shareholder cannot prove any direct effect on the stock's value, then a derivative suit is a more appropriate remedy. Companies under suspicion of backdating have been subjected to charges amounting to over $5 billion dollars.[211] Therefore, proof of damage to the company is practically a non-issue. Shareholders have already filed derivative suits against multiple companies alleging, among other things, breaches of fiduciary duty and fraud arising from the improper backdating and reporting of stock options.[212]

ii. Causes of Action

There are two causes of action a shareholder is likely to bring against a company or executives in the wake of stock option backdating: (1) a state cause of action for the breach of the fidu-

[208] *See Law Firms Fight for Lead Role in Comverse Backdating Suits*, *supra* note 61, at 12 (mentioning the fight between law firms for the lead role in the Comverse lawsuits).

[209] *Id.*

[210] *See* Zucker v. Zoran Corp., No. C 06-04843 (WHA), 2006 U.S. Dist. LEXIS 93469, at *2 (N.D. Cal. Dec. 11, 2006) (seeking to recover for inflatedly priced Zoran stock that did not truly reflect the company's compensation costs as a result of the alleged backdating); *see also* Hacker v. Peterschmidt, Nos. C 06-03468, C 06-04479, C 06-04509, C 06-04524 (SI), 2006 U.S. Dist. LEXIS 77325, at *3–4 (N.D. Cal. Oct. 11, 2006) (outlining a class action complaint against Openwave for issuing false and misleading financial statements caused from backdating of stock options).

[211] *See* Dash, *supra* note 33, at C1 (citing to Glass Lewis Company); *see also* Taub, *supra* note 48 (citing the *San Francisco Chronicle's* figure of $5.2 billion charged to companies to correct backdating).

[212] *See, e.g.*, *American Tower Corp. Execs Face Suit Over Options Backdating*, *supra* note 118, at 10 (alleging that option grant manipulation caused breaches in duties of loyalty, and subjected the company to costly SEC investigations); *see Judge Consolidates Suits Charging Rambus Execs Backdated Options*, 22 No. 5 ANDREWS CORP. OFF. & DIRECTORS LIAB. LITIG. REP. 13 (2006) (alleging that Rambus, Inc. failed to properly record in the money options as compensation on financial statements, "thereby inflating its net income").

ciary duty of loyalty; or (2) a federal cause of action under 10B5 of the Securities Exchange Act of 1934.

A plaintiff suing for the breach of the duty of loyalty will face different burdens of proof depending on whether the conflicted transaction was ratified or not.[213] If all aspects of the conflicted transaction were disclosed to the disinterested directors or shareholders, the transaction will be considered to be an "arm's-length" transaction and directors' decision will thereby likely be protected by the business judgment rule.[214] In this case, a suing plaintiff must overcome the difficult burden of proving that the transaction lacks entire fairness to the corporation.[215] This, however, is likely not the case, as the essence of the backdating scandal stems from the fact that the options were left undisclosed to shareholders.

Since shareholders can show that adequate disclosures of stock options were not made, namely left unreported to the SEC, the burden is then on the parties to the transaction, namely the directors, to prove entire fairness.[216] This will be difficult considering it is unlikely executives can prove it was entirely fair to the corporation for it to receive millions less in revenue because an executive fraudulently changed the grant dates on his stock options.[217] In addition, companies abound that have loss serious market capitalization, such as Brocade Communications who

[213] *See* Lewis v. S.L. & E., Inc., 629 F.2d 764, 768 (2d Cir. 1980) (deciding the burden of proof issue); *see also* Black, *supra* note 99 (describing the different burdens of proof).

[214] *See* Black, *supra* note 99 (referring to arms-length transactions); *see also* Feld Thoughts, *Board of Directors: Duty of Care and Duty of Loyalty* (July 11, 2006), *available at* http://www.feld.com/blog/archives/001822.html (describing the business judgment rule as a court's reluctance to "rethink a board's action or decision if it's reasonably clear that the board made rational decisions and acted within the notions of their fiduciary duties").

[215] *See Lewis*, 629 F.2d at 768–69 (stating that the "business judgment rule places a heavy burden on shareholders who would attack corporate transactions"); *see also* Black, *supra* note 99 (describing the burden of proof as entire fairness).

[216] *See Lewis*, 629 F.2d at 769 (citing §713 that proves that "a contract 'shall establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the time it was approved by the board . . .' Thus when the transaction is challenged in a derivative action against the interested directors, they have the burden of proving that the transaction was fair and reasonable to the corporation."); *see also* Sage v. Culver, 147 N.Y. 241, 247 (Ct. App. 1895) (stating that a "trustee is bound to explain the transaction, and show that the same was fair, and that no undue advantage had been taken by him of his position . . .").

[217] *See, e.g.*, *Slush Fund and Fake Employees*, *supra* note 3 at A1 (stating that executives received millions in backdated options); *see* Dean, *supra* note 95 (citing the $51 million in unreported compensation expenses of the executives of Affiliated Computer Services).

have seen their stock drop by more than 70% between 2002 and 2007.[218]

For a 10B5 violation, a private plaintiff has an implied right of action under the '34 Act,[219] and must prove all of the elements, including a misrepresentations in connection with the purchase and sale of a security,[220] a breach of a fiduciary duty,[221] a manipulative or deceptive device employed,[222] a material misrepresentation,[223] scienter,[224] reliance,[225] and causation.[226]

VI. THE FUTURE OF BACKDATING

In the midst of the backdating scandal, as of 2002, the SEC has attempted to curb the future potential for backdating in the United States by enacting new rules to govern the disclosure of stock options. In July 2002, Sarbanes Oxley was enacted, which requires stricter disclosure of accounting and financial activities, including the requirement that stock options be reported to the

[218] Glenn Curtis, *The Dangers of Options Backdating*, INVESTOPEDIA.COM, Feb. 26, 2007, http://www.investopedia.com/articles/optioninvestor/07/options_backdating.asp.

[219] *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971) (stating that a private right of action is recognized); *see also* Shell v. Hensley, 430 F.2d 819, 824 (5th Cir. 1970) (finding that that "individual right of action [is] implied under *Rule 10b-5*.").

[220] *See* Securities Exchange Act of 1934, §10 (codified at 15 U.S.C.S. §78(j) (2007)) (announcing the unlawfulness of manipulative and deceptive devices in interstate commerce and in any national securities exchange); *see generally* Pommer v. Medtest Corp., 961 F.2d 620 (7th Cir. 1992) (stating the requirements of the Securities Exchange Act).

[221] *See* Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646, 656 (1983) (holding that if a special relationship exists, the person who receives non-public information has a fiduciary duty to disclose it before trading); *see also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977) (mentioning the fiduciary duty breach requirement).

[222] *See Santa Fe*, 430 U.S. at 473–74 (describing Congress' objective to prevent manipulative or deceptive devices).

[223] *See* TSC Indus., Inc. v. Northway Inc., 426 U.S. 438, 449 (1976) (stating that the standard for what constitutes a genuine issue of material fact is whether a reasonable shareholder would consider it important in deciding how to vote).

[224] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1975) (stating that "scienter" is necessary for a private action under Rule 10B5 of the Securities Exchange Act of 1934).

[225] *See Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (stating that reliance is an "element of a Rule 10b-5 cause of action").

[226] *See id.* (noting the requirement for a "causal connection"); *see also* Sec. & Exch. Comm'n v. Rana Research, Inc., 8 F.3d 1358, 1364 (5th Cir. 1993) (holding that "reliance is not an element the SEC must prove to enjoin violations of the securities laws"); Sec. & Exch. Comm'n v. C. Jones, 312 F. Supp. 2d 1375, 1379 (D. Colo. 2004) (stating that the "SEC must prove the following elements: (1) a material misrepresentation, (2) in connection with the purchase and sale of a security, (3) scienter, and (4) use of the jurisdictional means.").

SEC within two days after they are granted.[227] This is in comparison to the weeks or months previously allowed for reporting.[228]

According to a study by Randy Heron comparing the manipulated grant activity before and after the new two day reporting requirement, it virtually eliminates the improper backdating.[229] Therefore, much of the scandal can potentially be confined to the period before 2002. However, despite these efforts, many of the grants are still not being filed within this two day window. In 2006 nearly a quarter of the grants filed were not filed on time,[230] and even as of 2005, only 87% of the stock option grants were filed on time.[231] In Heron's study, the percentages of backdated options for the untimely filed grants are practically equal to the calculated figures from the pre-2002 data.[232] This illustrates an inherent weakness with Sarbanes Oxley; it contains no explicit sanctions for those who simply ignore the two day reporting rule.[233] Therefore, despite recent efforts, backdating remains a continuing problem.

[227] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (requiring that securities be filed before the end of the second business day); *see also* Maremont, *supra* note 35, at A1 (noting the requirement for executives to report stock options within two-days under the Sarbanes-Oxley Act).

[228] *See* Curtis, *supra* note 219 (noting prior to 2002, disclosures need not occur until the end of the fiscal year).

[229] *See* Randall A. Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?* (Oct. 26, 2006) (unpublished paper, on file with the Indiana University Kelley School of Business) (finding that for grants that were filed on time there was only 7% of them that were potentially backdated compared with 19.9% of those that were filed late).

[230] *See id.* (citing a study that found that nearly a quarter of stock option grants were not filed on time).

[231] *See* Posting of Douglas McIntyre to 24/7 Wall St., http://247wallst.blogspot.com/2006/07/backdating-of-executive-stock-options.html (July 19, 2006, 9:25 EST) (stating that only 87% of option grants were filled out on time in 2005).

[232] *See* Heron & Lie, *supra* note 230 (showing that the percentage of options backdated prior to 2002 were in the low to mid 20% range, while options not filed on time post-2002 were at nearly 10%).

[233] *See* Mary Jo Frank, *Does Sarbanes-Oxley Work?*, DIVIDEND, Spring 2007, at 40, *available at* http://www.bus.umich.edu/NewsRoom/BusinessSchoolPubs/DividendAlumniMagazine/Spring_2007/DarnSox.pdf (noting that lack of sanctions allows executives to ignore reporting requirement).

CONCLUSION

Recent corporate scandals have left the corporate investment world in a state of unrest. The public is encouraged to invest, but the amount of faith we can place in executives who engage in malfeasance, usually with a heavy dose of self-interest, is now being ever-diminished. And while many of these so-called "visionaries" built their companies from the ground up, such as resigned former founder and CEO, Dr. William McGuire, who took UnitedHealth and built it into a billion dollar health insurer,[234] it still does not give these executives the right to steal from the shareholders upon whose investments' back the companies were built upon. Hopefully the new reporting laws and SEC crackdowns will bring about serious reform in the future, so that investors can someday truly rely on the integrity of the market and the integrity of those at the helm of corporate America.

[234] *See* Dash & Freudenheim, *supra* note 51, at A1 (discussing McGuire as a medical entrepreneur who built UnitedHealth into a "colossus in its field," and setting the market capitalization of UnitedHealth in 2006 at $66 billion).