

## **Backdating: The New Securities Fraud?**

By Amy E. Wong

Stock options are a typical form of compensation in public companies. For Gregory L. Reyes, former CEO of Brocade Communications Systems, stock options gave him wealth, power, and, in a recent twist of fate, scandal.

The Securities and Exchange Commission (SEC), the Department of Justice (DOJ), and the Federal Bureau of Investigation (FBI) unveiled the criminal and civil securities fraud charges filed against Brocade's ex-CEO and former HR manager, Stephanie Jensen, on July 20.

In a joint news conference in San Francisco, the agencies alleged that the two former employees "routinely backdated stock option grants to give employees favorably priced options without recording necessary compensation expenses."

The topic of intense debate is whether the pair purposefully backdated options to periods when Brocade's stock price was at a record low and whether the information was properly recorded and disclosed.

This case, in essence, is an extension of other major scandals that recently rocked the corporate world, in which executives rake in tons of cash at the expense of unsuspecting shareholders.

Stock options allow recipients to purchase shares at the strike price, which is the value of the stock at a certain date. Backdating, the alteration of dates on the stock, allows stock option recipients—who are usually top-tier employees—to lock in shares at low prices and cash in big when stock prices increase.

Backdating options is not illegal if shareholders and the government know about it. However, in Brocade's specific case, backdated options caused major accounting errors that harmed public shareholders.

In 2000, Brocade reported earnings of \$67.9 million. After Reyes departed, the company reported a \$951-million loss. These accounting errors led to overstated earnings of more than \$1 billion. To add to public suspicion, Brocade's downfall coincided with the year when

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Reyes made a staggering \$556 million, most of which came from selling his options.

There has been disagreement over whether Reyes personally profited from backdated options. Government investigations revealed that the date on some of Reyes' options is identical to the incorrectly dated options that other executives received. The SEC claimed in its civil complaint, "Reyes himself received backdated options."

Richard Marmaro, partner at Los Angeles-based law firm Skadden, Arps, Slate Meagher & Flom, maintained his client's innocence in a written statement: "Financial gain is always the motive in securities fraud cases, and here there was none. There is not even an allegation of self-enrichment or self-dealing. Nor is there any evidence of an intent to misstate the financial statements of the company."

According to Marmaro, Reyes was not the beneficiary of the backdated stock options in question. Reyes merely acted according to the orders given by Brocade's board of directors, awarding options to employees in order to attract and retain talent.

He continued, "Additionally, the amounts of under-reported stock option compensation expenses alleged in this case did not have any impact on the company's financials or on the value of the stock."

Marmaro defends Brocade and Reyes, saying that neither breached federal securities laws with the deliberate intent to misstate the company's financials and mislead shareholders. Responding to allegations of criminal conduct, Marmaro asserts that "there were some paper problems in the company's HR department" that resulted in backdating—nothing more.

Furthermore, Marmaro criticizes the DOJ and the SEC for scapegoating the innocent because of "some perceived need to show quick action in response to the stock option issues being discussed in the media."

In the midst of ongoing investigations, Linda Thomsen, chief of enforcement at the SEC, stated at Thursday's conference that it is not a question of whether Reyes profited from backdated options himself. It is about taking responsibility for concealed information that may have adversely affected stock prices.

Currently, in an attempt to restore public confidence in corporations, the SEC is investigating 80 other companies—both technology and S&P 500—for similar cases of backdated options.

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As U.S. Attorney Kevin V. Ryan said at the joint news conference, “It is integral to the public trust in our financial markets that books and records are maintained honestly and that the true financial condition of public companies is disclosed accurately.”

In wake of this groundbreaking case, lawyers, executives, and accountants are trying to differentiate between criminal conduct and innocent accounting errors.

Larry Ribstein, professor at the University of Illinois College of Law, commented on the government’s tightening control on American corporations. If the government indicts both the executive and HR manager, will it also persecute CFOs and anybody else remotely involved in company scandals? If the government punishes executives for backdating options, will it also lash out at other compensation practices?

Ribstein wrote in *Ideoblog*, “Does the government need to make an example for deterrence purposes? [...] If the companies were inflating their earnings by not recording expenses, that’s a problem. But criminalizing this business practice is not the answer.”

He continued, “There is little doubt that the combination of regulation, civil liability and markets can solve—indeed, probably already has solved—any problems here. In fact, criminal charges are so patently not the answer that I suspect that one big effect of this scandal will be a reexamination of the whole issue of criminalizing agency costs.”