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[Back to Article](#)

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## Backdating Inquiries Mean Business for Texas Firms

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For more than four years, the Sarbanes-Oxley Act of 2002 has been a lucrative source of business for Texas lawyers who help clients comply with the intricacies of the corporate governance law passed in the aftermath of the Enron Corp. meltdown.

Now there's a growing, new source of corporate governance work.

The U.S. Securities and Exchange Commission and the U.S. Department of Justice each are investigating alleged stock option backdating at dozens of U.S. companies, with the SEC probing securities filings at more than 80 U.S. corporations.

With federal prosecutors and SEC investigators breathing down their necks, Texas corporations are hiring defense firms, and plaintiffs firms are beginning to file shareholder derivative or class-action suits related to alleged option backdating at Texas companies.

"This all heated up for us in June of this year," says Charlie Parker, a securities litigation partner in Locke Liddell & Sapp in Houston.

"It's kind of become a rather large source of work for many lawyers," says Michael Gold, a corporate partner in Baker Botts in Washington, D.C.

The work, Gold says, cuts across many practice areas.

"This is the kind of issue that kind of crosses a whole lot of legal and accounting . . . issues. You have tax issues embedded in this. You have employee compensation issues embedded in this. You have corporate governance issues at the heart of this," Gold says. "In the purest, worst form, if the alleged conduct is true, it is fraud where there was a bad intent."

Parker and Paul Bessette, a partner in Akin Gump Strauss Hauer & Feld in Austin and chairman of the firm's securities litigation practice group, in addition to other lawyers who do securities work on the defense side, say they're receiving telephone calls from clients who want to hire lawyers for internal

investigations into how their companies awarded executive stock options. Clients who are reasonably confident they complied with federal securities laws but want lawyers to review their procedures also want advice, the lawyers say.

Houston-based Vinson & Elkins also is picking up work from clients concerned about the options backdating investigations, says Robert Kimball, a corporate finance and securities partner in Dallas. He describes two groups of clients — corporations where there may be a problem and corporations with executives who want lawyers to look at past options practices.

Bessette says Akin Gump put out an e-mail alert to let clients know what the government is looking at with regard to the stock option grants. And other firms are doing the same. V&E, for instance, e-mailed clients an update on July 26 that explains backdating, details the consequences of the activity and summarizes developments in investigations. That same day, the SEC approved new rules for reporting executive compensation. The new rules, which go into effect Dec. 15, will require public companies to disclose more and easier-to-understand information about executive compensation. They also require companies to explain how and why any options are backdated.

Companies usually grant options to buy stock at the same price the stock is trading on the date of the option grant. Under that scenario, called "at the money," the option to buy has no immediate value.

But when a corporation backdates an option by awarding it as of an earlier date, when the stock price was lower than the current market price, the option becomes immediately valuable and "in the money," because the exec can buy the stock at less than market price.

Backdating stock option awards isn't necessarily unlawful. But a corporation can run into problems with the SEC or the DOJ when it doesn't disclose enough information about the award or doesn't properly expense an in-the-money, backdated option; the problem is not telling the public about the practice and not properly accounting for the value.

"In most cases, all they had to do was be honest with the shareholders and disclose what was going on, and it wouldn't be an issue. The difficulty is management has such a hard time with honesty and integrity, providing information to shareholders," says William Federman, a plaintiffs lawyer and partner in Federman & Sherwood in Oklahoma City, Okla., who filed a shareholder derivative suit against Irving's Michael's Stores Inc. in June.

### Revealing Data

Option backdating is not an isolated activity in corporate America, according to a July 14 study by two professors who looked at the timing of stock option grants. Erik Lie, an associate professor at the University of Iowa, and Randall Heron, an associate professor of finance at Indiana University, estimated that 18.9 percent of "unscheduled, at-the-money" options grants to top executives between 1996 and 2005 were backdated or otherwise manipulated.

The professors found the percentage was higher before Sarbanes-Oxley instituted a rule in 2002 requiring companies to report option awards within two days, according to the study. Following the two-day rule, 10 percent of options were backdated, Lie and Herron reported in their study, which is available on the University of Iowa's Web site.

The professors found a higher frequency of backdating among technology companies, small companies and companies with high stock price volatility.

The study looked at 39,888 stock option grants to top executives from 1996 to 2005, but Lie declines to say how many of the corporations in the sample are based in Texas.

"There are a lot of Texas companies in my sample. I haven't singled them out to see if they are more likely or less [to backdate]," Lie says. "I'm intrigued at this idea of looking at . . . geography in general; so far I just haven't had the time to look at it."

Darren Robbins, a partner in Lerach Coughlin Stoia Geller Rudman & Robbins in San Diego, says he wouldn't be surprised to see 10 to 15 shareholder derivative suits filed in Texas over options backdating. Robbins' firm is on the plaintiffs' team in suits against Houston's Cyberonics Inc. and Affiliated Computer Services of Dallas.

Over the past few months, dozens of U.S. companies, including at least three in Texas, have announced that the SEC or federal prosecutors have requested information about past stock option grants. Nationally, the investigation heated up July 20, when the U.S. Attorney's Office for the Northern District of California and the SEC filed criminal and civil securities charges against the former chief executive officer and former vice president of human resources of Brocade Communications Systems Inc., of San Jose, Calif., alleging they routinely backdated stock option grants without properly expensing them.

In a statement on July 20, Brocade said it is public record that the company restated financial results twice in 2005, following an internal audit committee review of historical stock option granting practices, and it has strengthened disclosure controls and procedures. It also said that during the first quarter of 2006, the company reserved \$7 million for an offer of settlement made to the SEC, but that SEC commissioners must approve the settlement, and there is no further update on the matter. The company also declined comment on the charges against the former executive officers.

When asked about the status of Brocade's settlement offer, Patrick Murphy, branch chief of enforcement for the SEC in San Francisco, says, "Our investigation is continuing."

#### Lone Star Litigation

In Texas, Affiliated Computer Services (ACS), Cyberonics and Michael's Stores are involved in the stock options brouhaha.

In May, ACS announced that the SEC informally is investigating stock option grants made by the company from October 1998 through March 2005. The company also announced that it is a defendant in three shareholder derivative suits filed in state district court in Dallas and in chancery court in Delaware that allege breach of fiduciary duty and unjust enrichment in connection with stock option grants to certain officers from 1996 through 2002. ACS intends to vigorously defend the suits, according to the statement issued in May.

In June, ACS was sued in the U.S. District Court for the Northern District of Texas in a federal shareholder derivative suit, *Alaska Electrical Fund v. Jeffrey Rich, et al.*, which alleges, among other causes of action, breach of fiduciary duty, abuse of control and gross mismanagement in connection with stock option awards that allegedly were backdated.

Lesley Pool, senior vice president and chief marketing officer at ACS, refers questions to Bill Deckelman, executive vice president and general counsel at ACS, but his assistant says he is traveling overseas until Aug. 10. Joe Kendall and Willie Briscoe, attorneys at Provost & Umphrey in Dallas who filed the federal suit

on behalf of the plaintiff, also did not return telephone messages before presstime on July 27.

In June, medical-device manufacturer Cyberonics announced it received a subpoena from the U.S. Attorney's Office for the Southern District of New York requesting documents related to its stock option grants. The company also announced that the SEC is conducting an informal inquiry into stock option grants and that its audit committee is conducting a review of its stock option grants.

On July 20, a Cyberonics shareholder filed a shareholder derivative suit against the company, its board and certain senior executives, alleging "defendants allowed senior Cyberonics insiders to divert hundreds of millions of dollars of corporate assets to themselves via the manipulation of grant dates associated with hundreds of thousands of stock options granted to Cyberonics insiders" and alleging the defendants participated in concealing the options backdating.

Plaintiff's attorney Timothy Crowley, a partner in Crowley Douglas & Norman in Houston, who filed *James F. Gerrity III v. Robert P. Cummins, et al.* in U.S. District Court for the Southern District of Texas, did not return two telephone messages before presstime.

Through a spokeswoman, David Wise, vice president and general counsel of Cyberonics, declines comment.

And in Irving, Michael's Stores announced in June that its audit committee is reviewing historical stock option practices from 1990 to 2001. Also in June, the company received a subpoena from the U.S. District Court for the Southern District of New York requesting documents related to stock option grants from 1996 to the present and a letter from the SEC asking the company to preserve all documents related to stock option grants from 1990 to the present.

The retailer also faces two shareholder derivative suits filed in June, one in a Dallas County state court and the other in the U.S. District Court for the Northern District of Texas. The federal suit, *Albert Hulliung v. David E. Bolen, et al.*, alleges breach of fiduciary duty and unjust enrichment, among other causes of actions, in connection with stock option awards. The defendants in Hulliung are the company and other individuals, including board members

Defense attorney Patricia J. Villareal, a partner in Jones Day in Dallas who represents Michael's, did not return a telephone call before presstime. A Michael's spokesman says the company does not comment on pending litigation.

Bessette says the backdating controversy hasn't reached its crest yet, but he doesn't believe it has the legs to develop into a long-running corporate governance problem.

"I don't think ultimately it's going to be anything close to the financial scandals, the Enrons, WorldComs, the number of restatements over the last several years over various revenue-recognition issues," he says. "There's going to be a sorting-through process."

But Bessette says he expects to see more derivative litigation and class-action litigation filed against corporations that already are dealing with the SEC and federal prosecutors.