Executive COUNSEL
THE MAGAZINE FOR THE GENERAL COUNSEL, CEO & CFO

Lessons from the Options Backdating Scandal

The Archeology of Compensation Litigation

By Stuart L. Gasner

If litigating a lawsuit about compensation issues is a lot like doing a "dig" at an archeological site, the options backdating scandal was a veritable Pompeii.

When the Wall Street Journal ran its famous "Perfect Payday" article in 2006, it unleashed a torrent of internal investigations at hundreds of public corporations, which in turn led to billions of dollars in accounting restatements, as well as scores of shareholder and derivative lawsuits, SEC proceedings, and for an unlucky few, criminal prosecutions. It was as if a Vesuvius had erupted, with the flow of lava freezing in place a decade of compensation practices. Legions of prosecutors and defense lawyers were soon on the scene, chisels and brushes in hand.

I represented a variety of clients caught up in the options backdating mess. They ranged from CEOs and outside directors to staffers in HR. The outcomes ranged from informal interviews followed by prompt exoneration to multi-year campaigns that included indictments and SEC trials. After document production in the millions of pages, a mountain of depositions, and in some cases weeks of trial, what did this archeological dig at the options backdating site uncover about compensation policy?

For one thing, we learned that much of the energy devoted to options backdating litigation was probably an enormous waste of resources. That was certainly a subtext of the court's opinion earlier this summer in our case, *Securities and Exchange Commission v. Shanahan,* in which the Eighth Circuit Court of Appeals affirmed the dismissal of the SEC's case against an outside director at a prominent corporation in St. Louis, someone who had the unenviable job of being assigned to the Compensation Committee in the late 1990s.

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In addition to exonerating the defendant by agreeing with the district judge that there was no evidence of wrongful intent, the court went out of its way to question the materiality of options dating disclosures – which were typically a sentence or two in a footnote to the company's financial statements, and a footnote about a non-cash accounting entry that only a CPA could appreciate. In retrospect, one wonders whether the SEC's time and energy would have been better spent investigating the Madoff fraud, the safety and stability of housing-based derivatives, or any number of other more worthy pursuits.

What we also learned is how much influence Congress has over compensation practices, and how legislative policies can drive executive behavior in unexpected ways. One "layer" that I uncovered in my archeological digs was that tax policy in the 1990s effectively forced corporations to rely heavily on options to compensate their top executives, penalizing companies that paid salaries to their executives in excess of $1 million by not allowing those salaries to be deductible. That in turn put pressure on options to make a ton of money, which in turn created an incentive to push the envelope in pricing options, which in turn led to an epidemic of backdating at hundreds of companies. The "dig site," in other words, ended up covering an enormous landscape, mostly thanks to Congress.

Another layer of the excavation revealed that Congress not only created the conditions that led to options backdating, it also stopped it. Sarbanes-Oxley changed the rules to require that options grants be reported to the SEC shortly after the grant. Before Sarbanes Oxley, a remarkable number of companies apparently backdated their grant dates. After Sarbanes-Oxley, they didn't. If stopping backdating was the goal, Congress could say "mission accomplished" after passing Sarbanes-Oxley and devising a sensible, clear rule.

But of course, merely stopping a practice is not the end of the story, especially when the "Bonfire of the Vanities effect" kicks in. Once there's a scandal and a toxic brew of publicity, politics, and pressure on enforcers to "do something," the path to litigation is pretty much set.

With options backdating, it was set the day the Wall Street Journal published "Perfect Payday." Whether the path leads to the doorstep of any particular executive is largely a matter of luck.

That leads to the next layer of excavation, and laborious hours spent with the litigation equivalent of chisel and brush, trying to find evidence to reconstruct the reality of what happened with respect to any particular client who is the target of an investigation or a defendant in a lawsuit.

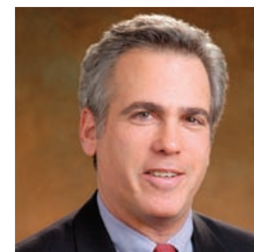
What was extraordinary about the options backdating cases, though, was how little could be clearly seen at the dig site. Unlike the excavation of Pompeii, which revealed with macabre precision streets, buildings and people caught in everyday activities, the late 1990's backdating site revealed only shards of pottery and the dim outlines of the village. Scores of people were typically involved in the process of granting, accounting for, and preparing options paperwork, but years later few remembered the details of what no doubt seemed at the time to be ministerial tasks. Others chose not to be available, or shaded their stories to point blame in other directions. Many records were lost or incomplete.

What often emerged was that the options backdating story was immensely complicated. The rules for pricing options and determining the proper date of the grant were complex, and responsibility for the process was widely diffused, with decisions being made by operational supervisors, HR, Finance, committees of the board, the whole board, and upper management. Even reputable auditors often failed to detect (or chose to ignore) that options backdating was going on beneath their noses.

Under these circumstances, the Eighth Circuit got it right in *SEC v. Shanahan* when it concluded it was simply impossible to hold an individual outside director responsible.

So what lessons for the future? Hiring good auditors, reliable CFOs and controllers, and skilled lawyers will help prevent being thrown into the dig site, especially if coupled with an attitude of trying to do the right thing. Keeping good records and having a sensible document destruction policy may make any future excavation easier.

However, in the end you never know what obscure area of corporate policy is going to be the fuel for the next Bonfire of the Vanities. It could be anywhere, as long as there are executives making what the public perceives as too much money, some "grey area" accounting, and an enterprising reporter or disgruntled employee to light the match. ■



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