

A dramatic, high-contrast photograph of a stormy sky with dark, swirling clouds and a bright light source breaking through near the top center. The overall color palette is a range of blues, from light and hazy to deep, dark navy.

# INVESTOR ALERT

GENERAL COUNSELS AT THE CENTER OF THE OPTIONS BACKDATING STORM

by ALAN I. ELLMAN

**B**y now, the investing public is well aware of the extent to which corporate executives backdated stock options as a means to inflate their compensation and that of their employees. More than 220 companies have been the focus of internal or governmental investigations, at least 100 companies have restated earnings in the amount of \$12.7 billion, sixteen executives have been indicted, and more than ninety executives and directors have been dismissed. But a lesser-known, and perhaps more disturbing, aspect of the options backdating scandal is the extent to which companies' general counsel—the "sentries of the marketplace"—were involved in actively perpetrating the underlying fraud. Four general counsels have been criminally indicted, eight have been named by the SEC in complaints or formal investigations, fourteen have been fired or resigned, and forty have been named as defendants in shareholder lawsuits. Instead of emboldening general counsels to report options backdating up the ladder to their boards of directors, the Sarbanes-Oxley Act of 2002 did nothing to prevent or expose this fraud. Voices calling for the roll back of Sarbanes-Oxley need to be reminded of how widespread the options backdating fraud is and how general counsels could have and should have prevented and exposed the misconduct.

Stock options give employees the right to buy a company's stock at a preset "strike price," typically the market price on the date of grant. The process of backdating involves setting the strike price with the benefit of hindsight, for example granting options on March 1 but using the stock price of February 1 as the strike price. If the February 1 price is lower than the March 1 price—as is invariably the case with backdated stock options—those options are "in the money" and inherently worth more, on paper, to the recipient. Under applicable accounting rules, the amount by which a stock option is in the money at the time of grant must be recorded as compensation expense. A company that fails to record, as a compensation expense, the difference between the price of its stock on the date of the actual grant and the "backdated" exercise price of the options improperly understates its compensation expense and overstates its net income and earnings per share.

Unlike the typical securities fraud scenario, options backdating places the general counsels at the center of the fraudulent conduct. The usual allegations of fraud are levied against the executives and employees with control over the financial or operational aspects of the business. The in-house legal department generally is not involved in the activities at the heart of the alleged wrongdoing. Actions against in-house counsel typically involve allegations of insider trading or that the general counsels assisted their companies in covering up evidence of fraud. Stock options backdating is different, however, in that the general counsel plays an integral role in the conduct at issue. The general counsel is essential to the creation of the stock options award plan; explains the rules of the plan to management; prepares stock option grant documents, such as unanimous written consents ("UWCs"), which directors use to formally approve option grants; files Forms 4 with the SEC acknowledging the grants; and signs proxy statements which generally state that options are granted at the

fair market value of the stock on the date of grant. It is difficult to imagine the perpetration of a backdating scheme without the complicity—or at the very least dereliction of fiduciary duty—of a company’s general counsel. In addition to manipulating the documentation of stock option grants (the sine qua non of backdating), these general counsels often directly profited from the fraud through their own receipt of backdated options.

The backdating schemes which have implicated general counsels involved each of these core functions. The former general counsel at Comverse Technology, William Sorin, pled guilty to criminal charges of securities fraud. Comverse’s CEO and CFO are alleged to have chosen dates when the company’s shares closed at prices well below the then-current price of the stock. Sorin then allegedly drafted UWC forms for execution by the compensation committee, which neither provided for, nor reflected, the dates when the consent forms were actually signed, i.e., the date the approval was actually granted. Rather, the UWCs contained “as of” dates, i.e., the favorable dates chosen by the CEO or CFO which were weeks or months earlier. Sorin reaped \$1.9 million in excess stock option profits due to backdating. He is currently serving a prison sentence of one year and one day.

Myron Olesnyckyj, former general counsel at Monster Worldwide, pled guilty to criminal charges of federal securities fraud and conspiracy to commit securities fraud. Olesnyckyj admitted that after Monster went public in 1996, he and others

agreed to choose the dates of stock option grants after looking at the historical records of the company’s stock price movements. Olesnyckyj then concealed the backdating from the company’s financial records, resulting in the company’s failure to increase its compensation expenses and reduce its earnings accordingly in its financial records. “I understood the company’s books and records... were inaccurate and misleading,” he said. Prosecutors said Olesnyckyj concealed this practice from Monster’s auditors, telling an employee in Monster’s Human Resources department by e-mail, “No written document should ever state lowest price over next 30 days! The auditor(s) will view that as backdating options and we’ll have a charge to earning... .” Olesnyckyj’s sentencing was scheduled for February 15, 2008.

Take-Two Interactive Software’s former general counsel Kenneth Selterman pled guilty to a criminal charge of Falsifying Business Records in the Second Degree. Selterman’s plea related to a letter submitted to the Nasdaq National Market falsely characterizing the types of stock options that had been issued to executive officers at Take-Two. Under his plea agreement, Selterman will pay a \$50,000 fine and he will be permanently barred from holding “control management positions” in publicly traded companies. In addition, he has agreed, should the SEC require it, to a lifetime bar from practicing before the SEC as an attorney. He is currently serving a three-year prison sentence.

Susan Skaer, former general counsel at Mercury Interactive, is alleged to have received backdated stock options under six separate grants while at Mercury and sold shares for illicit proceeds of over \$3.5 million. Skaer also attended, and took minutes for, substantially all of the board meetings wherein options were backdated, and was involved in falsifying internal documents in an attempt to cover up backdated stock option grants. Skaer, or someone acting according to her instructions, altered backdated UWCs by whiting out the fax dates at the top of the forms the compensation committee members sent to her. One of the committee members, however, unintentionally pulled the curtain from Skaer’s knowing and intentional deception when he apparently faxed one of the UWCs to Skaer upside down, so that the actual fax date appeared at the bottom of the document, an error Skaer overlooked and therefore failed to cover up. The SEC has filed charges against Skaer, which she is contesting.

HCC Insurance Holdings announced that its former general counsel Christopher Martin “was aware that options were being retroactively priced in a manner inconsistent with applicable plan terms and the procedures memoranda that he had prepared, that granting in-the-money options had accounting implications, and that he did not properly document [the] Compensation Committee’s informal delegation of authority to [the CEO].” The company also announced that Martin “resigned,” effective immediately, and that it disgorged from both Martin and the CEO the improper proceeds associated with their receipt of backdated stock options. A senior HCC officer specifically blamed Martin for the company’s stock option problems, stating that it was Martin’s job to protect the company and its shareholders.



**MOST RECENTLY, LABATON SUCHAROW SECURED  
A \$117.5 MILLION SETTLEMENT IN *IN RE MERCURY*  
*INTERACTIVE SECURITIES LITIGATION*, WHICH IS  
CURRENTLY THE LARGEST SETTLEMENT AGREEMENT  
TO DATE IN AN OPTIONS BACKDATING CASE.**



**LABATON SUCHAROW HAS BEEN APPOINTED  
AS LEAD OR CO-LEAD COUNSEL IN 29 PERCENT OF ALL  
OPTIONS BACKDATING CASES.**

THE MOST PROMINENT EXAMPLES OF THESE CASES INCLUDE:

**AMERICAN TOWER, HCC INSURANCE HOLDINGS,  
MERCURY INTERACTIVE, MONSTER WORLDWIDE,  
SAFENET, SEMTECH AND SONIC SOLUTIONS.**

THE FIRM IS ALSO PROSECUTING A DERIVATIVE LAWSUIT  
AGAINST OFFICERS AND DIRECTORS  
OF HOME DEPOT.

Instead of being the legal gatekeepers that Sarbanes-Oxley envisioned, some general counsels succumbed to the pressure of management and went along with or blessed options backdating. Stephen Cutler, then-Director of Enforcement at the SEC, commented in 2004 that: "We have seen too many examples of lawyers who twisted themselves into pretzels to accommodate the wishes of company management, and failed in their responsibility to insist that the company comply with the law." Indeed, after implicated general counsel Lisa Berry left KLA-Tencor, the new general counsel, Stuart Nichols, apparently tried to stop that company's backdating practice in 2001. After getting an e-mail early that year from the company's outside counsel stating that failure to record backdated options as an expense was improper, Nichols forwarded that information to then-CEO Ken Schroeder. In its complaint against Schroeder, the SEC said he responded with an e-mail saying "Help me, don't just tell me how to follow a strict interpretation of the rules," and adding that he wanted a "wartime counselor," not someone who can recite page and verse."

One of the primary legislative responses to the corporate wrongdoing of the last decade outlined in the Sarbanes-Oxley Act was placing accountability on corporate gatekeepers—especially general counsels—to maintain the fairness and honesty of the capital markets. Section 307 of the Act requires counsel to immediately investigate and "report up the ladder" any alleged or suspected internal criminal activity, fraud, or breach of fiduciary duty to senior management and, if necessary, the board of directors. Sarbanes-Oxley

also required that Forms 4 (evidencing stock option grant dates) be filed with the SEC within two days of the grant, instead of as long as 45 days after the end of the fiscal year, largely closing the loophole through which to backdate options. In one sense, Sarbanes-Oxley heralded the end of backdating. But although the actual backdating of stock options may have largely ceased by the end of 2002, the fraudulent accounting implications of backdating continued to have ripple effects until as late as 2006, since most companies' stock option plans provide that option grants vest over a given period, usually four or five years. That means that a company which granted in-the-money options in 2002 that vested over a four year period would need to record compensation expense from the first year of vesting (2003) until the last year (2006). General counsels whose companies ceased backdating because of the new Sarbanes-Oxley Form 4 requirement were undoubtedly on notice that their companies' financial statements continued to understate compensation expense and overstate net income and earnings per share until the last backdated options vested. The defense that a general counsel had no finance or accounting experience and was unaware of the accounting implications concerning the granting of stock options is likely to ring hollow, as general counsels are generally in charge of establishing the stock option plans and explaining the rules of the plans to management.

These cases of general counsels misconduct underscore that Sarbanes-Oxley needs to be strengthened and enforced, not watered down like some voices in government and business are advocating. The general counsels were central to stock options backdating, and post-Sarbanes-Oxley these problems, which the implicated general counsels were fully aware of, should have been brought up the chain and dealt with by the companies themselves rather than uncovered by outside parties. Instead of emboldening general counsels as sentries of the marketplace to expose options backdating, Sarbanes-Oxley did little to encourage these lawyers to disclose the fraud perpetrated on their companies' shareholders. [LS](#)

# leadcounsel

## Labaton Sucharow LLP—Going Green

Labaton Sucharow is doing its part to help reduce unnecessary waste and save our environment through its firmwide Going Green initiative, and has printed this publication on recycled paper. If in the future you would prefer to receive *Lead Counsel* as an electronic pdf file instead of a printed copy in the mail, please contact Stacey Szluka at [sszluka@labaton.com](mailto:sszluka@labaton.com)

## Editorial Staff

Edward Labaton  
Senior Editor

Natalie Ching  
Content Editor

Jennifer Tetefsky  
Marketing Director

Stacey Szluka  
Production Coordinator

## Contributors

Jill E. Fisch  
Nicole M. Zeiss  
Michael W. Stocker  
Alan I. Ellman  
Morissa Falk  
Yoko Goto  
Sharon F. Cooper

Labaton Sucharow LLP provides legal counsel to institutional and individual investors, union health and welfare funds and other third-party payors of prescription drug claims, as well as consumers. It specializes in securities, antitrust, ERISA, and other class action litigation.

It is not intended or suggested that the information contained in this publication be applied in any particular case or situation without a detailed professional review of the facts of that case or situation.

## Labaton Sucharow

Labaton Sucharow LLP  
140 Broadway  
New York, NY 10005

888 753 2796 toll-free  
877 907 8242 report a fraud hotline  
212 907 0700 main  
212 818 0477 fax



Printed on process chlorine-free FSC-certified Mohawk Options 100% PC, which is made with 100% post-consumer recycled fiber. Mohawk Fine Papers purchases enough Green-e certified renewable energy certificates (RECs) to match 100% of the electricity used in our operations. This paper is also certified by Green Seal.

[www.labaton.com](http://www.labaton.com)