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Backdating Stock Options
September 7, 2006

Presented by the Litigation Committee of the Association of Corporate Counsel

Sponsored by CRA International, Inc. and Winston & Strawn LLP

Association of Corporate Counsel
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Panel

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Moderator
Jonathon Yellin– CRA International, Inc.

Events Preceding the Current Climate

• In May 2005, Professor Erik Lie of the University of Iowa published his findings from a review of nearly 6000 stock option grants awarded to CEOs during the period 1992 – 2002.

• Lie found abnormally low returns before grant dates and higher than normal returns after grant dates.
  ◆ The trends were more pronounced for unscheduled option grants.

• Lie concluded, “Unless executives possess an extraordinary ability to forecast the future marketwide movements that drive these predicted returns, the results suggest that at least some of the awards are time retroactively.”
Events Preceding the Current Climate

- On March 18, 2006, the *Wall Street Journal* published an article entitled “The Perfect Payday” that examined the probabilities that certain stock option grants dated just before sharp rises in the stock price were random.
  - E.g., Jeffrey Rich, CEO of Affiliated Computer Services was granted options six times between 1995 and 2002. All six grants were dated just before a rise in the stock price, often following a steep decline.
  - A *WSJ* analysis estimated the odds of this happening by chance were around 300 billion to 1.

- In July 2006, Professor Randall Heron of Indiana University and Professor Lie published their findings of a review of nearly 40,000 stock option grants to top executives dated between January 1, 1996 and December 1, 2005.
  - Professors Heron and Lie estimated that:
    - 13.6% of these grants were backdated or manipulated;
    - Before August 29, 2002, 23.0% of unscheduled, at-the-money grants were backdated; and
    - 29.2% of the 7,774 firms manipulated grants to top executives at some point during the period studied.
Basic Terminology

- **Back-dating** – Going back in time to create grant date where stock trading below actual grant date.
- **Mis-dating** – Honest but sloppy paperwork, e.g., delay in obtaining all UWC’s.
- **Springloading** – Setting grant date while sitting on material non-public information likely to drive up stock price.
- **Bullet-dodging** – Opposite of springloading. Delaying grant date while sitting on material non-public information that will likely drive down stock price.

Companies Under Scrutiny (Partial List)

<table>
<thead>
<tr>
<th>Affiliated Computer Services</th>
<th>Altera</th>
<th>American Tower</th>
<th>Analog Devices</th>
<th>Applied Micro Circuits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brooks Automation</td>
<td>Caremark Rx.</td>
<td>CNET Networks</td>
<td>Converse Technology</td>
<td>F5 Networks</td>
</tr>
<tr>
<td>HealthSouth</td>
<td>Jabil</td>
<td>Juniper Networks</td>
<td>KLA-Tencor</td>
<td>L-3 Communications Holdings</td>
</tr>
<tr>
<td>McAfee, Inc.</td>
<td>Meade Instruments</td>
<td>Medarex</td>
<td>Mercury Interactive</td>
<td>M-Systems Flash Disk Pioneers</td>
</tr>
<tr>
<td>Nyfix</td>
<td>Openwave Systems</td>
<td>Power Integrations</td>
<td>Quest Software</td>
<td>Rambus</td>
</tr>
<tr>
<td>Renal Care</td>
<td>RSA Security</td>
<td>SafeNet</td>
<td>Siemtech</td>
<td>Sepracor</td>
</tr>
<tr>
<td>Stolt-Nielsen</td>
<td>Sycamore Networks</td>
<td>Trident Microsystems</td>
<td>United Health</td>
<td>Vitesse Semiconductor</td>
</tr>
</tbody>
</table>
Potential Ramifications

• Government Investigations and Actions
  - SEC – Previously announced it was investigating more than 80 companies.
  - DOJ – U.S. Attorney for Northern California created an options backdating task force.

• Auditor and Institutional Investor Inquiries

• Shareholder Litigation
  - Securities Fraud
  - Shareholders Derivative Lawsuits

• ERISA Litigation?

• Restatement of Financial Statements

• Tax Consequences
  - Internal Revenue Code 162(m)
  - Internal Revenue Code 409A

• Negative Publicity

• Corporate Governance Concerns
Figure 1: Abnormal stock returns following receipt of stock options by CEOs. The graphs illustrate abnormal stock returns at Fama-French 3-factor model company monthly close price relative to stock option at annual earnings announcements. The figure compares the abnormal returns of CEOs who received stock options in the year before and after the earnings announcements. The results are based on a sample of 120 companies and 1,200 CEO options announcements. The sample includes firms from various industries and sizes. The results are reported in Table 1 and further details can be found in the text and Table 1.
Impact of SOX on Stock Option Disclosures

• Before August 2002, stock option grants were reported to the SEC using Form 5, which was not due until 45 days after the company’s fiscal year-end. Corporations were not specifically required to disclose dates of stock option grants.

• Following the passage of the Sarbanes-Oxley Act in August 2002, stock option grants must be reported to the SEC on Form 4 within two business days of the option grant date.

Figure 4
Cumulative abnormal stock returns around stock option grants before and after 8/29/2002

The figure shows the cumulative abnormal stock returns from 30 days before through 30 days after scheduled stock option grants to CEOs. Abnormal stock returns are estimated using the three-factor model described in Fama and French (1993), where the estimation period is the year ending 90 days before the grant date. The grant date is taken from either ExectraComp or grants prior to 8/29/2002 or Form SEV filings for grants after 8/29/2002. The grants from SEV filings have been partitioned into those that are included in the ExectraComp database and those that are not included in the ExectraComp database.
Option Backdating – an Illustrative Example

Hypothetical Corp. Ltd.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>Declared Grant Date</th>
<th>Actual Grant Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>$40</td>
<td></td>
<td>$50</td>
</tr>
</tbody>
</table>

Black-Scholes Value of Employee Stock Options

<table>
<thead>
<tr>
<th></th>
<th>1 Year Option</th>
<th>1 Year Option (Backdated)</th>
<th>10 Year Option</th>
<th>10 Year Option (Backdated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying Price</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Exercise Price</td>
<td>50</td>
<td>40</td>
<td>50</td>
<td>40</td>
</tr>
<tr>
<td>Days to Maturity</td>
<td>365</td>
<td>345</td>
<td>3650</td>
<td>3630</td>
</tr>
<tr>
<td>Interest Rate</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Volatility</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Option Grant</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Total Value</td>
<td>$3.1 million</td>
<td>$6.3 million (+103%)</td>
<td>$12.2 million</td>
<td>$14.1 million (+16%)</td>
</tr>
</tbody>
</table>
Direct Option Backdating Cost vs. Alleged Damages

- Direct cost of option backdating is the additional compensation provided to management through the lower exercise price.

- Upon revelation of backdating, additional costs and plaintiff’s alleged damages can include:
  - Stock price drop on revelation.
  - Accounting earnings restatements and multiplier effect on stock price.
  - Taxable earnings adjustments and additional taxes to be paid.
  - Cost of investigating backdating issues and restating earnings.
  - Loss of management credibility.
  - Management re-organization cost (search for new CEO, etc.)

SEC and DOJ Investigations

- Documents requested may include, inter alia, minutes of meetings of the compensation committee and board of directors, emails and other correspondence concerning option grants, including communications with auditors, and personnel files.
- The agency may also request interviews of directors, officers and employees who authorized, benefited from, or participated in option grants.
  - E.g., the DOJ conducted interviews of HR personnel who were instructed to falsify offer letters.
- Full cooperation may require waiver of the attorney-client privilege, which may affect civil litigation.
- Directors and/or officers may have relied upon the advice of in-house or outside counsel.
  - Potential conflict of interest issues.
SEC and DOJ Actions

• Actions to date have targeted individuals, not companies.
  • USA v. Reyes and Jensen
    • Reyes – former CEO and Chairman of Brocade Communications Systems, Inc. (“Brocade”)
    • Jensen – Brocade’s former VP of Human Resources
  • SEC v. Alexander, Kreinberg and Sorin
    • Alexander – former CEO and Chairman of Comverse Technology, Inc. (“CTI”)
    • Kreinberg – CTI’s former CFO
    • Sorin – CTI’s former General Counsel and Corporate Secretary
      (also served as a director)

SEC and DOJ Actions

• Department of Justice
  • Conspiracy to commit securities fraud, wire fraud and mail fraud.

• Securities and Exchange Commission
  • Violations of Securities Exchange Act of 1934 and its governing rules, including, among others § 10(b) and Rule 10b-5. (Generally, fraud on the market.)
  • Violations of Securities Act of 1933. (Generally, failure to abide by reporting requirements.)
Penalties and Relief Sought in DOJ and SEC Actions

- **DOJ**
  - Maximum Penalties: 20 years in prison; $5,000,000+ in fines.

- **SEC**
  - Injunctive relief against offending officers.
    - Prohibiting officers from acting as officers or directors of publicly traded companies.
  - Civil monetary penalties against offending officers.
  - Disgorgement of wrongfully obtained benefits.

Securities Fraud Class Action Lawsuits

- **Class Period:**
  - Typically from early- to mid-1990s through 2002, at which time the Sarbanes-Oxley Act changed the timing requirements for reporting stock option grants.
  - Sometimes through 2006 (e.g., date company reports it is self-investigating).

- **Causes of Action:**
  - Violations of §§ 10(b) and 20(a), and Rule 10b-5

- **Relief Sought:**
  - Damages
  - Attorneys fees and litigation costs
Securities Fraud Class Action Lawsuits

Damages Theories

• How will Plaintiffs attempt to capture any drop in stock price following an announcement that the company is under investigation or that the company has identified problems?
  • Proof of inflation of stock price on the front end and "loss causation" on the back end.
  • Isn’t the price drop really a reflection of general loss of confidence by the market in management?
• Attorneys’ Fees and Costs

Shareholders Derivative Lawsuits

• Lawsuit brought on behalf of the company against the board of directors.

• A shareholder must either make a demand upon the board prior to bringing a shareholders derivative lawsuit or allege that making such demand would be futile.
  • Demand may be futile if executives who benefited from option grants also serve on the board.
Shareholders Derivative Lawsuits

• Causes of Action:
  • Breach of Fiduciary Duty of Loyalty
    • A director who serves as an officer may have been the beneficiary of the option grant.
  • Breach of Fiduciary Duty of Care
    • Failure to properly monitor the company’s executive compensation practices.
  • Unjust Enrichment
    • Disgorgement of incentive- or equity-based compensation under Sarbanes Oxley Act.
  • Violation of Provisions of Exchange Act
  • Abuse of Control
  • Gross Mismanagement
  • Waste of Corporate Assets

• Relief Sought:
  • Damages – loss of reputation and goodwill. Tie back to drop in stock price, if any?
  • Disgorgement of equity-based compensation
  • Return to company of unexercised stock options and/or rescission of stock option grants
  • Imposition of Constructive Trust
  • Attorneys’ Fees

• D&O Policies –
  • The Wall Street Journal recently reported that insurance companies have identified options timing issues as a “major source of claims.”
  • Some insurers have already hinted that they may attempt to exclude options-related claims from future policies.

Insurance Coverage Issues

• Defense strategy may conflict with strategy to obtain and maintain insurance coverage

  Some examples:
  • Is the backdating allegation characterized as a single course of conduct or as many discrete acts?
  • Can a company avoid denial of coverage by settling claims without an admission of guilt?
What Can You Do?

• Recognize the environment of close scrutiny created by backdating problems.

• Understand the Board and corporate calendar implications.
  • Year end evaluation and compensation processes will begin shortly.

What Can You Do?

• Board and Compensation Committee meetings scheduled for 3Q and 4Q.
  • Questions regarding exposure and procedures will be asked.
  • Consider privileged nature of inquiry and review of practices.
  • Consider privileged nature of response.
  • Consider that “best practices” for equity compensation awards has changed because of these investigations!
What Can You Do?

• Step 1: Review Company Policies and Procedures.
• Step 2: Investigate Historical Practices.
• Step 3: Take Corrective Action.

Step 1: Review Company Policies and Procedures

• Review the company’s by-laws and equity award plans to determine what procedures must be followed.
  • Who has authority to grant stock options?
    • Board of Directors?
    • Compensation committee alone?
    • Executive officer?
  • When can options be granted?
    • Certain time periods specified? During different employment cycles (hiring, promotion, modify underlying plan)?
  • What is the procedure?
    • What paperwork, including grant letters, must be completed?
    • Who must sign off? Has internal audit recently reviewed?
Step 2: Investigate Historical Practices

- Identify the stock option grants during the period in question.
  - Early- to Mid-1990s through 2002 is minimum.
- Review the historical market price of the company’s stock on and around the date of each option grant.
  - Consider whether the grant was at or near a market low in the stock price (backdating) and whether the stock price rose substantially immediately after the option grant (spring-loading).

- For each option grant, identify the documents authorizing the grant and ensure that they accurately reflect the transaction and demonstrate adherence to company policies.
- Key documents include:
  - Minutes of meetings of the compensation committee and board of directors.
  - Authorizing documents (e.g., board resolutions).
  - Records of the options (e.g., grant letters).
  - SEC filings.
Step 2: Investigate Historical Practices

- Analyze Accounting Treatment
  - Was the proper amount of executive compensation expense recognized?
- Review Tax Payments
  - Did the company pay the correct amount of payroll tax.

Step 3: Take Corrective Action

- Determine whether inconsistencies occurred.
- Identify scope of problem.
- Report problem to Board.
- Determine whether issues are “material”; if so, report to SEC/proper regulatory agencies.
- Properly account for back-dated options.
  - This may involve restating past financials.
- Determine whether back taxes are owed on executive compensation.
Step 3: Take Corrective Action

• Prospective
  • Update by-laws and/or stock option plan.
    • Consider the size and constitution of the compensation committee; review procedures for review of equity awards.
    • Consider company procedures for timing of equity grants.
  • Implement procedures to ensure that option grant dates coincide with grant authorizations.

Issues of Concern

• Too much power vested in the hands of one or a few executives who also benefit from option/equity grants.
• Is Board/Compensation Committee apprised of all awards?
• Options/equity granted at any time during the year.
• Options/equity granted on hire date.
• Options/equity granted upon promotions.
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