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Lawyers and Backdating

By William Schuman

LAWSUITS ARISING out of stock-options backdating are washing over the legal landscape like a tsunami. These cases have been filed by the U.S. Securities and Exchange Commission (SEC), the U.S. Department of Justice (DOJ) and private plaintiffs in the form of class and derivative actions. The focus thus far has been on the public companies sponsoring the allegedly offending options and on the executives who benefited from receipt of them. However, another wave of backdating lawsuits seems to be coming: suits against the attorneys.

At risk for potential liability are both outside and in-house counsel who were consulted on the mechanics and disclosure of the offending options program or who participated in their implementation and execution. This may prove fertile territory for rigorous inquiry because whether backdating options is wrongful depends on the particular facts and circumstances. A failure to disclose adequately, account for properly, pay taxes as a result of or implement properly such programs can transform a permissible method of compensation into a violation of law. Faulty advice or execution can place outside and inside counsel in the sights of the issuing companies and their executives under attack, shareholders seeking additional sources of recovery and regulators attempting to assess blame and create reform.

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Therefore it is prudent for both law firms and general counsel to take proactive steps to determine whether they have meaningful exposure, and if so, to address it now. In addition, both outside and inside counsel need to assess the actual and potential conflicts they may face in addressing their own exposure and in defending clients who relied on their advice in the creation or disclosure of the offending backdating program.

Claims against outside counsel

If history follows form, the plaintiffs' bar and issuing companies and their executives under attack will seek additional targets against whom to assess liability. It will not be surprising for a company and its executives to defend themselves by explaining that their intent was to provide a lawful compensation mechanism to motivate and reward their managers for superior performance, in the best interests of the company and its shareholders. The implementation and disclosure of the program was left to the lawyers. Is that not why, the refrain will go, companies hire professionals, i.e., to structure complicated programs properly and to advise concerning the companies' obligations under those programs?

Accordingly, private litigants and the SEC will assert claims for negligence and intentionally wrongful conduct against their advisors. Moreover, this is not simply a matter of civil liability, though that exposure is painful enough. DOJ has filed criminal charges in several backdating cases, with more to come.

A tally of the many legal disciplines involved in stock-options programs provides insight into how vulnerable law firms may be. Constructing and implementing such a program requires detailed analysis of corporate structure, securities law considerations, employee benefits concerns, executive compensation issues, complex tax rules and disclosure obligations. Did the lawyers who assisted the company in creating the options plan advise the company that it will create additional expense and reduce earnings, and that those facts must be timely recognized and disclosed? When attorneys reviewed the stock-options plans in connection with plan registration filings with the SEC, did they advise the clients of their required disclosures?

Corporate and employee benefits lawyers may have been asked to lead clients through complex stock-options rules that impose varying requirements depending on the myriad situations in which the options are granted. For example, directors may approve an options grant on one day, the corporation may issue the options on another day and the effective date may be selected as one of those two dates, or a date between or preceding those dates. Each of these circumstances comes with different economic, and legal, results.

Still further, attorneys who review quarterly and annual filings typically analyze a host of documents to be sure requisite disclosures are made. The law firm performing the Form 10Q and Form 10K reviews may or may not be the firm that advised on the options plan. In either case, the reviewing law firm is exposed if the disclosure is not accurate.

Executives who receive backdated options have a reciprocal obligation in connection with their income taxes. The options may create substantial personal income that must be reported on the individual's personal tax returns. Subsequent to the effective date of Internal Revenue Code (IRC) § 409-A, the fair market value of an option is taxable to the employee when it vests, even if it is not exercised. In some situations, the recipient may be subject to an additional tax. IRC § 422 sets forth rules about qualifying for incentive stock-options treatment. Did the company's outside lawyers have any responsibility to the executives who received the options to provide advice on these issues? We shall see.

In-house counsel also are under attack in connection with options backdating. Traditionally, they are consulted only episodically on business matters. Often they act primarily as scriveners, responsible for reporting accurately what they are told, or as counselors whose legal advice to their management "clients" has been viewed as devoid of wrongful motive. However, many played an active role in stock-options programs. They often participated meaningfully in the creation and implementation of the programs and handled communications with the compensation committee or the board concerning the review and approval of the awards, and the documentation of the process.

Post Enron and Sarbanes-Oxley, the gloves have come off with respect to general counsel and their staff. In-house lawyers are increasingly viewed as gatekeepers whose real clients are the company's shareholders, not its management. In the last three years, for example, the former general counsel or other in-house lawyers at Rite Aid Corp. (alleged backdating of compensation documents), Computer Associates International Inc. (alleged conspiracy and obstruction of justice), General Re Corp. (alleged failure to report wrongdoing), Hollinger International (alleged failure to report wrongdoing) and BioPure Corp. (alleged securities fraud) were convicted of, pleaded guilty to, were indicted for or entered into a consent judgment for alleged wrongdoing in the performance of their duties. And, of course, Hewlett-Packard Co.'s recently resigned general counsel has been under investigation for her role in the now-famous investigation of news leaks by H-P board members.

At risk for liability are both outside and in-house counsel who advised on, or participated in, an offending options program.

So it is not surprising that the options backdating scandals are the next big thing in the assault on in-house counsel. War was declared by Senator Charles Grassley, R-Iowa, chairman of the Senate Finance Committee, in a hearing on options backdating, when he announced that enforcement would focus on the entire gamut of individuals involved, including lawyers. In an early salvo, Comverse Technology Inc.'s former general counsel was indicted for his alleged role in issuing options grants, drafting written consents and communicating with the compensation committee to obtain approval, among other things. Problematically, he was also a recipient of the stock awards. On Nov. 2, he pleaded guilty to one count of conspiracy to commit wire, mail and securities fraud.

Review by independent counsel, avoiding conflicts

In light of this exposure, law firms and in-house counsel should undertake a detailed examination of the stock-options advice they have provided over the last several years. Such an analysis will allow them to determine if they have a problem, and to take appropriate measures to minimize the exposure. Retaining independent counsel is advisable, as self-examination will not have the credibility that comes with an objective review. Moreover, the confidential and privileged nature of the review will be enhanced if it is conducted by independent counsel. The investigation needs to consider all of the disciplines upon which the options-related advice touched, including corporate, tax, executive compensation, employee benefits and disclosure issues.

A separate set of conflict-related considerations comes into play for a law firm that is asked by a client for which it rendered options advice to defend the company against allegations of wrongful backdating. In such a situation, the firm may be required to defend its own work in the process of defending its client. What if the firm's original advice concerning the options program was off the mark? Should the firm fall on its sword and explain that it was not the company's fault? Such a defense will point the liability finger at the firm itself. This conflict may be impossible to negotiate. Moreover, the firm may need to put on the witness stand its own partners in order to defend its work. In many states, the "lawyer as witness" rules make such representations difficult. If the case takes a turn south and the firm becomes a defendant, its litigation representation undoubtedly must come to an end in midstream, with wreckage all around.

As for in-house counsel who were involved in options activity, they should delegate the oversight of the review process entirely to others. Frequently, it is the general counsel's own conduct that will be scrutinized and judged. Credibility will be lost if the in-house attorneys are vulnerable to the "whitewash" allegations which inevitably will be made if the review is not independent.

The options backdating malady has become a painful condition. The medicine, distasteful though it may be, needs to be taken early if it is to have a meaningful chance of success. NLJ

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