

# THE WALL STREET JOURNAL

WEDNESDAY, JULY 19, 2006

© 2006 Dow Jones & Company, Inc. All Rights Reserved.

By **PETER LATTMAN**

**F**OR PUBLIC companies, investigations of possible stock-option backdating have become a huge headache. But for big law firms, they're the latest full employment act, generating hour after billable hour of work across practice areas, from tax and executive compensation to securities and white-collar defense.

Big law firms have traditionally tilted their practices to capitalize on the business topic of the day, from the M&A wave in the 1980s to the post-Enron and WorldCom bankruptcy boom. But the backdating scandal "is fairly unique in its complexity and scope and how many clients it touches and how serious and important it is to them," says



*James Barrall*

Jim Barrall, chairman of the executive compensation practice at **Latham & Watkins**, one of the nation's largest firms.

Because cases of backdating can require restating earnings, there is tremendous pressure on companies to address any problems immediately. And even as backdating touches myriad legal disciplines, individual players—from the company itself to a board committee to individuals—often require their own separate counsel.

Right now, more than 50 companies are being investigated by federal prosecutors and the Securities and Exchange Commission on suspicion of having backdated, or otherwise manipulated, the dating of their stock options to make them more lucrative. And a recent academic study estimated that more than 2,000 companies engaged in some form of manipulation of their grants to top executives. (An option gives its holder the right to buy shares at a particular exercise price—typically the market value on the date of the award.)

At Latham & Watkins, client inquiries on options dating began piling up in May. On a Saturday night, Mr. Barrall fired off an email from his home computer in Santa Monica, Calif., to his colleagues

## Options Backtrack

Key moments in the recent backdating scandal:

- **May 2005:** University of Iowa's Erik Lie publishes a paper examining CEO option awards in the journal *Management Science*
  - **Nov. 2, 2005:** Mercury Interactive Corp. announces discovery of 49 instances of reset option grant dates; Three top executives resign
  - **April 7, 2006:** UnitedHealth Group Inc. announces an internal review of "current and historic option grant procedures" following a Wall Street Journal article on options timing
  - **July 13, 2006:** The U.S. Attorney for the Northern District of California launches a task force focused on stock-options backdating
- Source: WSJ.com research

around the world in the corporate, tax and litigation departments:

"We are witnessing a growing crescendo of investigations and actions being brought against public companies, their boards of directors and their executives with respect to stock-option grant-dating practices. . . . We are well positioned to help you and your clients investigate stock-option grant practices, identify potential exposures and remediate problems."

After a flurry of emails throughout the weekend, the firm held an internal conference call in which it established an options-timing working group. In June, Latham held a firmwide seminar on options timing, with topics ranging from SEC enforcement to tax implications to insurance for directors and officers. Now, the group, more than 80 lawyers strong, receives daily emails and has set up an internal Web site to track options-timing issues as they evolve.

Whether the date on a stock-option grant is the actual date on which the grant occurred may not seem, at first blush, to be a thorny legal question. But "as you peel back the layers of the onion, what you find is that this gets extraordinarily complicated and cuts across many specialties in the legal field," says Robert Cleary, a white-collar defense lawyer at **Proskauer Rose** and a former U.S. attorney in New Jersey.

Take the tax implications of a backdated option, which could constitute "nonqualified deferred compensation" and expose option recipients to additional tax liabilities and penalties if the options aren't amended by year end. Or, in the realm of directors and officers insurance, lawyers are examining whether an

insurer can argue that misconduct by a single director or executive in granting or dating stock options can justify refusing to honor coverage for all of the other directors and officers who were involved in making the grant even if they didn't participate in the misconduct.

Many companies ensnared by the scandal have assigned the audit committees of their boards to conduct independent investigations into their stock-option practices or have formed special board committees to carry out the inquiries. Those committees often retain independent law firms, separate from the company's traditional outside law firm, to conduct the investigations.

Recent company filings indicate the costs of internal investigations vary, but they can be very expensive. "If you're required to conduct a very complicated broad-based internal investigation in a limited time frame, there are inefficiencies that are built into that time constraint," says Mr. Cleary of Proskauer. But there isn't always a choice. If a company doesn't reconcile its financial statements in time to meet a quarterly SEC filing deadline, for example, it faces the risk of being delisted.

When the software company **Mercury Interactive** filed restated financials on July 3 related to backdating, the company said it had incurred estimated expenses to date of \$70 million in legal, accounting and other professional fees. Attorneys familiar with such internal investigations say a significant portion of the fees would probably go to **O'Melveny & Myers**, the lawyers for a special board committee that conducted the inquiry; to **Davis Polk & Wardwell**, Mercury's corporate counsel; and to lawyers representing Mercury executives under investigation. Lawyers at these firms declined to comment.

On July 17, Israeli-based technology company **M-Systems Flash Disk Pioneers Ltd.** restated its financial results and said it had incurred legal, accounting and tax expenses of roughly \$1.5 million in an internal investigation into stock-option grants.

Some law firms are marketing themselves aggressively in the area. Earlier this month, Proskauer issued a press release saying it had formed a "Stock Options Task Force," bringing together more than 20 lawyers across practice areas. Mr. Cleary says that when he and

*(over please)*

his partners began to work on options-timing matters they asked themselves, “Why are we doing this all discretely? We can be much more efficient, much more nimble and much more effective in handling these issues collaboratively.”

Colleen Mahoney, a former SEC lawyer now at **Skadden, Arps, Slate, Meagher & Flom** in Washington, says the firm has received numerous calls from clients who haven’t heard from either the SEC or a U.S. attorney but would like to get ahead of the issue.

“Companies are calling us and saying, ‘I don’t know if I have an issue with stock options, but our auditors are asking us questions and our institutional investors are asking us questions,’” says Ms. Mahoney. Adds her partner, white-collar defense attorney Robert Bennett: “The companies say, ‘Even if I don’t have a problem, can you guys come in and give us some guidelines on how we can prevent having one in the future.’”

Representation of individuals is also keeping law firms busy. Dozens of executives touched by the investigations—whether executives who received backdated options or those who doled them out—have had to retain their own counsel. And in many cases, individual directors at implicated companies have hired lawyers of their own.

“In many ways, the end of sensational financial fraud cases like Enron also seemed to signal that the luster might be coming off white-collar practice,” says Thomas McNamara of **La Bella & McNamara**, a white-collar defense boutique in San Diego. “The options-timing investigations have changed all that. Once again, scores of big-firm white-collar departments are working full throttle.”

Where were the outside lawyers when questionable practices were happening in the first place? At larger companies, say lawyers, outside counsel may draft the stock-option plans and legal forms of agreement, but they don’t generally get involved in either the granting or timing of options. At smaller companies, outside counsel may have played more of a hands-on role.