Stock backdating investigations changed Silicon Valley

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By Brandon Bailey
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Hoping to spare her client from prison, an attorney for former Brocade executive Stephanie Jensen stood before a federal judge this month and argued that the furor over stock-option backdating was a "so-called scandal" that never amounted to much.

"Some would say it fizzled," added defense attorney Jan Nielsen Little, who argued that a wave of investigations that shook the tech industry had turned up little evidence of wrongdoing in connection with a practice that was "widespread, albeit misunderstood."

But as authorities gear up for a retrial next month of Jensen's former boss, ex-Brocade CEO Greg Reyes, federal officials and legal experts say the investigations found widespread accounting abuses at a host of companies. These led to numerous civil and criminal enforcement actions that helped change those practices, they say, despite some high-profile stumbles by prosecutors in recent months.

At its height, the backdating scandal touched dozens of local companies that came under federal investigation or launched their own accounting reviews, which led in some cases to firings, earnings restatements and shareholder lawsuits. Even Apple CEO Steve Jobs came under investigation; he was never charged with wrongdoing, although two other Apple executives paid millions to settle lawsuits by the Securities and Exchange Commission, without admitting fault.

In some cases, the government has struggled to prove criminal acts. In one prominent example, a federal appellate court overturned Reyes' conviction on backdating-related charges last summer. Another headline-grabbing case collapsed last month, when a different judge dismissed charges against two executives of Southern California chip-maker Broadcom, while overturning a guilty plea by a third executive and excoriating prosecutors for misconduct.

Nationwide, however, authorities have won at least 13 criminal convictions for backdating-related offenses, while the Securities and Exchange Commission says it brought 94 civil actions against companies and individual executives. Defendants settled most of the civil cases without admitting wrongdoing, but agreed to injunctions and in some cases financial penalties — ranging from $100,000 each for three former directors at Mercury Interactive to $10 million by Santa Clara-based Marvell Technology Group.

Scores of companies, meanwhile, voluntarily corrected their financial statements. And 23 companies have paid out nearly $2 billion to settle class-action lawsuits by investors alleging that companies had failed to disclose backdating and its effect on earnings, according to RiskMetrics, a financial research and risk management firm.

"I do think it was a real wake-up call for the industry, just given the number of people caught up in improper conduct," said Marc Fagel, regional director for the SEC in San Francisco.

Backdating became a big issue in Silicon Valley in 2006, when authorities began investigating scores of companies here and around the United States.

The tech industry has long made extensive use of options, giving employees the right to buy company stock at the price for which shares were selling when the options were granted — which means they reap a profit if the price subsequently goes up. The direct cost to the employer is minimal, but accounting rules require companies to report the options as a noncash expense.

Backdating can make options more valuable by retroactively setting them at a lower price. While the practice is not illegal, companies must disclose when they do it and account for it in their earnings. If not, authorities say the practice can effectively hide expenses, inflate profits and mislead investors.

Some executives and attorneys argue that most backdating violations were simply technical errors that meant little to investors.

All told, however, federal prosecutors around the country charged at least 22 corporate executives with criminal violations related to backdating over the last five years. While a few cases are still pending, court records and news reports show at least 13 executives were convicted. Five of those received prison sentences, as opposed to probation or fines. That includes Jensen, the former human resources chief at Brocade and the only Silicon Valley executive convicted to date. A jury found Jensen guilty of falsifying corporate records, and after an appellate court agreed, U.S. District Judge Charles Breyer sentenced her to two months in prison.

Legal experts say the issues raised by backdating are more complex than in cases of theft or embezzlement, and it can be difficult to convince jurors that executives had criminal intent.

Reyes' attorneys, for example, have argued he never profited personally from backdating and that he relied on accounting advice from senior executives and company auditors. A jury found Reyes guilty on 10 counts of securities fraud, but an appellate court ruled the trial was tainted by a prosecutor's improper statements in court. A new trial is scheduled for next month.

"Everyone agrees the options were backdated. The issue is, 'What did you know?' and 'When did you know?' and 'What did you mean to do?' That is often very difficult to prove," said Peter Henning, a Wayne State University law professor and former federal prosecutor who has followed the backdating scandals closely.

Henning and others say that's undoubtedly why the SEC filed a majority of cases as civil lawsuits.

"It's not surprising that more of these were handled civilly," said Joseph Grundfest, a law professor and co-director of the Rock Center on Corporate Governance at Stanford. "In a criminal case, you have to prove wrongdoing beyond a reasonable doubt, and in many of these situations you would have trouble demonstrating that a CEO knew he was in engaged in a criminal violation."

That doesn't mean no harm was done, argues Harvard law professor Jesse Fried, another expert on corporate governance. He said the practice artificially inflated company earnings and stock values, in many cases "enabling executives to reap larger cash bonuses and sell their stock at a higher price."

The government's investigations, as well as changes in accounting rules, have made companies more sensitive to legal requirements around backdating, added Grundfest. "There certainly were companies that were unnecessarily tortured because of backdating violations. But there were other companies at which the violations were serious and had to be addressed."