

STOCK-OPTION BACKDATING CASES REFLECT COSTS OF OVERCRIMINALIZATION

by
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Following the sensationalized trials of Enron and Worldcom executives, the public has an intensely negative perception of the phrase “stock-option backdating.” Contrary to media portrayals of the practice, stock-option backdating is not per se illegal. Options dating is lawful as long as the three conditions exist: (1) the company’s board has authorized the backdating, (2) the backdating has been fully disclosed, and (3) the company has reported the transaction under appropriate tax laws.¹

This LEGAL BACKGROUNDER will illustrate how the Securities and Exchange Commission’s (“SEC”) filing requirements in the aftermath of the Sarbanes-Oxley Act of 2002 (“SOX”)² provoke prosecutorial misconduct. By examining the recent criminal actions against Broadcom executives as an illustrative anecdote, the paper shows how prosecutorial indiscretion not only tampers with the lives of innocent people at taxpayers’ expense, but can also complicate the pursuit of convictions against actual guilty persons. Prosecutors can certainly address problems reflected in the Broadcom prosecutions by exercising greater restraint and respect for the rule of law. A much more effective deterrent against inevitable overreaching, however, is to moderate the underlying incentive: vague federal criminal laws. Greater precision in our criminal laws will decrease opportunities for abuse, while also increasing the likelihood that guilty parties will be convicted.

Stock Options, Backdating, and SOX

Stock options are contracts that employers give to employees as a form of compensation. With an option, the employee has the right to buy a share of stock at an “exercise” price. That price usually correlates with the selling price of the day the option was granted.³ If the company’s stock rises, the employee can essentially increase his income by purchasing shares at the lower price, as specified in the option. In this way, stock options serve as an effective form of executive compensation, because they create a financial incentive for the executive to take actions that will benefit the company.⁴ When a company grants stock options to its executives, they must file reports with the SEC.

¹M. P. Narayanan, Cindy A. Schipani & H. Neiat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1601-02 (2007).

²Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (Supp. III 2003)).

³Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSPECTIVES 49, 50 (2003).

⁴*Id.* at 49.

Options backdating occurs when the employee manipulates the date that the option was granted. For example, suppose an executive receives an option on April 15, when the company's stock price is \$40. Next, assume that on March 15 the company's stock price was only \$30. If the SEC filing represents that the option was granted on March 15, the executive makes an extra \$10 profit per share of stock. This type of price manipulation is legal as long as it was authorized by the company's board, fully disclosed to shareholders, and reported to the government under appropriate laws.⁵

Before the enactment of SOX in 2002, a company had 45 days to file notice of an options grant with the SEC. With the passage of SOX, the 45-day window to legally backdate stock options shrank to two days.⁶ The rationale for limiting backdating is that the practice benefits executives while impacting the company's bottom line and its shareholders.

Missing the Forest for the Trees: The Broadcom Prosecution

In 2007, Broadcom took charges of \$2.2 billion to past earnings to fix misdated options.⁷ As a result, Broadcom faced a class action lawsuit as well as both civil and criminal actions against the company's executives for their involvement.⁸ The class action suit settled for \$160 million in late December 2009.⁹ Federal prosecutors filed criminal charges against Broadcom co-founders Henry Samueli and Henry Nicholas and former financial chief Bill Ruehle in the Southern District of California.¹⁰ Samueli initially agreed to enter into a guilty plea for one count of violating 18 U.S.C. § 1001 – lying to the SEC – but Samueli later insisted that he only did so because of unfair treatment by the government.¹¹

Nicholas faced a number of charges, including: conspiracy; securities fraud; making false statements in reports filed with the SEC; falsification of corporate books and records; honest services mail fraud; honest services wire fraud; and aiding and abetting each of these acts.¹² In a separate indictment, Nicholas was charged with providing cocaine and ecstasy to his colleagues. That indictment also alleged Nicholas frequently indulged in hiring prostitutes.¹³ Ruehle's charges included: conspiracy; securities fraud; false certification of financial reports; two counts of making false statements in reports filed with the SEC; lying to accountants; five counts of falsification of corporate books and records; honest services mail fraud; honest services wire fraud; and aiding and abetting each of these acts.¹⁴

⁵Narayanan, *supra*, n. 1, at 1601-02.

⁶Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 882-83 (2008).

⁷Dan Nystedt, *Broadcom Takes Massive \$2.24B Backdating Charge*, Jan. 24, 2007, <http://www.infoworld.com/d/security-central/broadcom-takes-massive-224b-backdating-charge-072>.

⁸Gillian Flaccus, *SEC drops civil action against ex-Broadcom execs after criminal case tossed in California*, Feb. 4, 2010, <http://blog.taragana.com/business/2010/02/04/sec-drops-civil-action-against-ex-broadcom-execs-after-criminal-case-tossed-in-california-28340/>.

⁹Associated Press, NYTimes.com, *Broadcom to Settle Backdate Suit for \$160 Million*, Dec. 29, 2009, <http://www.nytimes.com/2009/12/30/technology/companies/30broadcom.html>.

¹⁰Peter J. Henning, *How the Broadcom Backdating Case Has gone Awry*, Dec. 14, 2009, <http://dealbook.blogs.nytimes.com/2009/12/14/how-the-broadcom-backdating-case-has-gone-awry/>.

¹¹Henning, *supra*, n. 10.

¹²18 U.S.C. § 371; 18 U.S.C. § 1348; 15 U.S.C. § 78m(a)(2) and 78ff, 17 C.F.R. 240.12b-20 and 240.13a-13; and 18: 2; 15 U.S.C. § 78m(b)(2)(A), 78m(b)(5), and 78ff, 17 C.F.R. 240.13b2-1 and 18: 2; 18 U.S.C. § 1341, 1346; and 18 U.S.C. § 1343, 1346. Information retrieved through <https://pacer.login.uscourts.gov/>.

¹³Stuart Pfeifer, *New Court Victory for Broadcom Co-Founder Henry Nicholas as Drug Charges are Dropped*, Jan. 29, 2010, <http://articles.latimes.com/2010/jan/29/business/la-fi-broadcom29-2010jan29>.

¹⁴18 U.S.C. § 371; 18 U.S.C. § 1348; 18 U.S.C. § 1350(c)(1); 15 U.S.C. § 78m(a)(2) and 78ff, 17 C.F.R. 240.12b-20 and 240.13a-13; and 18: 2; 15 U.S.C. § 78m(b)(2)(B) and 78ff; 17 C.F.R. 240.13b2-2 and 18: 2; 15 U.S.C. § 78m(b)(2)(A), 78m(b)(5), and 78ff, 17 C.F.R. 240.13b2-1 and 18: 2; 18 U.S.C. § 1341, 1346; and 18 U.S.C. § 1343, 1346. Information retrieved through <https://pacer.login.uscourts.gov/>.

As the other two criminal cases came to trial, Federal Judge Cormac Carney tried to preclude the introduction of statements made by Ruehle to Broadcom's corporate counsel during previous internal investigation.¹⁵ Since the same attorneys represented Ruehle in his civil defense, it was Judge Carney's opinion that the statements should be protected by attorney-client privilege.¹⁶ Rejecting that idea, the U.S. Court of Appeals for the Ninth Circuit determined that Ruehle did not make those statements in confidence, and therefore they were not protected by that privilege.

Ruehle's attorneys wanted to call Samueli and former general counsel David Dull to testify in Ruehle's defense,¹⁷ but both men indicated they would not testify unless they received immunity.¹⁸ The prosecutors, who typically hold the power to grant immunity, refused to do so. Presumably, Judge Carney wanted to hear their testimony, because he took the rare step of granting immunity despite the prosecutors' decision. Judges may only take such an action when it appears that the prosecution is trying to withhold relevant evidence from the jury. So in granting immunity,¹⁹ Judge Carney sent a strong signal that he suspected prosecutorial impropriety.

If prosecutorial misconduct had not already occurred, it certainly began after Judge Carney granted immunity to Samueli and Dull. One of the prosecutors called Dull's attorney and essentially threatened to press charges for perjury if Dull testified as he did in the civil case. Additionally, the prosecutor offered to "go soft" on Dull during cross-examination if he would testify that he had lost faith in Ruehle's integrity.²⁰ That same prosecutor later admitted that he had leaked information to the press regarding grand jury proceedings, which Judge Carney called "shameful" prosecutorial misconduct.²¹

On December 15, 2009, Judge Carney dismissed with prejudice the 14 counts of fraud and conspiracy against Ruehle as well as the remaining allegations against Nicholas. At least one reason cited for Judge Carney's dismissal related to the prosecutor's intimidation of Dull and other witnesses.²² Even more shocking, however, was Judge Carney's decision to vacate Samueli's guilty plea. After hearing Samueli's testimony regarding Ruehle, Judge Carney expressed that he was so "disturbed" by the government's actions that he decided to give the defendants all the breaks.²³ It is worth noting that Ruehle never needed to testify in his own defense, since Dull and Samueli did a sufficient job of that.²⁴

On February 4, 2010, the government dropped the last case surrounding Broadcom's backdating scheme. Judge Carney left room for the SEC to re-file its civil case against the four Broadcom executives, but he indicated that he did not think such a case would be successful.²⁵ In court papers, the SEC announced that it would not further pursue the case.²⁶ Whether the Broadcom executives deserved to be in court or not, prosecutorial misconduct was the main reason the government dropped the causes of action.

¹⁵Henning, *supra*, n. 10.

¹⁶*Id.*

¹⁷Dull was sued for securities fraud by the SEC, but did not receive any criminal charges. He testified that he did not believe the options had been improperly backdated.

¹⁸Henning, *supra*, n. 10.

¹⁹*Id.*

²⁰*Id.*

²¹Gillian Flaccus, *Federal Judge Tosses Charges Against 2 Former Broadcom Execs in Stock-Option Backdating Case*, Dec. 15, 2009, <http://blog.taragana.com/business/2009/12/15/federal-judge-tosses-charges-against-2-former-broadcom-execs-in-stock-option-backdating-case-11844/>.

²²Pfeifer, *supra*, n. 14.

²³Henning, *supra*, n. 10.

²⁴*Id.*

²⁵Dealbook, NYTimes.com, *S.E.C. Drops Action Against Broadcom Execs*, Feb. 5, 2010, <http://dealbook.blogs.nytimes.com/2010/02/05/sec-drops-civil-action-against-broadcom-executives/>.

²⁶*Id.*

Two Ways Overzealous Prosecutors Erode the Rule of Law

Whether or not the Broadcom executives' backdating practices violated SOX is something a court will never decide. However, the Broadcom case presents two important lessons regarding the erosion of the rule of law through prosecutorial misconduct. First, if the executives did not engage in criminal conduct, then the prosecutors had no business pursuing indictments in the first place. Second, if the executives' actions truly were illegal, then prosecutorial overzealousness obstructed a meritorious criminal prosecution.

The allegations of backdating arose during 1998 through the first quarter of 2006. Then, backdating for up to 45 days prior to formal notice was a lawful practice. Additionally, not all of the defendants remained officers of Broadcom through 2006. Nicholas resigned his position in early 2003.²⁷ So although the practice of backdating might have always been questionable because of its impact on the company's bottom line, it is possible that none of the executives knew they were engaging in criminal conduct.

If the Broadcom executives knowingly engaged in criminal conduct, the best interest of society and the rule of law demand that they be criminally punished. Those same interests, though, require that the rights of the accused be protected and the presumption of innocence be respected. The Broadcom situation illustrates what can happen when a prosecutor tries to overcome that presumption of innocence through overreach: the excessive prosecutorial badgering prevents criminal convictions. In this case, a court did not have the opportunity to decide the case on the merits. Rather, the judge determined that the prosecutors' misconduct made the trial so unfair that the interest of justice required the dismissal of all charges.

Conclusion

The Broadcom anecdote illustrates how overzealous prosecutors erode the rule of law. By having too strong of an adversarial mindset, prosecutors focus on winning the case and lose sight of the end goal of administering justice. It is quite possible that the Broadcom executives engaged in some inappropriate activities – whether related to backdating or illegal drugs. But because of a stronger motivation to win than to administer justice, the prosecutors stooped to intimidating witnesses, leaking information to the public, withholding relevant evidence from the jury, and violating attorney-client privilege.

One of the most effective ways to fix the problem of overzealous prosecutors is to remove vague and ambiguous criminal laws altogether. The Fourth, Fifth, and Sixth Amendments to the U.S. Constitution guarantee rights against unreasonable searches and seizures, to confront opposing witnesses, to a jury of peers, and additional enumerated rights to confer a general guarantee to a fair trial. With federal criminal laws like the vague backdating violations, the recently weakened but still arguably open-ended honest services fraud law, and others, prosecutors have great latitude to pick a target and prosecute that individual as a criminal. By removing ambiguous federal crimes, prosecutors will be compelled to focus on cases where concrete, criminal violations of the law occurred.

²⁷Arik Hesseldahl, *Broadcom CEO Nicholas Resigns*, Jan. 23, 2003, http://www.forbes.com/2003/01/23/cx_ah_0123brcm.html.