



**STRATEGIC APPROACHES FOR MANAGING SHAREHOLDER
LITIGATION ARISING FROM OPTIONS INVESTIGATIONS**

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I. HOW MUCH IMPACT WILL BACKDATING HAVE ON FUTURE SHAREHOLDER CLAIMS?

A. As of June 30, 2006, There Was Modest Federal Class Action Litigation Involving Options Backdating.

1. Joseph Grundfest's 2006 Mid-Year Assessment of Securities Class Action Case Filings found that options backdating issues were not drawing much federal class action litigation: only eight issuers had been named in pending lawsuits.
2. Professor Grundfest identified the following reasons for this dearth of federal class action filings:
 - a) Many disclosures relating to allegations of backdating were not accompanied by statistically significant stock price declines.
 - b) The alleged options backdating activities occurred so long ago that the statute of limitations defense may be effective.
 - c) In some situations, the uncertainties associated with the application of appropriate accounting principles may cause potential plaintiffs to recognize that they will have difficulty alleging that there was an intention to commit fraud.
 - d) Most of the litigation is being filed in state court through derivative actions because these actions do not, as a practical matter, require significant stock drops as a predicate to filing, and it may be easier to allege a violation of a fiduciary duty in many of these cases than to demonstrate a willful fraud.

B. Current Trends Indicate a Preponderance Of Derivative Actions, But With a Significant Increase in Class Actions as Well.

1. 83 issuers were involved in options backdating civil litigation as of September 29, 2006.
2. 19 of 83 (23%) involve securities fraud class actions – *this is a 137.5% increase (from 8 to 19) since June 30, 2006.*
3. 80 of 83 (96%) involve derivative litigation.

4. 16 of 83 (19%) involve both class action and derivative lawsuits.
5. 6 of 83 (7%) involve ERISA or 401(k) litigation.

C. Expect More Shareholder Litigation in the Future.

1. Lerach Coughlin Stoia Geller Rudman & Robins claims to be bringing 34 new cases on behalf of 350 to 400 pension funds, including funds in Europe and Asia.
 - a) Estimated damages are in the tens of billions of dollars.
 - b) Lerach Coughlin intends to recover not only the difference in stock price between the level where the shares were trading when the options were actually exercised and the backdated price, but also wants to take into account the compensation programs and plans that were approved for executives before shareholders knew about the backdating issues, as well as the diminution in market capitalization.
2. The plaintiffs' bar is also purportedly looking at claims against lawyers, accountants, auditors, and other service providers who were allegedly assisting issuers with options backdating.
3. California Public Employees' Retirement System (CalPERS) sent a June 7 letter to 24 issuers urging their directors to conduct an independent investigation into backdating allegations, and publicly disclose all findings from both internal and external investigations.
4. On September 15, 2006, CalPERS announced that it had retained Lerach Coughlin to represent it as lead plaintiff in its options backdating class action lawsuit against UnitedHealth Group, currently pending in Minnesota federal court. Lerach Coughlin was also approved as class counsel in this matter.

II. HOW ARE RESTATEMENTS DUE TO BACKDATING IMPACTING CIVIL LITIGATION?

A. The Current Statistics (As of September 29, 2006).

1. Of the 19 issuers defending securities fraud class actions, 74% (14) had restated their financials as a result of options backdating issues.

2. Of the 80 issuers defending shareholder derivative lawsuits, 42.5% (34) had restated their financials as a result of options backdating issues.

B. Why Do Restatements Frequently Lead to Litigation?

1. Restatements are indicative of error.
2. Restatements are indicative of materiality.
3. Restatements can provide necessary evidence of “loss causation.”
4. Restatements can provide necessary evidence of the “efficient market hypothesis” for a “fraud on the market” theory of reliance/transaction causation.
5. Restatements can provide plaintiffs with a treasure trove of discovery.
6. Restatements can lead to regulatory and/or criminal investigations, which themselves provide potential plaintiffs with notice of possible corporate misconduct as well as sources of discovery.

III. TYPES OF DERIVATIVE ACTIONS AND DEFENSES ARISING FROM BACKDATING.

A. Typical Defendants.

1. Senior executives who allegedly granted and/or received backdated options, or who participated in the preparation of the company’s financial statements (frequently called “Officer Defendants”).
2. Members of the Board of Directors, Compensation Committee, and Audit Committee during the period when the allegedly backdated options were granted and/or undisclosed (frequently called “Director Defendants”).
3. Officers and directors who sold shares during the period when the allegedly backdated options were granted and/or undisclosed (frequently called “Insider Selling Defendants”).
4. The company/issuer is usually named as a nominal defendant.

B. Allegations From Actual Options Backdating Derivative Action Complaints.

1. Alleged Damages to Company.
 - a) Defendants have been unjustly enriched at the expense of the company, which has received and will receive less money from defendants when they exercise their options at prices substantially lower than they would have if the options had not been backdated.
 - b) The practice of backdating stock options not only lines the pockets of the company's directors and executive at the direct expense of the company, which dollar for dollar received money when the options are exercised, but also may have resulted in the overstatement of the company's prior financial results.
 - (1) This is because options priced below the stock's fair market value when they are awarded bring the recipient an instant paper gain.
 - (2) Under accounting rules, that is the equivalent of additional compensation and thus must be treated as a cost to the company.
 - (3) The company did not account as an expense the amount by which the market price of the company's stock on the actual date the options were issued exceeded the exercise price of the options and thus the defendants' conduct may have caused the company to materially overstate its publicly reported financial results.
 - (4) The company's Forms 10-k included financial statements that were materially false and misleading and presented in violation of GAAP due to improper accounting for backdated stock options.
2. Breach of Fiduciary Duties of Care, Loyalty, Reasonable Inquiry, Oversight, Good Faith, and Supervision.
 - a) Permitting stock options to be backdated.

- b) Publishing financial statements that did not conform to GAAP.
 - c) Failing to supervise audits and reviews of the company's financial statements, internal controls, and procedures.
 - d) Failing to detect, prevent, and/or disclose the company's accounting misstatements and weaknesses in its internal controls and procedures.
 - e) Failing to test, oversee, and monitor the company's systems of internal disclosure, financial and accounting controls, governance procedures, and disclosure procedures.
 - f) Failing to ensure compliance with Sarbanes-Oxley.
 - g) Exposing the company to liability from, *inter alia*, class action suits for violation of the U.S. federal securities laws brought by and on behalf of those persons who purchased the company's stock during the relevant period as well as investigations launched by the SEC and possibly the IRS, all of which threaten to further cost the company millions of dollars in fines, penalties, and increased professional fees.
3. Abuse of Control.
- a) Defendants employed a scheme for the purpose of maintaining and entrenching themselves in their positions of power, prestige, and profit, and to continue to receive the substantial benefits, salaries, and emoluments associated with their positions.
 - b) Defendants' conduct constitutes an abuse of their ability to control and influence the issuer.
4. Gross Mismanagement.
- a) Defendants abandoned and abdicated their responsibilities and fiduciary duties with regard to prudently managing the assets and business of the company.
 - b) By committing this misconduct, defendants breached their duties of due care, diligence, and candor in the

management and administration of the company's affairs and in the use and preservation of the company's assets.

- c) During the course of the discharge of their duties, defendants knew or recklessly disregarded the unreasonable risk and losses associated with their misconduct, yet defendants caused the company to engage in the scheme complained of which they knew had an unreasonable risk of damage to the company, thus breaching their duties to the company.

5. Aiding and Abetting Breach of Fiduciary Duty.

- a) Defendants have pursued or joined in the pursuit of a common course of conduct, and have acted in concert with one another in furtherance of their common plan or design.
- b) Defendants further aided and abetted and/or assisted each other in breach of their respective duties.
- c) Defendants collectively and individually initiated a course of conduct which was designed to and did: (i) conceal the fact that the company was over-paying its directors, officers, and employees via backdated option grants; (ii) maintain defendants' directorial and executive positions at the company, and the profits, power, and prestige that defendants enjoyed as a result of these positions; and (iii) deceive the investing public regarding defendants' management of the company, the company's financial health and stability, and future business prospects.
- d) Each of the defendants aided and abetted and rendered substantial assistance in these wrongs. In taking such actions, each defendant acted with knowledge of the primary wrongdoing, substantially assisted the accomplishment of that wrongdoing, and was aware of his overall contribution to and furtherance of the wrongdoing.

6. Corporate Waste.

- a) Having to direct manpower to the task of restating the company's past financials to correct for the improperly backdated options.
- b) Incurring unreported compensation costs.

- c) Incurring legal liability and legal costs to defend these actions.

7. Unjust Enrichment.

- a) Defendants have been unjustly enriched at the expense of the company, in the form of unjustified salaries, benefits, bonuses, stock option grants, and other emoluments of office.
- b) All payments and benefits provided to the defendants were at the expense of the company. The company received no benefit from these payments.
- c) Certain of the defendants sold the company's stock for a profit during the period of deception, misusing confidential non-public corporate information. These defendants should be required to disgorge the gains which they have and/or will otherwise unjustly obtain at the expense of the company. A constructive trust for the benefit of the company should be imposed thereon.

8. Constructive Fraud.

- a) Defendants had a duty of candor and full disclosure regarding the true state of affairs of the company's business and assets and their conduct with regard thereto.
- b) Defendants made or aided and abetted the making of, numerous misrepresentations to and/or concealed material facts from the company's shareholders despite their duties to disclose the true facts regarding their stewardship of the company.

9. Sarbanes-Oxley Section 304 Disgorgement.

- a) SOX Section 304 requires forfeiture by a CEO and CFO of certain bonuses and other incentive-based or equity-based compensation in the event that their company prepares an accounting restatement due to material noncompliance, as a result of misconduct, with any financial reporting requirement under the securities laws.
- b) But there may not be a private right of action under Section 304. *See, e.g., In re Whitehall Jewellers, Inc.*

Shareholder Derivative Litigation, 2006 WL 468012 (N.D. Ill. Feb. 27, 2006); *Bisys Group Inc. Derivative Action*, 396 F.Supp.2d 463 (S.D.N.Y. 2005); *Neer v. Pelino*, 389 F.Supp.2d 648 (E.D. Pa. 2005).

10. Section 16(b) Short-Swing Profit Disgorgement (Exchange Act).
 - a) The company used artificial grant dates in order to provide option recipients with lower exercise prices.
 - b) Because the company used artificial grant dates, these stock option grants were not granted in conformance with the requirements of the company's stock option plan and were not properly approved by the company under SEC Rule 16b-3(d).
 - c) During the relevant period, individual defendants engaged in sales of the company's stock at various times that occurred within six months of the improper option grants set forth above. These sale transactions took place within the statutory six-month short-swing profit period prescribed by Section 16(b).
 - d) The individual defendants reported the foregoing transactions in Form 4 filings with the SEC, wherein they asserted that option grants were exempt from the statute under the company's option plan. 17 C.F.R. §240.16b-3(d)(1).
 - e) Because the option grants referred to herein were not properly approved by the company's Compensation Committee, these option grants are not exempt under SEC Rule 16b-3(d), and constitute non-exempt purchases under Section 16(b).
 - f) As a result, the individual defendants garnered an indeterminate sum of short-swing profits which is subject to disgorgement.
11. Section 14(a) and Rule 14a-9 Proxy Solicitation Violations Under the Exchange Act.
 - a) Section 14(a) and Rule 14a-9 prohibit materially false or misleading statements of material fact in proxy statements.

- b) Failure to disclose “option backdating scheme” in the proxy statements allegedly constituted a material omission and misrepresentation.
- c) As a result, plaintiffs seek to void the election of directors during the period in which the company issued materially false or misleading proxies.

12. Rescission.

- a) The stock options contracts between the individual defendants and the company entered into during the relevant period were obtained through fraud, deceit, and abuse of control.
- b) The backdated options were illegal grants and thus invalid as they were not authorized in accordance with the terms of the publicly-filed company stock options plans that were approved by the company’s shareholders and filed with the SEC.
- c) All contracts that provide for stock option grants between the individual defendants and the company and were entered into during the relevant period should, therefore, be rescinded, with all sums paid under such contracts returned to the company, and all such executory contracts cancelled and declared void.

13. Accounting of all stock option grants.

14. Breach of Employment Contracts and Stock Option Plan (against individual defendants).

15. Federal Securities Fraud (against individual defendants).

- a) Section 10(b) and Rule 10b-5.
- b) Section 20(a) (control person liability).

C. Procedural Defenses to Derivative Actions.

- 1. Failure to make demand on board of directors to pursue the claims, and/or failure to adequately allege futility of making such demand.
 - a) Claim belongs to the corporation – not the shareholders.

- b) Shareholders must either make demand on board or directors to file suit or allege futility.
- c) Futility is established if, accepting the well-pleaded facts of the complaint as true, the alleged particularized facts raise a reasonable doubt that either: (1) the directors are *disinterested* or *independent* with respect to the challenged transactions; or (2) the challenged transaction was the product of a *valid exercise of the director's business judgment*. Futility requires a showing that a majority of board is not "disinterested" or "independent." *E.g., Landy v. D'Alessandro*, 316 F.Supp.2d 49, 57-58 (D. Mass. 2004) (collecting Delaware authority and analyzing allegations of "secret stock options" granted to executive).

- (1) *Disinterested*. "From the standpoint of interest, this means that [a majority of the] directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally. *Id.* at 62 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)).

(a) Note: any disqualifying director interest must be an interest related to the challenged transaction (*i.e.*, the options grants at issue).

(b) Did a majority of the board gain any benefit from the backdating of option grants?

(c) Did a majority of the board have any other conflict of interest/self-dealing relating to the backdating of option grants?

- (2) *Independent*. "The question of independence flows from an analysis for the factual allegations pertaining to the influences upon the directors' performance of their duties generally, and more specifically in respect to the challenged transactions. . . . In other words, is the board incapable, due to domination or control, of objectively evaluating a demand, if made, that the

board assert the corporation's claims that are raised by plaintiffs?" *Landy*, 316 F.Supp.2d at 63 (internal citations omitted).

(a) Did the current board members participate in the options grant decisions at issue?

(b) Did the current board members serve on the compensation committee that granted the options at issue?

(c) Do option recipients control or dominate the current board members?

(3) *Business Judgment Rule*. "In determining demand futility, the [court] in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that the challenged transaction was otherwise the product of a valid exercise of business judgment." *Id.* at 64 (citing *Aronson*).

(a) The court makes an inquiry into the substantive nature of the challenged transaction and the board's approval thereof. *Id.*

(b) **"The business judgment rule can insulate unlawful conduct."** *Id.* The rule creates a presumption that directors acted in good faith and in the honest belief that their corporate actions were in the best interests of the company. "One can reasonably conceive of numerous situations in which directors might act on an informed basis, in good faith and in the honest belief that an action taken is in the best interests of the company and yet approve a transaction that, in the end, proves to be unlawful." *Id.*

(c) Thus, even if the board is alleged to have approved "illegal" or "unlawful" options grants, that does not necessarily mean that demanding the board to bring an action regarding those unlawful grants is futile.

2. Procedural Requirements of Federal Rule of Civil Procedure 23.1.²
 - a) Plaintiff must be a shareholder or member of issue at the time of the transaction of which the plaintiff complains.
 - b) The action is not collusive with the intention of conferring jurisdiction on a federal court.
 - c) The complaint shall allege with particularity plaintiff's efforts to demand board action or the futility thereof.
 - d) The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association.
 - (1) May consider plaintiff's conflict of interest with his direct claims/personal losses.
 - (2) Evaluate plaintiff's membership in pending class actions.

D. Substantive Defenses to Underlying Claims.

1. Corporate actions are protected by Business Judgment Rule.
 - a) BJR is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in bad faith and in the honest belief that the action taken was in the best interests of the company.

² "In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

- b) As discussed above, the fact that plaintiff alleges that backdated options are illegal or unlawful does not necessarily mean that the board's conduct in granting such options is unprotected by the BJR.
 - c) "Plaintiff must allege facts that create a reasonable doubt that the board acted without knowledge that the transactions violated the law, or reasonable doubt that the board acted with reliance on reasonably selected counsel." *Landy*, 316 F.Supp.2d at 65 (finding insufficient allegations that board knew of illegality of executive compensation at the time of approval); *compare Sanders v. Wang*, 1999 WL 1044880 (De. Ch. Nov. 8, 1999) (finding reasonable doubt of the exercise of business judgment when the alleged facts showed that board violated an express plan provision limiting the number of shares they were authorized to award, concluding that the violation was so clear that the board could not contend good faith or honest belief within the meaning of the BJR).
 - d) Thus, the availability of the BJR will depend on the particular facts regarding what the board knew and believed regarding the legality and propriety of the option grants at issue, as well as whether the board relied on the advice of counsel and other advisors.
2. There is no causal relationship between alleged breach and alleged damage.
- a) Most states require some showing of loss causation, but the standard of causation may vary among states.
 - b) New York recognizes different causation requirements depending on the relief sought – money damages v. restitution. *See Kwiatkowski v. Bear, Stearns & Co.*, 1999 WL 1277245 (S.D.N.Y. Nov. 29, 1999).
 - (1) Where plaintiff seeks damages to compensate for his or her losses, "the usual damages-causation rule for tort and contract breach cases is appropriate." *Id.* at *14.
 - (2) "[B]ut where the remedy being sought is a restitutionary one to prevent the fiduciary's unjust enrichment as measured by his ill gotten gain, the

less stringent ‘substantial factor’ standard may be more appropriate.” *Id.* (quoting *American Fed. Group, Ltd. v. Rothenberg*, 136 F.3d 897 (2nd Cir. 1998)).

- c) Delaware also imposes different causation requirements for breaches of fiduciary duty depending on whether the damages sought are transactional or restitutionary. *See Thorpe v. Cerbco, Inc.*, 676 A.2d 436 (Del. 1996) (refusing to award transactional damages because there was no “proximate cause” between controlling shareholders’ breach of fiduciary duty of loyalty and non-consummation of transaction, yet still awarding restitutionary damages for disgorgement of benefits and payment of corporation’s costs).
 - d) Accordingly, in an options backdating action, the causation requirements may vary within the complaint and among the defendants.
 - (1) Claims against individual officers and directors seeking disgorgement of profits and other compensation, if deemed restitutionary, may be subject to the “substantial factor” test – were the alleged breaches of fiduciary duty a substantial factor leading to the officer’s acquisition of ill-gotten gain? Even if there were other causes involved, the plaintiff could still prevail upon proving that the breach of fiduciary duty was a “substantial” (rather than “sole”) factor.
 - (2) Claims against the corporation seeking money damages for this same conduct, however, may be subject to a much higher standard of “but for” and “proximate cause” – did the alleged breaches of fiduciary duty regarding the issuance of backdated options legally and proximately cause the issuer to suffer real damages? Here, the existence of other factors that cause or contribute to the alleged losses could be a legitimate defense.
3. The alleged fiduciary duties are not recognized at law.
 4. There was no actual breach of the alleged duties.

5. Ask court to order plaintiff to post a bond.
 - a) Many states permit posting of bond equal to defendants' potential losses/damages/expenses/harm.
 - b) Can be substantial amount, particularly in options backdating litigation.

IV. SECURITIES CLASS ACTIONS: ALLEGATIONS AND DEFENSES.

A. Typical Defendants.

1. The company that issued the allegedly backdated stock options and related financial statements.
2. Senior executives of the company who allegedly sold shares of stock while in possession of material non-public information regarding the company's option granting practices.
3. Senior executives who allegedly received backdated options.
4. Senior executives who signed allegedly false and misleading financial statements and reports.

B. Typical Exchange Act Claims.³

1. Section 10(b) and Rule 10b-5 Securities Fraud.
2. Section 20(a) Control Person Liability.

C. Allegations From Actual Options Backdating Class Action Complaints.

1. Corporate statements in Forms 10-Q, 10-K, Proxy Statements, and press releases regarding earnings and options issues were materially false and misleading because:

³ In addition to claims arising under the Exchange Act, there are also potential claims under Section 11 and 12(a)(2) of the Securities Act, seeking rescission or damages for securities purchased on the basis of a false or misleading registration statement or prospectus. *E.g., Primavera Investors v. Liquidmetal Technologies, Inc.*, 403 F.Supp.2d 1151 (M.D.Fla. 2005) (analyzing Section 11 liability in connection with allegations that historical financial data contained in IPO prospectus failed to properly account for stock option compensation expense in violation of GAAP). Significantly, these Securities Act claims have no scienter or reliance requirements, but rather impose stringent liability for material misrepresentations or omissions in the offering documents.

- a) They failed to reflect that stock option grants were not given at fair market value of the stock on the grant date, but rather were improperly backdated.
 - b) Stock-based compensation expenses were not being recorded in accordance with APB 25.
 - c) The company did not comply with IRC Section 162(m) because it treated certain stock option expenses as deductible when in fact they were not entitled to such treatment under Section 162(m), thereby understating income tax liability.
 - d) The company improperly understated its expenses, improperly calculated the deductibility of certain executive compensation expenses under the IRC and overstated its earnings.
 - e) The company's financial statements were not prepared in accordance with GAAP. *See* 17 C.F.R. § 210.4-01(a)(1) ("Financial Statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided.").
 - f) The company's insiders received backdated options and thus took excess and unjustified compensation at the expense of the investing public.
 - g) Significant accounting errors exist in the company's historical financial statements.
 - h) The company had failing and deficient internal controls and procedures and lacked any meaningful ability to accurately report its financial results.
 - i) The company's illicit backdating scheme potentially subjected it to substantial regulatory fines, penalties, and other legal action, thereby compromising its overall financial conditions and prospects.
2. When the company eventually disclosed the "truth" and/or restated its financials, the stock price dropped significantly.

3. The market for the company's publicly traded securities promptly digested current information with respect to all publicly available sources and reflected such information in the price of the company's securities. Thus, all purchasers of the company's publicly traded securities during the class period suffered similar injury through their purchase of the company's publicly traded securities at artificially inflated prices and a presumption of reliance applies. (Fraud on the market theory).
4. The defendants acted with scienter in that they knew and/or recklessly disregarded the falsity and misleading nature of the information that they caused to be disseminated to the investing public.
5. The statutory safe harbor provided for forward-looking statements does not apply because the statements were not identified as "forward-looking statements" when made and there were no meaningful cautionary statements identifying important facts that could cause actual results to differ materially from those in the purportedly forward looking statements.
6. This conduct constitutes a violation of Section 10(b) and Rule 10b-5 in that defendants (a) employed devices, schemes, and artifices to defraud; (b) made untrue statements of material facts or omitted to state material facts necessary in order to make statements made, in light of the circumstances under which they were made not misleading; or (c) engaged in acts, practices, and a course of business that operated as a fraud or deceit upon plaintiff and others similarly situated in connection with their purchases of the company's publicly traded securities during the class period.
7. The conduct of the individual defendants constitutes a violation of Section 20(a) of the Exchange Act (control person liability).
8. Plaintiff and the class have suffered damages in that, in reliance on the integrity of the market, they paid artificially inflated prices for the company's publicly stock, and they would not have purchased such stock at the priced they paid, or at all, if they had been aware that the market prices had been artificially and falsely inflated by defendants' misleading statements.

D. Substantive Defenses to Securities Fraud Claims.

1. No materiality.

- a) Reasonable Investor Standard: “[T]o fulfill the materiality requirement [of Section 10(b) and Rule 10b-5], there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” *Basic Inc. v. Levinson* 485 U.S. 224 (1988), citing *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

- b) At least one court has ruled that a company’s failure properly to account for stock options in violation of GAAP was material. *Primavera Investors v. Liquidmetal Technologies, Inc.*, 403 F.Supp.2d 1151 (M.D. Fla. 2005).
 - (1) Allegations: “The historical financial data contained in defendant’s prospectus was false due to the defendants’ failure to properly account for stock option compensation expenses in violation of GAAP.” *Id.* at 1156.

 - (2) Holding:
 - (a) The false financial statements were material. *Id.*

 - (b) The false statements were not protected by the “bespeaks caution” doctrine because “a defendant’s cautionary warnings about a future risk cannot render immaterial an otherwise false historical financial statement.” *Id.*

 - (c) “Any reasonable investor contemplating investing during a company’s IPO would want to know whether the company was overstating its financial earnings in violation of GAAP.” *Id.* at 1157.

- c) SEC Staff Accounting Bulletin No. 99 – Materiality.
 - (1) Must consider *Quantitative* and *Qualitative* factors.

 - (2) No qualitative threshold of materiality (*i.e.*, no 5% rule).

(3) Quantitatively small misstatement of a financial statement item may still be material based on certain considerations:

(a) Whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate.

(b) Whether the misstatement masks a change in earnings or other trends.

(c) Whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise.

(d) Whether the misstatement changes a loss into income or vice versa.

(e) Whether the misstatement concerns a segment or other portion of the registrants' business that has been identified as playing a significant role in the registrant's operations or profitability.

(f) Whether the misstatements affect the registrant's compliance with regulatory requirements.

(g) Whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements.

(h) Whether the misstatement has the effect of increasing management's compensation – for example by satisfying requirements for the award of bonuses or other forms of incentive compensation.

(i) Whether the misstatement involves concealment of an unlawful transaction.

d) SEC Staff Accounting Bulletin No. 108 -- Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements.

- (1) Requires both a balance sheet and income statement analysis of prior misstatements.
 - (2) Reiterates need for quantitative and qualitative analysis.
2. No scienter or fraudulent intent.
- a) Under the Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4, plaintiffs have a heightened pleading requirement for securities fraud, and “with respect to each act or omission alleged to violate this chapter, [must] state with particularity facts giving rise to a strong inference that defendant acted with the required state of mind.”
 - b) Mere violations of GAAP are usually insufficient to establish scienter. *E.g.*, *In re Orbital Sciences Corp. Sec. Litig.*, 58 F.Supp.2d 682, 687 (E.D.Va. 1999); *Chill v. General Electric Co.*, 101 F.3d 263, 270 (2d Cir. 1996); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994); *In re Peritus Software Servs., Inc. Sec. Litig.*, 52 F.Supp.2d 211, 223 (D.Mass. 1999) (noting that “[a] host of courts have held that a mere failure to recognize revenue in accordance with GAAP does not, in itself, suffice to establish scienter.”).
 - c) Some courts have allowed circumstances surrounding GAAP violations to contribute to a strong inference of scienter. *E.g.*, *In re MicroStrategy, Inc. Sec. Litig.*, 115 F.Supp.2d 620 (E.D. Va. 2000) (“[W]hen the number, size, timing, nature, frequency, and context of the misapplication or restatement are taken into account, the balance of the inferences to be drawn from such allegations may shift significantly in favor of scienter. . . The mere fact that there was a restatement or a violation of GAAP, by itself, cannot give rise to a strong inference of scienter; the nature of such a restatement or violation, however, may ultimately do so.”); *In re Adaptive Broadband Sec. Litig.*, 2002 WL 989478 (N.D. Cal. 2002) (corroborating GAAP violations with detailed evidence of the contemporaneous decision making behind the accounting errors showing that statements were known to be false at the time they were made to the SEC and the investing public set forth sufficient evidence of scienter).

- d) In such cases where courts have looked to the circumstances surrounding GAAP violations to contribute to a strong inference of scienter sufficient to withstand a motion to dismiss, they have generally focused on five independent factors:
- (1) Whether there are allegations of insider trading;
 - (2) The magnitude of the improperly recognized revenues;
 - (3) Whether the GAAP violations relate to major balance sheet items based on contracts of tremendous magnitude and financial importance to the corporation;
 - (4) Whether the contracts are contingent upon some future occurrence or consignment transactions in which the other party has no obligation to pay the corporation the amount recorded as revenue; and
 - (5) Whether the GAAP violation contravenes the corporation's internal policies.
- e) At least one court has dismissed a securities fraud case alleging improper accounting of stock options on the grounds that the purported GAAP violations did not support an inference of scienter. *See In re Sportsline.com Securities Litigation*, 366 F.Supp.2d 1159 (S.D. Florida 2004).
- (1) Allegations:
 - (a) "In contravention of GAAP (APB Opinion No. 25), the Company failed to recognize compensation expense of \$3,419,000 for the quarter ended March 31, 2001 in connection with stock options granted to employees. In this manner the Company materially understated its reported operating loss and its net loss for the quarter. The non-recording of other expenses further understated the Company's reported operating loss and net loss for the quarter. In all, for the Company, there was a 2.54 percent change between the original and

restated gross profit for the quarterly period ended March 31, 2001.” *Id.* at 1167, n.5.

(b) Defendants chose to use the “intrinsic value” method to value their stock options. Because this method is objective, verifiable, and not based on estimates or data subject to differing interpretations, Defendants had to have known or at the very least were severely reckless in not knowing that these valuations were wrong.” *Id.* at 1168.

(2) Defendants’ Response:

(a) “The nature of the error made in applying GAAP was not based on a simple mathematical calculation, but rather that defendants made an error in determining the measurement dates of employee stock option grants.” *Id.*

(b) “FASB statement No. 123 requires companies to calculate the intrinsic value of stock options granted as of their ‘measurement date,’ which can be different than the ‘grant date.’” *Id.*

(3) Holding:

(a) The court found that “interpretations of the measurement date criteria embodied in APB No. 25 are far from obvious,” and thus rejected plaintiff’s claim that defendants knew or were reckless in not knowing that their option valuations were initially wrong. *Id.*

(b) The court then evaluated each of the five factors described above, and rejected the inference of scienter because: (i) there were no allegations of insider trading; (ii) the magnitude of the misstatements was comparatively modest; (iii) the GAAP violations primarily concerned the accounting for an employee stock option plan that was not part of SportsLine’s core business activity; (iv) the misstatements were not based upon future events that were necessarily not going to occur; and (v) there were no allegations that the GAAP

violations also violated SportsLine's internal policies. *Id.* at 1169-170.

3. No transaction causation (reliance or "actual cause").
 - a) No individual reliance. Plaintiff must show that "but for" the fraud, he or she would not have engaged in the transaction at issue.
 - (1) Did the plaintiff personally receive, hear, and rely on the alleged fraudulent statements?
 - (2) If the plaintiff had known the truth of the options backdating issues, would he or she still have bought stock in the issuer?
 - b) No "fraud on the market." Under this theory, causation is not premised on any specific transaction between plaintiff and defendant, nor is there required any proof that the plaintiff was even aware that a misrepresentation was made. Causation lies in the fact that the plaintiff relied on the market price of the security as an indicator of the future value of the stock. To the extent that the defendant's misrepresentations artificially altered the price of the stock and defrauded the market, causation is presumed. *See Basic Inc. v. Levinson*, 485 U.S. 224, 247, 108 S.Ct. 978, 992, 99 L.Ed.2d 194 (1988) ("Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.").
 - (1) Did the company's stock price generally reflect publicly available information?
 - (2) Was the company listed and actively traded on an efficient market?
 - (3) Did the company file periodic reports with the SEC?
 - (4) Did the company regularly communicate with public investors via established market communication mechanisms, including through regular disseminations of press releases on national

circuits of major newswire services and/or the financial press?

- (5) Was the company followed by securities analysts who wrote reports and distributed them to the sales force and customers of brokerage firms?
- (6) As a result of the foregoing, did the market for the company's securities promptly digest current information regarding the company from all publicly-available sources and reflect such information in the price of the company's securities?
- (7) Did the company's stock price increase in value as a result of the alleged misrepresentations and omissions regarding the options backdating?

4. No loss causation (proximate cause).

- a) The PSLRA expressly imposes upon securities fraud plaintiffs "the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." (*See* 15 U.S.C. § 78u-4(b)(4)).
- b) *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) rejects the theory that purchasing stock at an inflated price that subsequently declines constitutes "loss causation," and instead requires plaintiffs to plead and prove a causal relationship between the alleged misrepresentations and the alleged loss.
- c) In the options backdating context, this will require plaintiffs to plead and prove a causal relationship between the alleged misrepresentations and omissions regarding the option grants at issue and the alleged resulting damages – *a mere subsequent price decline will likely be insufficient*.
- d) Typically, this will require allegations and evidence of a "corrective disclosure" by the company coupled by a price decline that is causally related to that disclosure.

- e) Evidence of other “bad news” or similar market events that could otherwise explain a subsequent price decline may be helpful in defeating allegations of loss causation.
 - f) *Compare In re Dauo Systems, Inc. Securities Litigation*, 411 F.3d 1006 (9th Cir. 2005) (finding plaintiff adequately pleaded loss causation based on company’s GAAP violations) *with Powell v. Idacorp, Inc.*, 2006 WL 851116 (D. Idaho March 29, 2006.) (finding that plaintiff failed to plead loss causation).
5. The PSLRA statutory “safe harbor” for forward-looking statements (Section 21E(c) of the Exchange Act): If a forward-looking statement is immaterial or accompanied by meaningful cautionary language, or if a private securities fraud plaintiff cannot prove that the statement was made with actual knowledge that the statement was false or misleading, there is no liability in a private action for securities fraud for that statement.
6. Bespeaks caution doctrine.
- a) This is a judicially created rule providing that cautionary language meeting certain standards can render forward-looking statements inactionable under securities fraud laws if such forward-looking statements later prove to be incorrect.
 - b) This defense has been expressly rejected in at least one federal options case. *See Primavera Investors v. Liquidmetal Technologies, Inc.*, 403 F.Supp.2d 1151 (M.D. Fla. 2005) (holding that the “bespeaks caution” doctrine did not protect false historical financial statements that failed to properly account for stock option expenses in violation of GAAP).
7. Allegations of internal corporate mismanagement are not actionable under Section 10(b) or Rule 10b-5. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (holding that Section 10(b) does not apply to cases “in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary”).
- a) Interpreting the general anti-fraud provision of the Securities Exchange Act, the U.S. Supreme Court in *Santa Fe Industries, Inc.* held that traditional state law breach of fiduciary duty claims are not actionable under Section

10(b) unless the conduct alleged can fairly be viewed as “manipulative or deceptive” within the meaning of Section 10(b). 430 U.S. at 473-74. To avoid creating federal common law of fiduciary obligations, the Court stressed that Congress did not intend to take over for the states as corporate regulator through Section 10(b). *Id.* at 477-79; *see also Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1, 4 (2d Cir. 1983). Absent deceptive or manipulative conduct in addition to a breach of fiduciary duty, such as by omitting or misstating a material fact, under *Santa Fe* a breach of fiduciary duty alone does not give rise to liability under the anti-fraud provisions of the Securities Exchange Act.

- b) Applying *Santa Fe*, therefore, various Circuit Courts of Appeal have rejected attempts to bootstrap a failure to disclose the misconduct giving rise to the breach of fiduciary duty itself as an actionable omission of material fact for purposes of Section 10(b). *See, e.g., Panter v. Marshall Field & Co.*, 646 F.2d 271, 288 (7th Cir. 1981); *Field v. Trump*, 850 F.2d 938, 947-48 (2d Cir. 1988); *Kas v. Financial Gen. Bankshares, Inc.*, 796 F.2d 508, 513 (D.C. Cir. 1986); *Colin v. Onyx Acceptance Corp.*, 31 Fed. Appx. 359, 360 (9th Cir. 2002).

E. Procedural Defenses to Securities Fraud Claims.

1. Statute of Limitations. *See* Section V., *infra*.
2. Failure to meet heightened pleading requirements under Section 21D of the Exchange Act and Federal Rule of Civil Procedure 9(b).
 - a) Section 21D(b)(1) requires that the “complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”
 - b) Section 21D(b)(2) requires a plaintiff to plead with particularity facts giving rise to a strong inference that each defendant had the required state of mind.

- c) Section 21D(b)(3)(A) requires a court to dismiss the complaint if the above pleading requirements are not met.
- d) Section 21D(b)(3)(B) imposes an automatic stay of discovery during the pendency of any motion to dismiss.
- e) Rule 9(b) generally requires a plaintiff to plead fraud with particularity.

3. Dispute certification of class and/or appointment of lead plaintiff.

V. DETERMINING THE DATE OF IMPROPRIETY TO DEAL WITH LIMITATIONS ISSUES.

A. Securities Fraud Before Sarbanes-Oxley Effective Date (July 30, 2002): One Year/Three Year Rule.

Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilberston, 501 U.S. 350 (1991) requires litigation instituted pursuant to §10(b) and Rule 10b-5 to be commenced within the earlier of:

- 1. “One year after the discovery of the facts constituting fraud” (Limitations Period); and
- 2. “three years after such a violation.” (Repose Period).

B. Securities Fraud After Sarbanes-Oxley Effective Date: Two Year/Five Year Rule.

Sarbanes-Oxley Section 804 extended the common law statute of limitations to the earlier of:

- 1. “2 year after discovery of the facts constituting the violation” (Limitations Period); and
- 2. “5 years after such violation” (Repose Period).

C. Specific Options-Related Limitations Issues.

- 1. Does SOX apply retroactively to option grants that took place before it was enacted in 2002?
 - a) Probably not.
 - b) There is a consistent line of federal authority holding that SOX Section 804 does not apply retroactively to revive

previously time-barred claims. *E.g.*, *In re Enterprise Mortg. Acceptance Co., LLC, Securities Litigation*, 391 F.3d 401 (2nd Cir. 2005); *Lieberman v. Cambridge Partners, L.L.C.*, 432 F.3d 482 (3rd Cir. 2006); *Glaser v. Enzo Biochem, Inc.*, 126 Fed. Appx. 593 (4th Cir. 2005); *Margolies v. Deason*, 2006 WL 2597888 (5th Cir. Sept. 11, 2006); *Foss v. Bear, Stearns & Co.*, , 394 F.3d 540 (7th Cir. 2005); *In re ADC Telecomms., Inc. Sec. Litig.*, 409 F.3d 974 (8th Cir. 2005).

2. If SOX does apply, does the longer limitations period bar claims based on grants that took place more than five years ago, or are the options backdating practices part of a continuing course of conduct that brings the “violation” within the five-year period?
 - a) *Lampf* expressly bars any “equitable tolling” of repose period.
 - b) This bar would presumably apply to SOX 5 year statute of repose as well.

3. What is the “violation” that triggers the running of the Section 10(b)/Rule 10b-5 statute of repose?
 - a) Date of purchase and sale of the security. *See Kleban v. S.Y.S. Restaurant Mgmt., Inc.*, 912 F.Supp. 361, 367 (N.D.Ill.1995); *Otto v. Variable Annuity Life Ins. Co.*, 816 F.Supp. 458, 461 & n. 3 (N.D.Ill.1991).
 - b) Date of the alleged misrepresentation. *See Asdar Group v. Pillsbury Madison & Sutro*, 99 F.3d 289, 294-95 (9th Cir. 1996); *In re Exxon Mobil Corp.*, 387 F.Supp.2d 407, 421 (D.N.J. 2005); *Waldock ex rel. John H. Waldock Trust v. M.J. Select Global, Ltd.*,, 2004 WL 2278549 (N.D.Ill. Oct 07, 2004); *Bovee v. Coopers & Lybrand*, 216 F.R.D. 596 (S.D. Ohio 2003); *Wafra Leasing Corp. v. Prime Capital Corp.*, 192 F.Supp.2d 852 (N.D.Ill. 2002) (repudiating *Kleban*).

4. Evidence of alleged misconduct that had occurred outside limitations/repose period of § 10(b) suit may still be admissible for purposes of establishing scheme and/or scienter. *E.g.*, *In re Enron Corp. Sec. Litig.*, 235 F.Supp.2d 549, 689 (S.D.Tex. 2002); *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, 2005 WL 3704688 *7 (S.D.Tex. Dec 05, 2005).

VI. SECTION 16(b) SHORT SWING PROFIT IMPLICATIONS AS A CAUSE OF ACTION.

- A. Substantive Six Month Profit Disgorgement Provisions.** Section 16(b) gives an issuer and/or its security holders the right to sue their officers, directors, and 10% stockholders to recover profits realized by such “statutory insiders” from any purchase and sale, or sale and purchase, of the issuer’s stock within any period of less than six months.
- B. Procedural Six Month Profit Disgorgement Provisions.** Section 16(b) specifically allows shareholders to file such a claim if the issuer refuses or unreasonably fails to prosecute: “Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, *or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter*; but no such suit shall be brought more than two years after the date such profit was realized.”
- C. Rule 16b-3(d) Exemptions For Certain Approved Option Grants.** Rule 16b-3(d) specifically exempts certain option grants to officers and directors from the short-swing profit disgorgement rule described above, provided that any one of the following three conditions is satisfied:
1. The option grant is approved in advance by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors (Rule 16b-3(d)(1));
 2. The option grant is disclosed to shareholders in compliance with Securities Exchange Act Section 14, and is then approved in advance or ratified retroactively (no later than the date of the next annual shareholder meeting), by the issuer’s shareholders (Rule 16b-3(d)(2)); or
 3. The officer or director holds the underlying securities for a period of six months following the date of the option grant (Rule 16b-3(d)(3)).
- D. These Rule 16b-3(d) Exemptions May Not Be Available For Backdated Options Transactions.**
1. “Board approval” is likely to be challenged, particularly where the stock option plan does not permit backdating and/or the board or compensation committee approved the backdated options

unknowingly or recklessly. *See Andrew E. Roth, derivatively on behalf of Brocade Communications Systems, Inc. v. Gregory Reyes, et al.*, C 06 2786, United States District Court, Northern District of California, filed April 24, 2006 (seeking disgorgement of short-swing profits in excess of \$50 million).

2. “Shareholder approval” is likely to be challenged, particularly where the backdating was not disclosed to shareholders in a proxy statement or otherwise.
3. “6 month holding period” is likely to be challenged, particularly where the officer or director was aware of the actual grant date and nonetheless engaged in short-swing profit transactions.

E. Consequences: Executives May Be Liable For Short-Swing Profit Disgorgement.

1. If Rule 16b-3 exemptions are unavailable, then the options grant will be deemed to be a non-exempt stock purchase by the officer or director.
2. The purchase date will be deemed to be the date the board or committee approved the options grant.
3. This purchase will then be matched (retroactively) against any sales by the officer or director within a six-month period, to determine whether these transactions resulted in any profit.
4. If so, the officer or director is then subject to Section 16(b) liability for disgorgement of these profits.

VII. PROACTIVE STRATEGIES TO PREVENT SHAREHOLDER LITIGATION.

A. Preserve Your Documents.

B. Create A Special Litigation Committee.

1. Needs to be truly independent and disinterested.
2. Should have full corporate authority to investigate, as well as to hire independent counsel, accountants, and other advisors.

C. Conduct An Internal Investigation.

1. Consider outside counsel and forensic accountants.

2. Carefully manage your attorney-client and work product waiver issues.
3. Control the information flow.

D. Analyze The Scope And Nature Of Your Problem.

1. Who received the backdated options? Who granted them? Who approved the backdating?
2. What was the nature of the backdating? What was the grant date? What was the measurement date? What was the strike price? What was the accounting treatment?
3. Where are the underlying documents?
4. Why were the options backdated?
5. When did the backdating occur?
6. How were the backdated option grants effected? How much is the potential liability?
7. What did the board/compensation committee know about the option grants and when did they know it?
8. Was there reliance on counsel or other advisors?

E. Analyze Necessity and Timing of a Restatement.

F. Analyze Whether to Halt Trading.

G. Understand Your Particular Options Story.

1. Historical or current?
2. Acute or chronic?
3. Inadvertent or intentional?
4. If intentional, was the conduct done in good faith or with scienter?
5. Were the options practices disclosed or obfuscated?
6. Was there a subsequent cover-up?

7. Are the options recipients/grantors still with the issuer?

H. Match Your Litigation Strategy To Your Particular Facts.

I. Manage Your Message.

1. Have a clear message.
2. Have a clearly defined communications strategy.
3. Evaluate and manage both internal and external communications.
4. Consider a PR firm.

J. Develop and Implement Best Practices for Future Option Grants.