

Business Crimes Perspectives

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- Former Brocade CEO Gregory Reyes guilty of securities fraud relating to stock options backdating
- The case was the first to test the defenses of “lack of criminal intent” and “immateriality”
- Judges and juries clearly think stock option accounting matters to investors, regardless of how arcane it appears

BROCADE, ONE YEAR LATER: STOCK OPTION ACCOUNTING DOES MATTER TO INVESTORS. CEO GUILTY, ARE OTHERS NEXT?

In what may spark renewed interest among federal prosecutors handling cases of alleged stock options backdating, a jury in San Francisco found Gregory Reyes, the former CEO of Brocade Communications, guilty on ten counts of securities fraud. At the same time, the judge presiding over the case denied a pending Rule 29 motion for judgment of acquittal, thereby letting the jury verdict stand.

Reyes’ case is particularly noteworthy because his indictment, which occurred about a year ago today, was the first handed down by a federal prosecutor in the options backdating frenzy that began in the Spring of 2006. Aside from this dubious distinction, the case is important because it was the first to test what will likely be two common defenses to charges of stock option backdating: (1) lack of criminal intent and (2) immateriality.

CRIMINAL INTENT

Without the benefit of hindsight, the U.S. Attorney for the Northern District of California brought a case that, compared to other high profile cases that followed it, appeared to contain less evidence of intent to violate federal securities laws. The case against Reyes contained no allegations that documents were altered, destroyed, or concealed from outside auditors to hide evidence of backdating. On the contrary, based on the facts developed at trial, the grant process at Brocade appeared to be relatively open and transparent.

Reyes attacked the government’s evidence of intent in his Rule 29 motion by highlighting what the prosecution’s evidence did not prove. The prosecution, Reyes said, had failed to prove: (1) that Reyes understood the accounting implications of APB 25 or FAS 123, the accounting rules that govern how stock option expenses must be disclosed on a company’s financial statements; (2) that Reyes was aware that Brocade’s finance department did not properly account for the company’s stock option grants; and (3) that Reyes was involved in preparing or reviewing Brocade’s management representation letter to its outside auditors in which the company claimed that its accounting was in keeping with generally accepted accounting principles.

Though the judge expressed concerns at the hearing about the sufficiency of the prosecution’s evidence of intent in light its failure to establish that Reyes understood the relevant accounting rules, he noted in his order that those concerns had been allayed by a further review of the evidence, in particular the following:

(1) Reyes denied knowing that Brocade backdated options when confronted about backdating as part of Brocade’s 2006 internal review;

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(2) Reyes told an attorney involved in Brocade's 2006 internal review that, at some point during his tenure as CEO, he became aware that the granting of stock options carried 'accounting implications;'

(3) Reyes received an email attachment containing summaries of the relevant accounting rules;

(4) Reyes wrote in an email to colleague, "It is illegal to backdate stock options;"

(5) Reyes told a Human Resources employee who delivered stock option grants for his signature that "it's not illegal if you don't get caught;" and

(6) Reyes signed Brocade's financial statements and management representation letters.

MATERIALITY

In the year since his indictment, the market has demonstrated that investors appear to care little about stock options backdating. News of internal reviews or government investigations relating to options practices often have little to no effect on the movement of a company's stock price. But this reality provided no protection for Reyes.

Reyes argued that the prosecution had failed to meet its burden of proof on materiality: that it failed to prove there was a substantial likelihood that a reasonable investor would have considered Brocade's option practices important in deciding whether to buy or sell shares. In support, Reyes highlighted what the prosecution's evidence did not prove, namely that: (1) the non-cash stock option expenses under APB 25 were material to reasonable investors; (2) there was any connection between the announcement of restated stock compensation expense and a decline in Brocade's stock price; and (3) there was any connection between the omission of these non-cash expenses and Brocade's stock price.

The judge disagreed, however, finding that the following evidence was sufficient for a rational jury to conclude that the prosecution had met its burden of proving materiality:

(1) A leading mutual fund company, which owned a significant stake in Brocade, voted its shares according to guidelines that discouraged use of in-the-money options;

(2) A portfolio manager and equity analyst testified that non-cash expenses, though not the most important metric of a company's value, were pertinent to his investment decision; and

(3) The prosecution's expert witness testified that, if Brocade had properly accounted for stock options, it would have recorded large losses in 2001 and 2002.

And perhaps most significantly, the judge found that the backdating process itself could support a reasonable inference that omission was material. A reasonable juror could infer, wrote the judge, that the company maintained such a pricing system because it believed that investors cared about expenses that were understated as a result of it.

The jury verdict in the Reyes case shows that juries and judges think that stock option accounting—no matter how arcane or technical it appears at first blush—matters to investors. The verdict will likely clear the way for new prosecutions and civil enforcement actions against other companies and executives.

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