



WHITE-COLLAR CRIME

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Options Backdating and the Brocade Trial

The stock options backdating scandal generated by the media has, to date, “produced 16 criminal prosecutions, the disclosure that 220 companies have been subject to internal or federal investigations and 100 corporate earnings restatements totaling \$12.4 billion.”¹

Government theories of wrongdoing have vacillated in accordance with underlying facts, but, for the most part, focus on securities law disclosure failures and accounting issues. The recent trial of Greg Reyes, former CEO of Brocade Communications, for activities related to options backdating illuminates the types of issues and defenses generated by these cases.

As the act of backdating options is not, in and of itself, illegal, the government appeared to have an uphill battle in its case against Mr. Reyes, who did not personally benefit from the transactions at issue as he did not exercise or sell any backdated options. Nevertheless, the government obtained a conviction on all counts of its multipronged indictment.

Allegations Against Mr. Reyes

Brocade Communications develops and markets data storage networking products and services. The Silicon Valley company was formed in the 1990s and became a public company in 1999.²

Mr. Reyes served as Brocade’s CEO from July 1998 to January 2005. During that time, he also served as Brocade’s president and a member of its board of directors, of which he was the chairman for almost four years.³ In August 2006, Mr. Reyes was indicted, along with Stephanie Jensen, Brocade’s former vice



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president of Human Resources, for conspiracy to commit securities fraud, securities fraud, false SEC filings, falsifying Brocade’s books, records and accounts, and making false statements to accountants.⁴

According to the government, Mr. Reyes and Ms. Jensen conspired to backdate stock options awarded to Brocade’s employees from 2000 to 2004 in order to avoid the recording of compensation expenses on the company’s books. Pursuant to the generally accepted accounting principles in place during the alleged conspiracy, a company was not required to record a compensation expense for any employee stock option grant made “at-the-money” or for a price equal to the market price of the company’s stock on the date of the grant, because these option grants had no intrinsic value on the date they were granted. However, where a company made an employee stock option grant “in-the-money” or for an exercise price less than the market price of the company’s stock on the grant date, the company was required to record a compensation expense recognizing the stock option’s value. “In-the-money” option grants have value because they allow the employee to purchase its company’s stock at a price below the market price.⁵

The indictment against Mr. Reyes and Ms. Jensen alleged that they intentionally devised a scheme to avoid the recording of compensation expenses related to employee stock option grants. Specifically, the

government charged that Mr. Reyes and Ms. Jensen backdated various documents to give the appearance that stock options were granted on dates when the value of Brocade’s stock was low. These documents included committee meeting minutes, employment offer letters and other personnel records. The purpose of the backdating, according to the indictment, was to give Brocade employees valuable “in-the-money” stock options while avoiding the compensation expenses that would have been incurred had the options been granted at the same low price, but on the actual decision date when the market value of the stock was higher.⁶

It was undisputed at trial that backdating of options took place at Brocade and that the backdating resulted in an understatement of Brocade’s compensation expenses. The defense explained, however, that the practice of backdating options was widespread in Silicon Valley at that time and used as tool to recruit and retain qualified employees. According to the defense, any errors on Brocade’s books were the result of a fundamental misunderstanding of complex accounting rules. Indeed, the defense noted that, like Brocade, many other companies had to restate their financial statements to record compensation expenses incorrectly accounted for due to this universal misunderstanding.

The Government’s Case

In its case-in-chief, the government established the process for assigning grant options at Brocade. The system was implemented through Brocade’s human resources department, where a number of employees were charged with looking at historical stock prices and finding a date at which the price of the stock was low. This date, which usually predated the date on which the “look-back” was done, was then used in preparing paperwork to make it appear as

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though the options had been granted on the more favorable date. The paperwork, typically grant meeting minutes, was then given to Mr. Reyes for his signature and forwarded to the company's finance department. The responsibility for assigning employee option grants had been delegated by Brocade's board of directors solely to Mr. Reyes—a duty which he carried out without input from a committee or other board members.⁷

The government asserted that Mr. Reyes implemented the backdating system specifically to “insure[] that the employees received the benefit of the low prices while Brocade (illegally) avoided the cost of the resulting compensation expense.”⁸ In fact, the government argued, Mr. Reyes had no reason to backdate option grants except to improperly evade reporting the compensation expenses—expenses that according to the government's experts totaled more than \$173 million in 2001 and \$161 million in 2002. The government argued that this fact alone was evidence of fraudulent intent on Mr. Reyes' part.

Understanding that Mr. Reyes was claiming a lack of intent to commit a crime, the government also offered other evidence in support of the fact that he acted willfully with the knowledge that he was engaging in a wrongful act. In the context of the claims asserted in the indictment, the government framed the issue of intent as two separate questions.

First, did the defendant do something he knew was wrongful? Yes, he falsified Brocade's stock option grant minutes and then lied about it, which is legally sufficient proof that he acted with an intent to do something wrong. Second, did the defendant's conduct involve a “serious risk” of the violation of the securities laws? Yes, the defendant's falsification of the stock option grant minutes resulted in the falsification of the company's books and records, resulted in false statements being made to the auditors, caused the company to file false financial statements with the SEC that materially inflated Brocade's bottom line, and misled Brocade's shareholders and the investing public.⁹

The government argued that Mr. Reyes's execution of internal grant option documents was fraudulent because he knew that they reflected a date selected by human resources personnel rather than the actual date that the options were granted. Furthermore, the government asserted that Mr. Reyes knew that the documents would be relied upon by individuals within Brocade's finance department to determine whether there

were compensation expenses related to the option grants at issue.

As additional evidence of Mr. Reyes' knowledge of wrongdoing, the government relied upon the testimony of an outside attorney who interviewed him during Brocade's internal investigation into the backdating matter. According to the attorney, during his interview, Mr. Reyes repeatedly denied that Brocade backdated option grants. The government pointed to these false statements as evidence of Mr. Reyes' consciousness of guilt.¹⁰

Finally, although the government disputed that it was required to prove that Mr. Reyes understood the accounting process for employee option grants, it asserted that the evidence supported this conclusion as well. Accounting practices governing option grants at that time, referred to as Accounting Principles Board Opinion No. 25 (APB 25), dictated that “in-the-money” grants be recorded as compensation expenses on a company's books and records. The government argued that Mr. Reyes' execution of corporate documents which asserted Brocade's reliance on and compliance with APB 25 demonstrated his understanding.

The documents at issue included management representation letters to Brocade accountants and Brocade's Form 10-Ks filed with the SEC. These documents represented that no fraudulent information had been provided and that the corporation had accounted for its stock option plans in accordance with APB 25. The government argued that Mr. Reyes knew these representations to be false and understood that APB 25 required compensation expenses be taken for “in-the-money” grants, yet he executed the documents anyway.¹¹

The Defense

Throughout the trial, Mr. Reyes' attorneys continuously took issue with the government's characterization of the Brocade backdating process as a secretive conspiracy to defraud, organized and implemented by only a few individuals at Brocade who intended to deceive investors and others at the company. On the contrary, the defense asserted that the system of backdating option grants was an open process at the company, known to many including the company's in-house counsel and CFO.

As for his role in the backdating process, the defense submitted evidence that the process had been conceived not by Mr. Reyes, but by Brocade's former CFO who was in charge of the human resources department.¹² In creating the system, the

defense argued that the CFO, as well as others from the human resources and finance departments misapplied APB 25. Brocade's misapplication of the accounting standard for option grants is easily understood, posited the defense, as evidenced by the fact that many other companies in the same industry similarly misunderstood the application of APB 25.¹³

Accordingly, the defense argued that the government had failed to prove the existence of a general scheme to defraud. Moreover, the defense asserted that the government had not shown that Mr. Reyes acted with fraudulent intent. The defense did not dispute that he signed option grant documents that had been backdated, but argued that Mr. Reyes did so in an open manner, known to many others within Brocade and with their tacit approval. As evidence of this, the defense submitted e-mail communications between and among members of management that demonstrated a general corporate knowledge of the backdating process.¹⁴ Accordingly, the defense countered the government's argument that Mr. Reyes' execution of backdated documents was in and of itself proof of fraudulent intent.

Additionally, the defense called expert witnesses who asserted that as a busy CEO, Mr. Reyes properly delegated duties related to the preparation of grant option documents to others within the company. Similarly, given that his background was in sales, not accounting, it was argued that Mr. Reyes relied on those within the finance department to properly interpret APB 25 and account for expenses related to employee option grants. Thus, he contended that he relied on information from others at Brocade that led him to believe that the backdating practices were not only permissible, but did not have undisclosed accounting implications.

Furthermore, the defense argued that the government had not proved that Mr. Reyes had any reason to believe that the representations contained in SEC filings were not accurate.¹⁵ This was true especially because he did not have a true understanding of the requirements of APB 25. As pointed out by the defense, the government did not call a witness to testify that Mr. Reyes was familiar with APB 25. The defense also noted that the government did not call any witnesses from the finance department, relying instead on human resource witnesses who were involved in the preparation of backdated minutes and option grants—an issue that was not in dispute. As stated by the defense, “This speaks volumes about the quality of the government's case and about

what [the finance department witnesses] would say about Finance's application (or misapplication) of APB 25. There is not a scintilla of evidence demonstrating that any of these employees told Mr. Reyes that Brocade was not properly accounting for, or disclosing in its SEC filings, noncash stock-option expenses."¹⁶

Materiality Issue

The defendant also disputed the quality of the government's evidence on the issue of materiality. Specifically, there was a dispute as to whether the types of expenses involved with "in-the-money" grants, and the understatement of those expenses, were significant to investors. Both sides called witnesses to testify on the issue of materiality, the defense arguing, after eliciting expert testimony, that investors did not consider the "noncash" expenses such as those at issue in this case when deciding whether to buy or sell Brocade securities. Because the types of expenses at issue were immaterial, the defense continued, it is counterintuitive to believe that Mr. Reyes would have risked so much to engage in the scheme alleged by the government.

The government relied on testimony from employees of investment firms who noted their company's general disapproval of option plans that allowed in-the-money grants and the significance of these issues to investment professionals. In addition, the government argued that the impact of the backdating scheme was material given the significant financial impact of the unstated compensation expenses. The government's expert testified that if Brocade had properly accounted for the stock options, it would have recorded a loss of \$110 million in 2001 (rather than the \$3 million profit initially recorded) and a loss of \$45 million in 2002 (rather than a profit of almost \$60 million).¹⁷

Motion for Acquittal

• **Mr. Reyes' Motion for a Judgment of Acquittal.** After the government rested its case-in-chief, Mr. Reyes sought an acquittal based on the government's failure to prove either intent or materiality. In claiming that the government failed to prove that he intended to cheat or deceive Brocade or its shareholders, the defense noted that all Brocade employees called by the government as witnesses had referred to Mr. Reyes as a dedicated and hard-working leader. The defense further emphasized that there was

no evidence that he received any personal gain from the alleged scheme or had any other motive to act improperly.¹⁸

There was some debate among the parties and the court as to whether the government was required to show anything more than Mr. Reyes' knowledge that he was doing a wrongful act and that the act involved a significant risk of violating the securities laws.¹⁹ Mr. Reyes argued that the government also was required to show that he had an understanding of the accounting consequences of Brocade's backdating practices in order to sufficiently demonstrate an intent to defraud.²⁰ During oral argument on the defendant's Rule 29 motion, U.S. District Court Judge Charles R. Breyer continually pressed the government on this point.²¹

Because backdating options is not in itself illegal, the government appeared to have an uphill battle against Mr. Reyes, who did not personally benefit from the transactions of backdated options. But, the government got a conviction on all counts of its indictment.

Indeed, in considering the defendant's Rule 29 motion, the Court noted that the defense had successfully "poked a significant number of holes in the proof that the government presented."²² Nonetheless, the Court denied Mr. Reyes' motion, finding that the government had submitted sufficient evidence that a rational trier of fact could find the essential elements of the crimes beyond a reasonable doubt. In so holding, the Court stated that "it is not the function of the Court to weigh the merits of such arguments or to determine which inferences should be drawn from the evidence."²³

Conclusion

On Aug. 7, 2007, after five and a half days of deliberations, the jury in the Reyes case convicted the defendant of all counts. During their deliberations, the jury twice asked for read backs of testimony from the attorney who conducted the internal investigation of Brocade.

Mr. Reyes' conviction raises interesting issues for sentencing, currently scheduled for November, given that he did not personally

gain from the conduct.²⁴ The calculation of the loss figure will be in hot dispute.

The options backdating cases have been slow to develop, perhaps because proof of knowledge and intent is hard to come by. The sentencing determination in Reyes could impact the pace of these cases. The issues, so hotly contested throughout the Reyes trial, the first criminal trial related to backdating options, are likely to be repeated and refined in any future trials.



1. Pamela E. MacLean, "Lawyers 'Fly Blind' on Options Penalties," Nat'l Law Journal, Aug. 20, 2007.

2. Grand Jury Indictment, *United States v. Reyes*, CR 06-0556 (CRB).

3. Id. at ¶7.

4. Mr. Reyes and Ms. Jensen also were charged with two counts of honest services fraud, but these counts were dropped by the government prior to trial.

5. Grand Jury Indictment at ¶¶9-13.

6. Id. at ¶¶16-17.

7. *United States v. Reyes*, Transcript of Closing Arguments, July 26, 2007.

8. The United States' Response to the Defendant's Motion for a Judgment of Acquittal, *United States v. Reyes*, CR 06-0556 at p. 17.

9. Id. at p. 8.

10. Id. at pp. 10-11.

11. Id. at pp. 13-14.

12. *United States v. Reyes*, Transcript of Closing Arguments, July 26, 2007.

13. Id. (transcript)

14. Id. at pp. 129-133.

15. In fact, the defense also argued that Brocade's Form 10-Ks did not contain inaccurate information, but properly disclosed the fair value of stock option expenses. In its closing argument, the defense asserted that this information, disclosed not on Brocade's income statement, but elsewhere in the SEC filings, essentially told the public, "If you wanted to expense and/or put a value on these items, this is what it should be." *United States v. Reyes*, Transcript of Closing Arguments, July 26, 2007.

16. Memorandum of Points and Authorities in Support of Gregory L. Reyes's Motion for Judgment of Acquittal, *United States v. Reyes*, CR 06-0556 at pp. 26-27.

17. Order Denying Motion for a Judgment of Acquittal, *United States v. Reyes*, CR 06-0556, at p. 5.

18. Memorandum of Points and Authorities in Support of Gregory L. Reyes's Motion for Judgment of Acquittal, *United States v. Reyes*, CR 06-0556 at p. 28.

19. The United States' Response to the Defendant's Motion for a Judgment of Acquittal, *United States v. Reyes*, CR 06-0556 at p. 17.

20. Memorandum of Points and Authorities in Support of Gregory L. Reyes's Motion for Judgment of Acquittal, *United States v. Reyes*, CR 06-0556 at pp. 12-13.

21. *United States v. Reyes*, Transcript of Jury Trial Proceedings, July 6, 2007 (argument on Reyes's Rule 29 motion).

22. Order Denying Motion for a Judgment of Acquittal, *United States v. Reyes*, CR 06-0556, at p. 6.

23. Id. at p. 10.

24. Peter Henning, "The Reyes Sentencing," White Collar Crime Prof Blog (Aug. 8, 2007) (available at http://lawprofessors.typepad.com/whitecollarcrime_blog/2007/08/the-reyes-sente.html).