

## **AN UPSIDE-DOWN VIEW OF THE WORLD**

AUGUST 17, 2006

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The article by Peter Burrows of BusinessWeek, "Witch Hunt in the Silicone Valley" (August 15, 2006) [http://www.businessweek.com/print/technology/content/aug2006/tc20060815\\_814875.htm](http://www.businessweek.com/print/technology/content/aug2006/tc20060815_814875.htm) is a must-read for all stakeholders in corporate America. Burrows' interview with Network Appliance, Inc. CEO Dan Warmenhoven tells a story that truly turns the world upside down.

The interviewer starts by asking Warmenhoven about his overall sense of the stock option scandal. His response is, "I think it's become a witch hunt." He goes on to say that he thought the role of the SEC was to build investor confidence, and what the SEC is doing now is destroying it.

That is a very interesting perspective. I never realized that the SEC had now become a cheerleader for corporate America. Not only should it ignore illegal activities, but, apparently, it should promote them, along with pyramid schemes, rampant insider trading, and other activities that destroyed the capital markets in 1929. I am sure that SEC chairman Christopher Cox would not embrace this notion.

The interviewer continues by pointing out that in the case of backdating options at below-market price on the actual date the options were granted -- guaranteeing paper profits to the option recipient -- insiders were getting a better deal on shares than the companies' shareholders. Warmenhoven's first response is to state that "...backdating options wasn't illegal. You just had to make sure you disclosed it and properly expensed them."

He further went on to say that the law has now changed because new regulations compel companies to expense all options. Most importantly, Warmenhoven reminds us that because options vest over a four-year period, most of the guys who received these grants in 1999 and 2000 never got a chance to cash out because prices fell.

Again, the logic eludes me. I will address Warmenhoven's upside-down view of legal theory in a moment, but I would first like to turn the reader's attention to his comment that for the most part, the recipients of backdated options didn't profit. Warmenhoven conveniently drops all backdating periods other than the market peak. This scandal started in the mid 90s and continued through 2002. Furthermore he failed to remind the reader that in many cases, vesting was accelerated by the so-called options committee, so that the

options became exercisable and were sold long before the four-year vesting period was fulfilled.

Turning back to Warmenhoven's world view of legality is a real brain-twister. I assume from his statement that attempted robbery is no longer a felony. Only crooks that succeed deserve prosecution! The interviewer reminds Warmenhoven that, while backdating itself isn't illegal if fully disclosed and properly accounted for, many firms have admitted they did not properly disclose or account for backdated options. Warmenhoven's response is ingenious. He says, "This is going to sound weird, but what difference did it make (if the options expense was recorded on company's official financial records using generally accepted accounting principles, or GAAP)? It was going to be removed from the pro forma reports anyway, and that's all the investment community cared about."

Wow, he is right -- that does sound weird. To begin with, the matter that a felony has been committed seems of no importance to Warmenhoven. In fact, he even takes the argument to a new level of absurdity by telling the interviewer that it was never going to come to light. The level of disdain Warmenhoven shows for the law, his shareholders, and the investment community is shocking.

Basically, he supports the view, "feed them the information that looks and sounds good, and the fools will buy it." Yet again, Warmenhoven's world is upside down. Of course if you hide negative facts from your stakeholders you can fool them, but not forever. When the truth comes out, there is a market reaction -- and a cost. This can be evidenced by stock prices dropping significantly upon disclosure of backdating abuse.

The punishment will not end here. The IRS may not consider Warmenhoven's view that not properly expensing options is really okay. Expect the IRS to demand substantial back taxes and penalties. This will force companies to disgorge substantial cash and force more restatements.

The civil and criminal penalties for non-disclosure are also not trivial. These companies that failed to follow the law will face litigation on all fronts, as they should. The litigation will cost substantial money and resources to defend and will tarnish the reputation of many of the corporations' executives. Of course, the stakeholders, including the corporations' D&O insurers, the auditors, and shareholders, have paid, and will continue to pay the price. In the real world, unlike Warmenhoven's upside-down world, everyone pays the price for the illegal gains of a few.

The SEC was founded to eliminate such practices in order to rebuild investor confidence after a serious market crash. It looks to me like the SEC continues to operate

under its original charter, and one hopes that it, along with others, can turn the world right-side up and stop the contagion of illegality and non-transparency that has plagued our marketplace over the last decade.

If not, stakeholders will pay the price.

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