

Broadcom: Lessons from the Frenzy Over Stock Options Backdating

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The stock options backdating cases are fading into history, but, the author suggests, the tactics the government used in those cases — and the defenses that fought those tactics — will play out again as the feds turn their sights toward the causes of the economic meltdown.

A federal judge in Santa Ana, CA, recently dismissed with prejudice federal criminal fraud charges against several Broadcom Corp. executives and essentially terminated one of the last of the stock options backdating cases brought by federal prosecutors. As the dust settles on this case, there are lessons to be drawn from that one case and from the plethora of investigations the government commenced on the issue of stock options backdating.

As a whole, the investigations demonstrate the wide sweep the government will take when it tackles an issue of corporate fraud. At its peak, the government put approximately 123 companies under investigation for alleged accounting violations in the backdating and pricing of stock options given as compensation to company executives. The investigations cost companies hundreds of thousands of dollars to defend, and resulted in the firing of several high-level executives. Yet, at the end of the day, the government only brought a handful of charges from all the investiga-

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tions it opened. This is a scenario we have seen repeatedly since the fall of Enron — the government does not want to be accused of being asleep at the switch (Enron) or of failing to notice and act upon obvious clues of misconduct (Madoff). So, to try to ensure that this does not happen, the government swings too far in the other direction; it makes its investigations too broad and sweeps into its grasp many companies and individuals who should not be investigated at all. This (too) broad a sweep causes individuals and companies to endure a tremendous amount of needless stress, hardship and expense. Unfortunately, it does not appear that this tactic by the government will disappear anytime soon (in fact, this tactic has probably become engrained into the government’s playbook as a result of the recent financial meltdown and the cry for prosecutions of Wall Street bankers). The best defense to these overbroad investigations is an aggressive offense. Best practices dictate that your company engage experienced counsel to conduct a “shadow” investigation of the government’s investigation. The goal is to “get ahead” of the government’s investigation then marshal the facts and legal arguments to press the government to close the investigation of your company and turn their focus to other companies in the industry.

INDEPENDENT COUNSEL

The Broadcom case, itself, has another lesson for all executives who have had any part in the conduct under investigation. Irell & Manella (“Irell”) was hired to handle Broadcom’s internal investigation. In the course of that investigation, the law firm interviewed several people, including the former CFO, William J. Ruehle. In addition to that investigation, Irell was also litigation counsel for certain Broadcom executives, including Ruehle, in a shareholder derivative securities fraud suit and a separate securities class action filed against the executives alleging securities violations related to the options grant practices that were the subject of the company’s Irell-handled internal investigation. In the course of the latter investigation, the law firm interviewed several people, again including Ruehle. The Irell interviews with Ruehle were turned over to the government as part of its efforts on behalf of the company to cooperate

with authorities and not get the company prosecuted. Unfortunately, the statements given by Ruehle to the Irell attorneys were used by the government to secure an indictment against Ruehle. Ruehle brought a motion to suppress the statements he gave to the Irell attorneys. Ruehle asserted that the attorney-client privilege protected his conversations with Irell from disclosures to third parties without his consent. Ruehle argued that he had an expectation of confidentiality, contended he did not understand at the time of the interview with Irell that the information he provided to them could be disclosed to third parties, and maintained that he believed his statements to the Irell attorneys were protected because the attorneys were working for his employer. The government argued that Ruehle was told by the Irell attorneys that they represented the company and not him, and that the company held the privilege as to statements he made to Irell, and the company, alone, could decide to waive the privilege and turn the statements over to the government (the warnings that the government claimed the attorneys gave Ruehle are the so-called corporate Miranda warnings mandated under a United States Supreme Court case called *Upjohn*). The district court suppressed the statements, holding that Ruehle had established that he “reasonably believed that the Irell lawyers were meeting with him as his personal lawyers, not Broadcom’s lawyers.” In so holding, the district court rejected the testimony of two Irell attorneys who claimed they gave Ruehle these *Upjohn* warnings, noting that the two attorneys were unable to produce interview notes or any written records that memorialized the warnings.

On appeal, however, a panel of Ninth Circuit judges reversed, holding that under applicable federal common law, the burden of proof regarding the applicability of the attorney-client privilege rested with Ruehle, and held that Ruehle had not carried his burden in proving that his conversations with Irell were protected by an independent attorney-client privilege belonging to him. Specifically, the panel concluded that Ruehle had not demonstrated that his conversations with Irell were “made in confidence,” which the panel stated was a necessary element of proof that must be established before finding that a communication is protected by the attorney-client privilege. Notably, the panel stated that Ruehle was aware at the outset of the internal investigation that the Audit Committee had directed

Irell to disclose its investigative findings to the company's outside auditors, Ernst & Young (and thus was aware that the conversations were not privileged). Therefore, the government could use the statements Ruehle gave to Irell to prosecute Ruehle.

There are, in fact, many lessons to be drawn from this part of the Broadcom case. One, that the company should have engaged a law firm other than its "regular outside counsel" (Irell) to conduct the internal investigation. The better practice would have been to engage an objective outside firm with no connection to the company to do the internal investigation and deal with the government inquiry, while Irell could have represented the company in the civil suits. Another, that the company and the law firm should have been more cognizant of possible conflicts. It was only after Irell interviewed Ruehle that they obtained separate counsel for him. Counsel and the company need to be aware that the circumstances may dictate that employees be furnished with separate counsel at the outset to represent them in the civil litigation and parallel internal investigation. The case also points to the need for counsel conducting the internal investigation to clearly document and memorialize the fact that employees were given the Upjohn warning so the employee being interviewed has no mistake about the role of loyalties of the attorney conducting the interview. And another, that the employee or officer who is asked to be interviewed by corporate counsel in conjunction with an internal investigation should strongly consider getting separate counsel immediately to safeguard his or her interests.

POWER OF THE PROSECUTORS

Importantly, a lesson from the Broadcom case is that it exemplifies the almost unfettered power of the prosecutors and agents and how such power can be abused without a strong-willed judge who is willing to scrutinize the government's conduct. The Broadcom case involved charges against three former executives. In addition to Ruehle, the government indicted the company's former chairman, Henry Samueli, and the former chief executive, Henry Nicholas. Early in the case, Samueli entered a guilty plea to one count of falsely testifying before the S.E.C. about the backdating,

while Nicholas and Ruehle chose to fight the charges.

Ruehle was tried first. His attorneys wanted to call two former executives as witnesses for the defense: Samueli and Broadcom's former general counsel, David Dull. He wanted them to testify that they were not aware of any problems in the options grants. Both memoranda indicated that they would plead the Fifth Amendment privilege and would not testify unless the government granted them immunity, which the prosecutors refused to do. The defense appealed to the judge to grant the immunity. Typically, a judge will not grant immunity unless the government raises no objection. Here, however, the judge took the rare step of granting immunity for the defense, citing his powers to do so under federal law if it appears the government is trying to hide relevant evidence from the jury.

Knowing that the defendants were immunized and would now testify for the defense, the government made a serious tactical and ethical mistake. One of the federal prosecutors contacted Dull's lawyers and told them that, if their client gave the same testimony as he did before the S.E.C. in its civil case (favorably to the defense), he would be committing perjury — a not-so-subtle threat to prosecute him. According to Dull's lawyers, the prosecutor then said that if Dull would testify that he had lost faith in Ruehle's integrity, the government would go "soft" on their cross-examination of him. This same prosecutor later admitted he leaked information to the news media about Samueli's lack of cooperation in the investigation, which was a serious breach of the federal law mandating grand jury secrecy.

The second witness to testify for the defense was Samueli, who had previously pled guilty before the same judge hearing the trial. He — like Dull — essentially bolstered the defense's case by testifying that he did not think the stock option grants were improper. At the conclusion of his testimony, the judge dismissed the charge against him, finding that, while he might not have been completely forthcoming to the S.E.C., he did not lie, and, therefore, committed no crime.

At the end of the trial, the defense made a motion to throw out the case by asking the judge to enter a judgment of acquittal because of insufficient evidence of intent and prosecutorial misconduct. The judge granted the motion, finding both insufficient evidence to convict and that the prosecutor

had committed misconduct. The Judge concluded that, given these conclusions, submitting the case to a jury would make a mockery of justice.

THE FUTURE

Rarely do judges dismiss indictments, and even more rarely do they grant a defense request to immunize witnesses over the government's protest — this case is a rare victory for the defense. In this case, we see how a client is well served by hiring an experienced specialist in white collar defense who knows the federal system inside and out (all defense attorneys in the case but one were former federal prosecutors), and who can effectively probe the weaknesses in the government's case and doggedly pursue any evidence of misconduct by the government.

The stock options backdating cases are, for the most part, fading into history. However, you can bet that those government tactics — and the defenses needed to combat those tactics — will play out again as the feds turn their gunsights toward the causes of the economic meltdown.