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## These Stock Options Just Didn't Add Up

**T**OP executives on the receiving end of munificent pay packages like to argue that their troughs full of stock options have no relationship to the improprieties that keep erupting across corporate America.

But an episode last week involving [Brocade Communications](#), a San Jose, Calif., company that makes switches for computer storage networks, suggests that every now and again there just might be a connection after all.

Back in the bubble of 2000, you may recall, Brocade Communications was one heck of a stock. The shares went public in May 1999 at a split-adjusted \$4.75. By October 2000, the stock had climbed to \$133. It closed on Friday at \$5.99.

Last Monday, after the stock market closed, Brocade announced that its board had appointed a new chief executive to replace Gregory L. Reyes, its longtime chief; that it would be restating its results for the last six fiscal years; and that its annual financial report would not be filed on time to the Securities and Exchange Commission.

Other than that, the company said, everything's going great.

Financial restatements are distressingly common, of course. But Brocade certainly wins a prize for having to recompute its results for every one of the six years that it has existed as a public company.

The amounts being restated are considerable. In fiscal 2004, for example, Brocade's net loss swelled to \$32 million from \$2 million as a result of the restatement. For 2003, its loss grew to \$147 million from \$136 million, and in 2002, its net income rose to \$126 million from \$60 million as a result of the new computations.

The restatements, the company said, all had to do with errors in its option accounting. After a review, the audit committee of Brocade's board concluded that the company must record additional compensation charges relating to option grants from 1999 through the third quarter of 2003. What's more, the

committee found "improprieties in connection with the documentation" of option grants given to a small number of employees before mid-2002 and concluded that the company's documentation related to certain option grants before August 2003 was unreliable.

Exactly what went wrong with Brocade's options program is not clear; the company is not saying.

An analysis last April by Glass Lewis & Company, an institutional advisory firm, found that Brocade had used unrealistic assumptions in calculating its option expense in its financial footnotes. The assumptions, related to the average life of its options and the underlying volatility in Brocade's stock, wound up understating the true costs of the grants, Glass Lewis said.

Options have been the drug of choice for years at Brocade, as they have been at many Silicon Valley businesses. These companies have fought strenuously against the move last year by accounting rulemakers to require that the costs of this employee compensation be run through the profit-and-loss statement. Along with other companies, Brocade signed a letter to members of Congress in July 2003 that argued against the expensing of options.

As is also typical at technology companies, Brocade's top management, especially Mr. Reyes, have been big recipients of options. In last year's proxy, Brocade noted that 4 percent of the total number of options granted to its employees in fiscal 2003 went to Mr. Reyes.

Brocade's directors also receive stock options as part of their compensation: 80,000 options when they join the board and 20,000 options for each year they remain as members. They also receive annual cash compensation of at least \$25,000.

Under a new plan, which Brocade put to a shareholder vote last year, the company proposed a system by which a committee of the board would be free to determine how many options to dispense to directors, when to dispense them, their vesting provisions and terms. "An inflexible compensation structure limits our ability to attract and retain qualified directors," the company noted in its proxy last year. "The board of directors believes that the amended and restated 1999 Director Option Plan is necessary so that we can continue to provide meaningful, long-term equity-based incentives to present and future non-employee directors."

Shareholders shouted down the plan. Fully two thirds of the shares that were voted rejected it.

Many analysts who follow Brocade have concluded that Mr. Reyes's hasty departure was clearly related to the accounting improprieties. But in a conference call on Monday afternoon, David L. House, a Brocade director who is a former chief executive of Allegro Networks and a former president of [Nortel Networks](#), refused to link the two events. Indeed, he told surprised listeners that even though Mr. Reyes would no longer run the company, he would stay on the board and have "a significant and important role" there.

Mr. Reyes has been the body and soul of Brocade practically since the company was born. He became its chief executive in July 1998, before the company went public. He became chairman in May 2001.

But why would Mr. Reyes still have a coveted place on Brocade's board, given the wall-to-wall restatements that occurred on his watch? Leslie Davis, a spokeswoman for the company, wrote in an e-mail message: "Greg has been a key contributor to the success of the company and will still add great value. Greg will advise on strategic and customer issues where he can continue to contribute to the success of Brocade." Ms. Davis declined to make any of the company's directors available.

At the end of Brocade's last fiscal year, Mr. Reyes had 1.7 million options with exercise prices of either \$5.53 or \$6.54 each. Ms. Davis said Brocade had not determined whether those options would become immediately exercisable now that Mr. Reyes has, to use the company's expression, passed the baton.

Will the company also continue to reimburse Mr. Reyes for the use of his private plane, as it did when he was chief executive? For fiscal 2002 and 2003, he received \$624,000 in such reimbursements. Not determined yet, Ms. Davis said.

Brocade gets some credit for identifying the stock option improprieties. And it has instituted more restrictive policies in its option program recently. But its insistence on keeping Mr. Reyes shows how entrenched the obeisance to chief executives remains at some companies, even among directors who have a fiduciary duty to mind the store.

Obviously, shareholders interested in reforming corporate America have a good deal more work to do.