

Decoding the Stock Option Backdating Scandal

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Recently, public company practices involving the issuance and, particularly, the dating of stock options, have been called into question. The intense level of scrutiny, and the serious irregularities that have been exposed, suggest that this issue has risen to the level of a full-fledged “corporate scandal.” Consider the following:

- * More than 60 public companies have announced internal probes into their stock option practices.¹
- * The Securities and Exchange Commission reportedly is investigating 51 of these companies, while the Department of Justice, wielding criminal process and penalties, is looking into the activities of 41 companies.
- * Nearly 80 class action or shareholder suits have been initiated against some 30 companies in response to options backdating.²
- * Approximately 20 companies have indicated that they are likely to restate financial statements as a result of options backdating.
- * Thus far, at least 13 executives and directors, including three chief executives and two in-house counsels, have resigned or been ousted after questions arose about manipulation of dates of option grants.
- * Just recently, on July 3, 2006, one company announced that three of its directors have received Wells notices from the SEC advising that the agency is considering enforcement action based on issues involving backdating of options.³

¹ A regularly updated overview of public company disclosures related to stock options backdating matters can be found at: *Options Scorecard*, *The Wall Street Journal*, <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html>.

² *Id.* See also The Stanford Law School Securities Class Action Clearinghouse website, <http://securities.stanford.edu>.

³ Mercury Interactive Corporation, <http://www.mercury.com/us/company/pr/press-releases/070306-ir-a.html>

- * On June 29th, shares of Apple Computer, Inc. fell more than 3% in after-hours trading after it became one of the largest companies to announce irregularities regarding the issuance of stock options.
- * SEC Chairman Christopher Cox recently stated that the SEC is revisiting the pending executive compensation rule to include a provision on the issue of backdating options.⁴

The issue surrounding industry-wide irregularities in the stock option arena was brought to light by a March 18 *Wall Street Journal* article which reported that an analysis of public company stock option grants revealed that, in an inordinate number of instances, the grant dates corresponded to a company's lowest trading price. The probability of this finding was so remote, that it strongly suggested that grant dates had been manipulated.

This article attempts to "decode" certain of the backdating issues raised by looking at the types of abuses that have become relevant and their potential consequences. We also address best practices in issuing stock options in the current environment.

Overview of Stock Options

Companies use stock options as a tool to tie the compensation of officers and other employees to performance. Generally, the compensation committee of the board of directors, or the committee's designee (typically the CEO), approves individual option grants.

The standard practice is to grant stock employee options "at the money." This means that the option's exercise price matches the contemporaneous price of the underlying stock at the time of the grant. This practice, typically, is set forth in the stock option plan which governs the stock option process. Accordingly, the "upside" to be expected from the option stems from, at least theoretically, increases in the company's stock price over time and not any inherent value "hard-wired" into the option on the grant date.

⁴ Speech by SEC Chairman to the New York Financial Writers Association (June 8, 2006). <http://sec.gov/news/speech/2006/spch060806cc.htm>. "while I can't comment on the SEC's ongoing investigations of specific companies, I can tell you what the Commission's position is. Back-dating must be fully disclosed. And the granting of back-dated options must be properly accounted for."

Types of Abuses

Backdating

“Backdating” can be accomplished in a variety of ways, but each of them results in the setting of a grant date that precedes the actual date of the corporate action that effected the grant. This is done in order to achieve a lower exercise price and hence a higher value to the recipient. Backdating results in an option already being “in the money” at the time of the grant.

The internal reviews and federal investigations have revealed a number of backdating practices. Some of the manipulative practices that have been exposed include: the use of a grant date that precedes the date of the compensation committee meeting at which the option grants were awarded (or a date that precedes the grant date by the committee’s designee); alterations to corporate records to change the date of the option grant; and the use of an “effective as of” or “look back” grant date.

But what is the “actual” date of the grant? Although each case will differ based on the facts presented, the following may be instructive:

- * Determine who has authority to make the grants. Review the stock option plan to determine the appropriate committee or group to administer the plan and to make grants under it. Next, review the compensation committee charter to determine what, if any, limits have been placed on granting stock options. Then, look at the relevant board resolutions to see if they were properly adopted and whether any additional restrictions were placed on option granting.
- * Determine if there are any restrictions on the grant date selected. Many stock option plans provide that grants are to be made on the date selected by the administrator. Others may be more restrictive and may, for instance, require new grants to be made on the start date, while annual re-grants are to be made each year in a month specified. In addition, take a look at the company’s public disclosures to see if it discloses any company policies surrounding the granting of stock options.
- * Determine the date that the plan administrator actually acted to approve the grant. Determining precisely when a group takes action can be difficult and is often imprecise. However, this determination may turn on the manner in which the authorization is effected and the intent of the group. In other words, when a board or committee acts at a meeting, it will typically call for a formal discussion and vote. Absent instructions or a policy to the contrary, such a group

may well intend that the vote or decision become operative that day - whether or not the secretary of the meeting then documents the action "in real time."

Actions by unanimous written consent, however, typically cannot become effective until the last director signs and returns the consent. In this case, each director maintains, in essence, a veto right over the proposed action. Unanimous written consents "as of" a particular date have proven particularly problematic in a number of recent stock option dating investigations.

Spring-dating or Spring-loading

"Spring-dating" or, sometimes, "spring-loading," occurs when a corporation selects a date after the actual date that an award determination was made in order to acknowledge that the option was effective. In these cases, the exercise price is said to spring into existence when the lowest price over the pre-determined period is achieved. In many cases, a policy of spring-dating will require that the strike price be set at the actual grant date in the event that the underlying stock price only increases over that period. Consequently, this practice ensures at the money or better.

Potential Adverse Consequences

Financial Statement Impact

Under APB 25, the method of accounting for stock option grants used by most companies until recently,⁵ a compensation expense need not be recorded if a stock option maintained no "intrinsic value" – or, phrased differently, it was granted with an exercise price at least equal to the fair market value of the underlying shares on the date of grant. However, because a backdated option grant results in the award of an "in the money" option, a compensation expense should be recorded equal to the difference between the exercise price and the fair market value at the date of the grant. The date of grant under APB No. 25 is the date that both the number of shares under the option and the exercise price are fixed.

The backdating of options results in the understatement of expenses and, consequently, the overstatement of performance. If material, the practice could require a company to restate its financial statements to reflect the existence of additional compensation expense. Moreover, because compensation expense is recorded over the vesting period of the option, a single occurrence of improper

⁵ Currently, under FAS No. 123R, companies are required to expense the grant date fair value of stock options over the employee's vesting period.

dating could result in the restatement of multiple years of financial statements. As noted by the SEC in *SEC Staff Accounting Bulletin No. 99 - Materiality*, misstatements that result in increasing executive compensation or conceal illegal transactions “may render material a quantitatively small misstatement of a financial item.”

Under certain circumstances, spring-dating of options could lead to variable accounting because the intrinsic value of the option may not be determinable until some point after the actual grant date. If applicable, variable accounting would require that compensation expense be estimated using the options intrinsic value at each balance sheet date after the grant date but before the measurement date.

False or Misleading Disclosures

It also should be noted that backdating (or the variation of spring-dating) is not *per se* illegal or improper. However, these practices do raise serious disclosure issues – even in those situations where they may not present an accounting issue. In particular, the company’s annual report and proxy statement, containing many of the disclosures surrounding the stock option plan, may be misleading for failing to specify that option grants were or could be backdated.

The company’s filings also could be deemed fraudulent for failing to disclose conflicts of interest involving executive management arising from the practice of backdating. Additionally, if these filings represent that executive stock options were granted in accordance with the stock option plan, i.e., at the fair market value of the underlying stock on the date of the grant, when, in fact, they were granted “in the money,” the disclosure could be considered false or misleading.

Sarbanes-Oxley Certifications

SEC rules promulgated under SOX Section 302 require CEO’s and CFO’s of public companies to certify, among other things, that they have reviewed their company’s quarterly and annual reports and that, to the best of their knowledge: (1) the financial statements and information is materially accurate, (2) disclosure controls and procedures are effective and (3) they have disclosed to the company’s auditors and audit committee any control deficiencies.

Options backdating and other manipulations, if committed with the knowledge of the certifying officer, could subject the officer to SEC enforcement action or DOJ criminal prosecution for false certification. Further, although not explicit under SOX, a false certification could subject the officer to liability in private securities civil litigation. Enforcement and civil liability could attach even if the officer was not the recipient or did not otherwise personally benefit from the backdated grant.

False or Misleading Section 16 Reports

Section 16(a) of the Securities Exchange Act of 1934 requires executive officers and directors of public companies to report their transactions in the underlying company's securities, including receipt of stock options, on forms filed with the SEC. Reporting the wrong grant date could be considered false and a violation of the beneficial ownership reporting provisions of the federal securities laws.

Questions Concerning Effectiveness of Internal Controls

Improprieties in connection with stock option grant practices could reflect material weaknesses in internal controls. This consideration is relevant to the company's audit, and could impact the company's Section 404 internal control assessment and certifications under SOX.

Class Action or Shareholder Suits

Public companies face the possibility of shareholder lawsuits alleging violations of Sections 10(b) and 20 of the Securities Exchange Act of 1934, and Exchange Act Rule 10b-5, as well as derivative actions asserting breaches of fiduciary duty.

The lawsuits filed to date against companies implicated in the option backdating investigations allege that the companies violated the aforementioned provisions of the federal securities laws by making false statements to the public and filing fraudulent financial statements with the SEC. They also have alleged insider trading by the executives who profited from the backdated options. Derivative actions attack the failure of the board to implement stock option plans properly and to account fairly for such grants in the company's financial statements.

Income Tax Issues

If an entity is found to have inappropriately managed its option dating practices, it may become liable for past due taxes, interest and other penalties. Specifically, the tax benefits expected from employee stock option exercises may be lost and a company may face problems with IRC Section 162(m), which limits the deduction for certain executive compensation to \$1,000,000.

Stock Price Decline and Reputational Damage

Disclosure that an issuer is considering the possibility of a backdating problem may subject it to significant stock price decline and reputational damage – even if it is ultimately vindicated in its practices. Whether or not wrongdoing is found, management's attention will be diverted, costs will be incurred, and employee distraction will arise. Given these circumstances, markets will typically react.

If an inappropriate practice is discovered, the company may be subjected to informal or formal SEC investigations, shareholder lawsuits and other problems. If the practice was intentional, the quality of management and the stability of its governance standards will surely be questioned and, under certain circumstances, boards can be expected to take disciplinary action including discharge of senior executive officers who knew of or facilitated the practices.

Regulatory and Law Enforcement Action

The SEC has civil and administrative enforcement powers to enforce the federal securities laws, including violations attributable to the manipulation of options dates. Remedies, or sanctions available to the SEC in enforcement proceedings include: civil injunctions and cease-and-desist orders; money penalties; disgorgement of unlawful profits; officer and director bars; industry bars and orders prohibiting accountants and attorneys from practicing before the SEC.

The Department of Justice has the authority to criminally prosecute violations of the federal securities laws. Criminal actions can result in incarceration, fines, and restitution.

Suggested “Best Practices”

A Review of the Past

We suggest that all companies have a discussion with counsel to determine if a review of their historical option-dating practices is merited. Thereafter, the preliminary findings should generally be communicated to the Audit Committee. They may determine that a more thorough investigation is appropriate.

To the extent it is, we suggest that consideration be given to retaining independent counsel who has experience in conducting sensitive investigations of this nature. This counsel should be prepared to review related documentation, interview relevant persons, assess the propriety of current and historical option granting policies, and present their findings to the Audit Committee and, if necessary, the Board of Directors. In addition, counsel should assess whether self-reporting to the SEC is appropriate, financial restatements must be made or notice should be made to the company’s D&O insurance carriers.

In the end, each management team will be assessed against the same yard-stick – whether it is unaware of any potentially inappropriate grants or whether it is aware of facts that suggest backdating was prevalent – did it act reasonably under the circumstances.

Looking Forward

Although no set of practices fits every company, we have set forth below a list of practices that issuers interested in improving their stock option granting policies may wish to discuss with their counsel:

1. Establish Written Policies. Like other critical corporate policies, policies governing stock option grants should be in writing. Further, these policies should be reviewed not less than annually to ensure that they are up-to-date. At each annual review, the person or group in charge of the company's public disclosures should also concurrently review all statements concerning the company's option dating policies to ensure that they dovetail with any policy changes.

2. Training. Personnel involved in the granting of stock options, including in-house counsel, H.R. and accounting should know and be intimately familiar with the company's option dating policies. At a minimum, companies should provide mandatory training for all new hires involved anywhere in the stock option granting process. If necessary, companies may wish to improve the experience level of mission critical persons.

3. Improve Your Document Controls. Issuers should take steps to ensure that all stock option grants are properly documented when and as they occur. Minutes should be inserted in the minute books, consents should be timely signed and returned and waivers of notices executed. In some cases, issuers may wish to eliminate the use of written consents altogether in their option granting policies. To the extent that a unanimous written consent is used, care should be taken to ensure that the grant is not deemed effective prior to actual authorization.

4. Consider Granting Annual Grants at Date/Time Certain. Companies may wish to grant annual or "reload" grants to employees on a particular date or after a particular event (such as during the open window period following the reporting of annual results). In this manner, there is less opportunity for abuse or the appearance of impropriety.

5. Routinize New Hire Grants. Routine new-hire grants, especially for non-executive officers, may be benefited by establishing a process by which all such grants are made on a particular day of each week, month or quarter. Generally, when this process is followed, boards and compensation committees will provide authority to grant stock options up to, but not exceeding, a specified number of shares. To ensure that the grant is actually effectuated on that date, companies may wish to authorize multiple executives (which, under the circumstances may need to be

employee-directors) to execute the necessary documentation. In this manner, companies are more likely to have the necessary signatures when required.

6. Consider Establishing a Series of “Hard Stops”. The following situations should necessarily trigger a hard stop and further review by more senior management and/or the appropriate committee of the board of directors:

- any grant date that precedes that particular employee’s start date;
- any grant by an authorized executive beyond stated approval limits by the board of directors;
- the implementation of a spring-dating policy;
- any attempt at ratification by a committee to affirm or “cleanse” a questionable grant;
- the replacement of one stock option for another, including the modification of option documentation after it has been reflected as “final” by an authorized preparer; and
- granting of options to coincide with the publication of significant corporate news or the publishing of performance information.

7. Consider Implementing a Disclosure Committee. Many companies have formed multi-disciplinary disclosure committees comprised of personnel from accounting, legal, IR, finance and internal audit. These committees may prove useful in establishing tighter disclosure controls and related policies.