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Management Alert

Options Backdating: Is Your Company at Risk?

Over the last four months, the media and law enforcement agencies have focused a harsh spotlight on public companies' alleged "backdating" of stock options and other purported manipulations. More than 60 companies have announced investigations into their option timing practices by the Securities and Exchange Commission (SEC), the Department of Justice (DOJ) or the Internal Revenue Service (IRS). Many companies have also formed their own special committees to conduct internal investigations of their corporate option practices. In addition, companies face the specter of multiple civil actions based on alleged breaches of fiduciary duty and misstatements to the investing public. A recently released analytical study, conducted by Professor Randall A. Heron of the Kelley School of Business of Indiana University and Professor Erik Lie of the Henry B. Tippie College of Business at the University of Iowa, concluded that more than 2,000 public companies may have manipulated or backdated options at some point over the past 10 years.

In light of these developments, this Alert provides information on issues relating to the timing of option grants, possible pitfalls a company may encounter and some proactive ways in which companies can address or avoid such pitfalls.

Background on the Option Timing Controversy

When a company grants stock options to its executives and others, it grants the right to buy stock at a fixed price - commonly known as the "strike" or "exercise" price. This "grant" is conferred on a specific date, with the strike price fixed as of that date. The optionholder calculates her financial gain by subtracting the strike price from the fair market value of the stock at the time she exercises the option, which could be several years later, to purchase shares of the company's stock. For tax, accounting, and shareholder relations purposes, most companies generally set the strike price of their options at the fair market value of their shares as of the date of the grant.

A number of companies, however, may not have conferred stock options in such a manner. Some companies allegedly "backdated" options and engaged in other option timing practices. "Backdating" occurs when a company sets a retroactive strike price to a date earlier than the date of the grant. If the stock price on the actual grant date exceeds the retroactive strike price, then the executive receiving the option enjoys an instant paper profit built into the option that would not have existed on the original grant date. Other suspected option timing devices include "spring-loading" a grant by

setting the strike price for an option just before an announcement of news likely to cause an upswing in the stock price, or "bullet-dodging" by granting an option just after an announcement that causes the stock price to drop. Less egregious forms of alleged option timing include: failing to provide formal approval for a grant until after the specified grant date and after the stock price has risen; using an "effective as of" grant date for options approved by written consent as of the date the corporate resolution is prepared, rather than the date that all directors have signed the resolution; and pricing option grants as of the date of an offer letter for a new hire rather than the first day of employment.

Potential Risks From Backdating and Other Option Timing Irregularities

A company and its officers and directors may confront the following risks as a result of increased scrutiny of stock options grants:

• **Possible investigation by the SEC, DOJ or IRS.** Given the sheer volume of companies that have disclosed SEC, DOJ or IRS investigations of their respective stock option grants, other companies are likely to receive similar inquiries into their options practices. Not only must companies endure the high cost and distraction of such investigations, but the SEC also has the power, if the SEC uncovers improprieties, to seek civil and administrative remedies. In addition, to the extent the DOJ believes any activity is particularly egregious, it may seek criminal charges against companies or officers and directors.

• **Restatement of financial statements.** As a result of an investigation by a governmental regulator or an internal investigation instigated by the board of directors, a company may be required to restate its publicly filed financial statements to reflect unreported or under-reported compensation expense and to adjust retained earnings. Under accounting guidelines, misstatements that increase management compensation may be material, even though they involve a quantitatively small amount of compensation. Furthermore, manipulation of option grant dates can force a company to restate its financials using "variable plan" accounting for prior periods.

• **Possible class action and shareholder derivative lawsuits.** The option timing controversy has caught the attention of plaintiff class action lawyers. Companies already face an increasing number of lawsuits that assert claims against officers and directors for federal and state securities violations, breach of fiduciary duty and corporate waste based on failure to adhere to appropriate controls and governance practices, or financial reporting and other disclosure requirements

• **Possible ERISA class action lawsuits.** Although the Employee Retirement Income Security Act (ERISA) technically does not govern equity compensation plans, however, plaintiff class action lawyers are bringing class action lawsuits alleging that the manipulation of option grant dates violates various fiduciary duties of the company's officers and directors in connection with a company's 401(k) plan and/or violates ERISA plan documents. Apparently, some plaintiff class action lawyers seek to avoid the administrative procedures under the Sarbanes-Oxley Act by asserting ERISA claims directly against a company.

• **Adverse market implications.** Option timing problems may result in negative market implications for the company, including stock price decline, adverse analyst coverage, downgrades or other rating adjustments by Moody's and S&P.

• **Internal controls and corporate governance issues.** A company's practice of option manipulation may indicate inadequacies in a company's internal controls and possible inaccuracies in its management certifications. Option timing problems also may raise questions about other corporate governance practices in need of reform.

• **Tax implications.** The company and the optionholder run the risk of potentially adverse tax consequences if the IRS determines that a company granted options at a strike price

lower than fair market value, including:

- Options intended as incentive stock options would not qualify, causing the optionholder to recognize ordinary income instead of capital gain;
- Options may be treated as a form of deferred compensation, resulting in premature taxation and a 20% penalty tax on the optionholder; and
- The company may lose its deduction for income recognized by proxy-named officers on the exercise of an option to the extent that an officer's total compensation for the year exceeds $1,000,000.

As a result, option strike price backdating may force companies to correct their tax returns and potentially pay past due withholding and other taxes, interest and penalties.

• **Violation of stock exchange listing requirements.** The use of discounted stock option exercise prices could be treated as a material plan amendment that has not been approved by company shareholders as required by stock exchange rules.

• **D&O insurance coverage.** The option timing scandal could lead to higher directors' and officers' insurance premiums. If a company is alleged to have manipulated option grant dates at or around the time it obtained its insurance coverage, its insurer may seek to rescind coverage for misstatements in application or renewal questionnaires.

• **Invalid options.** Most equity compensation plans require companies to issue options at fair market value. Shareholders and 401(k) plan participants could challenge improper grants as ultra vires transactions with the result that courts may find the options void. Similarly, potentially defective share registration on a Form S-8 could provide employees with a claim for rescission of the option and a return of their exercise consideration should the company's stock price fall after exercise of the options.

Proactive Measures To Reduce Risk

Companies should consider taking the following steps to reduce any possible risks from option timing problems:

Companies should thoroughly review their own stock option practices, consult counsel and refer any suspicious practices to their audit committees for further investigation. Such a review should include a statistical review of stock prices and grant prices, as well as an assessment of Form 4 and other SEC filings, and the documentation process.

If such a review raises red flags regarding option timing, the audit committee should consider whether it is prudent to create a special committee of the board of directors comprised of outside directors with the assistance of separate outside counsel to conduct an independent review of these practices.

Companies should educate their boards of directors and management about the problems associated with stock option timing in an effort to prevent future problems. In addition, companies should consider implementing written formal option granting policies, as well as predetermined schedules for option grants.

Seyfarth Shaws's Options Timing Task Force.

Seyfarth Shaw has formed a task force to assist clients in addressing all options dating issues that may arise. The task force includes members of the firm's Securities and Financial Litigation, Corporate and Finance, ERISA and Employee Benefits Litigation Practice Group, and Employee Benefits and Executive Compensation practice groups. Our team has extensive experience in representing companies and their officers and directors in almost every aspect of the employment relationship, including executive compensation and option grant issues, SEC reporting and other disclosure issues, corporate governance, securities law advice and

ERISA counseling and litigation. Members of this team also have experience in representing audit and special committees and in defending companies, their outside auditors, and their directors and officers in all aspects of securities litigation, SEC, DOJ or IRS investigations and other shareholder litigation and enforcement matters.

To receive more information regarding any stock option dating issue, please contact your regular Seyfarth Shaw attorney, or any member of our Options Timing Task Force listed below:

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