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# Option Backdating

## *Practical Advice for Dealing with Civil and Regulatory Enforcement Issues*

**By Gidon M. Caine**

This is not an easy time to be in the general counsel's office of a public company. The investigations into stock options backdating tend to reach into various parts of the organization, often simultaneously. Some practical rules of the road are in order, to allow the general counsel's office to spot and address the relevant issues in an appropriate, cost-effective manner.

### Background

On Aug.11, the SEC released the final text of new rules for the disclosure of executive and director compensation. A few days later, an SEC Commissioner, discussing backdated options, cautioned that "if the facts permit … it wouldn't surprise me to see charges brought against outside directors."

The federal government has indicted executives of Comverse Technology, Inc., alleging in part that the company issued options "as of" a date when the stock price was depressed, and has indicted two executives of Brocade Communications Systems, Inc. for allegedly backdating offer letters, among other documents. The SEC has sued these two Brocade executives, as well as the former CFO, whom the Commission alleges knew of the practice, but failed to "investigate or review the impact of backdated or falsified options grants on Brocade's financial statements, nor inform the Audit Committee of what he had learned."

But not all the news is bad. SEC Commissioner Atkins recently stressed that the enforcement staff is "taking all measures to differentiate between [falsifying documents] and dating issues arising from ministerial, logistical delays." One possible way to help with this differentiation is to review past and current option grant practices now. If there are questionable options practices, the board should consider what action to take, which in some instances may include director-supervised investigations. Importantly, the potential consequences of such actions should be carefully considered as well.

### Potential Ramifications

Option backdating is generally not illegal, but the failure to disclose or account for backdated options properly can have significant implications. Knowledge and intent will be key in distinguishing between technical errors and more serious issues. Merely technical issues should not, in many instances, be treated as a crisis mandating special committee investigations, up-the-ladder reporting and disclosure or similar extraordinary actions.

These are some of the possible implications of option granting errors or irregularities:

- ***SEC, Department of Justice, and IRS Investigations***. More than 80 companies are the subject of investigations by federal or state agencies, each with its own rules or protocols.
- ***Restatements***. Under APB 25 (which has been superseded by FAS 123R), backdated options may be discounted options, requiring a company to restate its financials and record a compensation expense. This may lead to a finding of a material weakness in internal controls, as well as possible forfeitures of option profits under § 304 of Sarbanes-Oxley (SOX).
- ***Tax Implications***. Discounted stock options may result in significant tax issues. They are not exempt from the $1 million cap on certain executive pay, and all or part of the spread when the option is exercised may not be deductible. Discounted options will not be exempt from new legislation governing "nonqualified deferred" compensation. This may require amending the options before Jan. 1, 2007. Discounted options cannot qualify for favorable tax treatment provided for incentive stock options.
- ***Potential Civil Liability***. Improper accounting for options, improper disclosure, and restatements, could lead to claims under federal and state law. It could lead to allegations that the company or key individuals violated the financial reporting, books and records, internal controls, proxy solicitation, anti-fraud, and transaction reporting provisions of the federal securities laws. There may be criminal liability for conspiracy, and mail or wire fraud. At the state level, disclosures may spawn derivative suits, alleging that officers and directors breached fiduciary duties to the corporation.

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- ***Inquiries from Institutional and Others***. Institutional shareholders and shareholder groups have inquired about stock option grant procedures. Some have promised to post company responses on their Web sites.
- ***Auditor Reviews***. Auditors have asked companies to represent that they do not have backdated options during the years covered by audit reports, and have sought documentary evidence covering substantial periods. This has caused some companies to delay the filing of periodic reports to review their option grant practices.
- ***SEC Filing Delays; Possible Delisting***. Companies that cannot file their periodic reports on time must file a Rule 12b-25 notification, and those that restate financial statements may be required to file an 8-K as to non-reliance on historical financial statements. The NASD and NYSE have notified late filers that they face delisting.
- ***SEC Reporting/Disclosure Issues***. Whether and when to disclose backdating investigations raise important disclosure issues. New SEC rules also change how companies disclose executive compensation, and require a new compensation discussion and analysis, which explains grant methods and timing, including whether options were granted to executives before the issuance of material information. That analysis will be subject to the certification requirements under Sarbanes-Oxley.
- ***Corporate Governance Issues***. Irregularities regarding stock option grant practices may give rise to a finding of deficiencies in a company's corporate governance functions, internal controls, and audit functions. In addition to possibly giving rise to claims that directors failed in their oversight responsibility, material non-compliance with the option plan could lead to invalidation of option grants, violation of Securities Act registration requirements, or violations of stock exchange rules.

## Recommended Stock Option Grant Practices

In view of these potential ramifications, companies need to administer stock option plans carefully. They should consider adopting very specific procedures, including where appropriate, some of the ones detailed below. This list is intended to be a list of "best practices" and not necessarily required by law.

- ***Regular Grant Cycle***. Option grants should normally be made on a regular grant cycle, with exceptions made for those new hires receiving individualized option grants. Companies ought to batch authorize new hire option grants with regularly scheduled grants to avoid the appearance of special treatment. Vesting credit can be given from the date of hire if not inconsistent with the plan.
- ***Release of Material Information Before Granting Options***. As a legal matter, "spring-loading" (when options are granted in advance of the release of positive news) is not illegal if the grantor of the options has access to the same material facts as the optionee at the time of the grant. But in today's highly charged corporate governance environment, companies should consider whether to grant stock options only after all material information has been publicly disseminated. Granting options during normal trading windows might be considered.
- ***Recordkeeping***. Grants should comply with option plan's terms, which in almost all instances require that options be granted at no less than "fair market value" on the "date of grant". The resolutions authorizing the grant should explicitly set the option exercise price exactly as the plan provides. The same pricing formula should be used consistently for all related purposes.
- ***No Altering the Specified List of Optionees***. Additional optionees or grants should *not* be added to the board or compensation committee schedule listing the names of optionees and the number of shares subject to the grant. Otherwise, the additional grant could be deemed to have been made at a price less than fair market value.
- ***Eliminate or Closely Monitor Officer or Single Director Grants***. Companies should specifically evaluate the extent, if any, to which option granting authority should be delegated by the compensation committee or board to executives. Companies generally should not delegate authority to the companies' most senior executives, but should delegate option granting authority (within director-approved parameters) for lower-level employees.
- ***Authorize Options at Meetings***. Authorizing grants at board or committee meetings may help establish that the grants were made on an informed and deliberate basis, satisfying the enhanced disclosure requirements contemplated by the new SEC rules. Companies should note that under state law, unanimous consents may not be effective until the last director has signed and other procedural requirements (such as filing the consent with the Board or committee minutes) have been satisfied.
- ***Grant Notification***. Companies should promptly communicate option grants to the optionee, to avoid any potential tax or accounting consequences that might arise from late notification.
- ***Review Internal Controls***. Compensation committees should exercise general oversight, and public companies should review and test their procedures and controls. As noted above, auditors may require such a review.
- ***Review Other Equity Based Compensation Awards***. Because of the accounting and tax implications, similar issues may arise for restricted stock or other equity-based forms of compensation where the timing of the grant is tied to its value.

## Conclusion

Each company needs to consider its own unique circumstances in determining what strategies or actions to implement, but given the current environment, companies should review their option grant programs with these nine considerations in mind. General counsel and their staff should be proactive, so that they can begin to address the issues in a comprehensive and thoughtful manner.

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