Options Dating Issues

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As widespread news coverage continues, dozens of companies have now been targeted in Securities and Exchange Commission, Justice Department and Internal Revenue Service investigations concerning unusual correlations between options grant dates and low points in company stock prices. Derivative and shareholder class action lawsuits have already begun to flood the courts. SEC Chairman Cox has announced that the SEC is considering further regulatory changes to address the dating of options.

I. WHAT IS THE ISSUE?

Academics and market analysts have reported that at numerous public companies there is a statistically significant correlation between executive stock option award dates and low points in company stock prices. Although dating of stock option grants can of course coincide with low stock prices purely as a matter of chance, several scenarios present greater challenges for companies, Board members and executives that have received such "low price date" options. Several different such scenarios have been presented:

1. Backdated Option Grants: The most challenging scenario involves options that have been backdated from their actual grant date to take advantage of a lower stock price at a prior date and thus "build in" a return on the options at the outset. Without disclosure or other explanation, this conduct – if it materially affected the financial reporting of the company – could lead to charges of securities and accounting fraud, misappropriation of corporate assets and breach of fiduciary duty against the company, option recipients and Board members. In addition, the company and the individuals that received such options could face material tax and accounting consequences.

The practice of backdating stock options, in and of itself, does not constitute a violation of any law or regulation. But there are various practices that may run afoul of either law or regulation and any public company that is concerned about its option grant practices should consider the following issues:

- Do the terms of the plan pursuant to which the options were granted permit a grant at less than fair market value? If the plan prohibits such an award, the company may face claims of breach of fiduciary duty and corporate waste or a claim that the grants are ultra vires transactions such that all of the options are invalid.

- Have the backdated options been considered and approved by the company's Board or the appropriate committee thereof (typically the Compensation Committee)? Failure to obtain the requisite approval could result in allegations of self-dealing, breach of fiduciary duty, failure of internal controls, and/or corporate waste. Even Board-approved backdated

options could be so attacked, but "business judgment rule" considerations could come into play as a defense to such claims.

- Has the company failed to include the true value of the options in disclosing executive compensation? If an officer receives backdated options at a lower price than on the date of the actual grant, and the options are already "in the money," a claim might be asserted that the disclosure materially understated total compensation.

- Has anyone at the company purposefully falsified or manipulated documents in an effort to hide the backdating practice? Evidence of such actions could potentially open up the company, and the individual, to both criminal and civil liability.

2. Dating Questions Created By Late Completion Of Required Corporate Actions: These scenarios involve circumstances in which the Board and/or committee actually decides to grant options on the date utilized for the option grant date, but the corporate formalities, such as committee or Board consents, are not completed and returned to the corporate secretary until a later date when the stock price has increased. Here, the company may be able to argue that any misdating was merely a mistake -- at least for past incidents. Fact questions may be presented as to whether post-grant date actions consisted of the completion of more ministerial documents such as Board minutes or option agreements or situations where the necessary elements of a valid option grant have not been completed. Moreover, a claim of "mistaken" dating may not be sufficient to avoid tax, accounting and other issues. In the wake of the current regulatory focus, it would obviously behoove companies to implement procedures to allow immediate and contemporaneous finalization of all authorizations and consents on the date intended for the granting of options.

3. Date Of Employment Issues: These scenarios involve options awarded to an employee with a date before the employee actually began employment with the company. Here, fact issues as to whether the executive had actually commenced employment as of the grant date, whether the award date utilized was permitted by the company's stock option plan and whether the appropriate Board or committee approval was obtained with respect to the grant date will be of importance.

4. Options Granted Shortly In Advance Of Disclosure Of Positive News: This scenario involves the granting of options on a date when insider option recipients know of non-disclosed material information that, upon public disclosure, will likely cause the stock to increase. Issues presented by this scenario include whether the Board knew about the non-public information in determining to grant the option and had intended the option as a reward mechanism for executive achievement and/or retention purposes or whether only the executive option-recipient (and not the Board) was aware of the positive non-public information on the option grant date. Claims could be asserted of insider trading, securities fraud and breach of fiduciary duty on the part of insider option recipients, as well as breach of fiduciary duty or corporate waste on the part of the Board. In addition, depending on the facts and circumstances, the company could be subject to securities law violations for material misstatements or omissions in their periodic filings with the

SEC. Sarbanes-Oxley certification issues may also be implicated. On the other hand, there may well be defenses related to the executive's non-involvement in the dating of the option grant, Board approval and good faith business judgment, among others.

5. Delayed Option Dating: This scenario involves option grants that shortly follow the release of "negative," previously non-public information about the company. Regulators or plaintiffs' lawyers may contend that the options grant date was purposefully delayed to take advantage of the anticipated dip in stock price that would follow the release of the negative information, alleging that intentional delay constitutes a form of insider trading, breach of fiduciary duty and corporate waste. Of course, such a claim would be difficult to establish, as negative news may simply have preceded the options grant date.

6. Backdated Exercise Dates: This memorandum deals primarily with backdated option grant dates, but there have been instances in which executives have been charged with criminal tax evasion in connection with falsely backdated option exercise dates.

II. AUDITOR ISSUES

Options dating questions may be raised by company auditors and could present issues of whether (1) the company's financials will need to be restated; (2) the company has complied with Sarbanes-Oxley's internal controls requirements; or (3) there have been attempts to conceal the company's practices from the auditors.

III. INSURANCE

Options dating practices will likely be raised on directors and officers ("D&O") insurance applications and renewal questionnaires. Misstatements on insurance applications and renewal questionnaires might be used by insurers as grounds for seeking rescission of insurance policies.

Moreover, should proceedings be brought against a company, a D&O insurer may raise coverage exclusions for "fraud," "personal profit or advantage" and "unlawful remuneration."

IV. TAX ISSUES

Tax issues can also be presented by options misdating. For example, a misdated option could potentially be treated as non-performance measured compensation for purposes of the Internal Revenue Code § 162(m) deduction cap, resulting in a company having underreported income and being subject to back taxes and penalties. Moreover, the grant of "in the money" options could, in certain instances, result in the IRS seeking imposition on the employee option recipient of an additional 20 percent tax and penalty interest under Code § 409A.

V. MERGERS & ACQUISITIONS

This area should be a subject for due diligence in acquisitions of public companies.

VI. PRIVATE CIVIL LITIGATION

The Plaintiffs' bar has already begun to file derivative and shareholder class action lawsuits that piggyback on the regulatory investigations and stock drops following announcements of investigations. However, lawsuit filing does not necessarily translate into lawsuit success. There may be strong defenses, including but not limited to the circumstances of the company's option procedures, lack of scienter, and lack of loss causation to the company or its shareholders. A disinterested Board Committee may determine that derivative litigation is not in the company's best interest and seek dismissal of a derivative lawsuit on that ground.

VII. WHAT SHOULD PUBLIC COMPANIES DO?

There is no doubt that regulatory and enforcement agencies have access to the same statistical analyses reported by analysts, academics and the media that would show whether a public company has unusual options grant date patterns. Accordingly, public companies should consider examining with counsel their executive stock options grant history in order to be in a position to determine whether such patterns exist for the company and in order to be in a position to answer questions from their shareholders, Boards, media, regulators, insurers and their auditors, and to take steps to correct any past deficiencies. Any irregularities should be promptly reported to the Audit Committee. In the event that the SEC and/or other law enforcement agencies turn their focus on a company's options granting practices, such proactive steps would most likely be viewed positively in the agencies' assessment of whether to initiate enforcement proceedings and/or impose fines or sanctions against the company and/or its directors and officers, even if these steps would not solve all of the tax or accounting issues.

With respect to future grants, companies should examine their stock options plans to be sure that their terms are consistent with the company's needs, to adopt procedures to ensure immediate contemporaneous approvals of stock option grants and to take such other steps as are appropriate to avoid exposure under the other theories discussed above.

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We are available to answer any questions you may have on this issue or to handle any inquiry, investigation or litigation in this area.

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