Stock Options
Backdating and Other Issues Involving Stock Option Grants: New Rules from the SEC and a Game Plan for Avoiding Liability

Virtually every public company uses or has used stock options as a key component of its compensation package for employees. Despite their popularity, stock options have been the subject of frequent controversy -- from the long dispute over option accounting to frequent shareholder complaints about dilution and option repricing. However, these past controversies pale in comparison to the current furor over the backdating of stock options and related practices involving the timing of option grants. These practices can cause accounting, tax, disclosure and corporate governance problems, among others. The recent criminal charges against the former executives of Brocade Communications Systems, Inc. underscore the seriousness with which the regulators are treating this issue. Furthermore, on July 26, 2006 the Securities and Exchange Commission (SEC) adopted tough new executive compensation disclosure rules that will bring even more attention to companies’ stock option granting practices.

By way of background, companies typically intend to grant stock options that are “at the money” on the date of grant, i.e., the options have an exercise price equal to the grant date fair market value of the optioned shares. In fact, the option plans of many companies require that this be the case. The term “backdating” has been used loosely in the media to refer to a variety of actions taken in connection with stock option grants that have as a common purpose or effect the use of a low stock price, as of a date prior to the actual grant date, as the basis for setting the exercise price of the option. Backdated options are “in the money” at grant and are sometimes called “discounted” options.

This alert highlights, in question and answer format, the stock option grant practices that are attracting the most scrutiny and the steps that companies may take to address proactively potential problems before they reach the public eye and become problematic to the company and its directors and officers.

**My company’s directors and officers are individuals of the utmost integrity. If I know that my company has not, and will not, intentionally manipulate stock option grant dates or documents, why do I need to worry about backdating?**

Deceit, fraud or bad intent are not required for the propriety or legal compliance of a company’s stock option grant practices to be challenged. In fact, many of the practices currently under scrutiny may have been conducted in good faith. The administration of stock option programs may not have been the highest priority item for many public companies, and adequate controls and procedures could be lacking. Even companies that have given serious attention to stock option administration are susceptible to problems arising from sloppiness or innocent mistakes on the part of plan decision-makers and administrators. Therefore, it is not advisable for a company to simply assume that its option grant practices are unassailable simply because it believes it has acted in good faith in operating its option program.

**If no one at the company is aware of any problems with backdating, is it not more prudent for us to “let sleeping dogs lie” rather than launch an internal investigation which might uncover embarrassing problems?**

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If no one at the company is aware of any problems with backdating, is it not more prudent for us to “let sleeping dogs lie” rather than launch an internal investigation which might uncover embarrassing problems?
A company may be reluctant to start an investigation that it believes is likely to find some problems, even relatively minor ones. However, the backdating issue is now prominently on the radar of the SEC, the U.S. Department of Justice (DOJ), the Internal Revenue Service (IRS), institutional shareholders and shareholder advocacy groups, auditors and the plaintiffs’ bar. As a result, if a company is not proactive in identifying and addressing problems, the problems may nevertheless surface in other ways. Audit firms in particular are digging more deeply into issuers’ option grant practices, not only because of the current firestorm of controversy generally, but as a result of encountering these issues with audit clients already under investigation by one or more of these agencies. Some companies are being identified as targets for investigation merely as a result of reviews by the media, academics, financial analysts and hedge funds of the relationship between option exercise prices and movements in the company’s stock price.

Given the multitude of potential sources of inquiries regarding option grant practices, companies are well advised to take a proactive approach. Early identification of potential problems may provide the company opportunities to mitigate liability -- opportunities that might not be available if regulatory agencies are the first to discover the problems. For example, under the deferred compensation tax rules (discussed below), some actions to self-correct problems may have to be taken before the end of 2006. In addition, in our experience, the SEC and DOJ have tended to provide meaningful credit, including deciding not to prosecute wrongdoing, to companies that have proactively identified and self-corrected problems of this nature.

If we decide to conduct an internal investigation of our stock option granting procedures, should it be conducted by in-house or outside counsel?

An internal investigation needs to be thorough, accurate, fair, timely and, perhaps most importantly, credible. It may be appropriate in some circumstances for in-house counsel to conduct an internal investigation, particularly if there are financial constraints or no problems have yet been identified. However, if problematic issues have been identified, if there is a substantial concern about what may be found or if additional resources are needed to complete the investigation in as prompt a manner as possible, then it is generally beneficial for a company to retain outside counsel to conduct the internal investigation. Outside counsel, particularly those who have formerly worked at the SEC or DOJ, are usually viewed by regulators as being more credible in conducting internal investigations than in-house counsel. In addition, outside counsel may bring certain expertise of the various disciplines involved, including executive compensation, tax, corporate governance, enforcement and insurance coverage. Moreover, outside counsel experienced in conducting internal investigations will be in the best position to conduct them efficiently and effectively, and most likely recognize the necessary steps to protect any applicable privileges.

What are the main stock option grant practices that have come under scrutiny?

**BACKDATING**

*Intentional Backdating of Legal Documents:* Media reports have identified a number of instances where it is alleged that the board of directors or compensation committee of a company intentionally backdated stock option grant documentation from the actual grant date to take advantage of a lower stock price at a prior date. The effect of such an action is to provide “in the money” grants to employees.

*Late Completion of Corporate Action:* A board of directors or compensation committee may decide on a certain date to grant options but delay the completion of corporate action necessary to approve the grants. This may occur, for example, if a unanimous consent is not signed by all directors or committee members until a later date when the stock price is higher (the laws of many states provide that a unanimous consent is not effective until the last director signs it). As a result of the delay, the option exercise price, set as of the date of the initial grant decision, is less than the value of the
stock on the actual grant date (when the corporate action is completed). Another common scenario is where the board of directors has established a “committee of one” to make option grants, usually to employees below the executive officer level, as a means of streamlining the option grant approval process. Companies using this approach sometimes may fail to develop adequate procedures for contemporaneously documenting the grant decisions made by the one-person committee. There is usually no intent to deceive in these situations but even an inadvertent delay in the approval process can have adverse consequences.

Pre-Employment Grants:
Some companies adopted a practice of granting options to new hires as of a date prior to the first day of employment. For example, an employment offer letter issued pre-employment may promise a prospective employee an option grant at the then-prevailing market price. For most purposes, however, it is not permissible to grant an option as of a date before the employee’s first day of work. These are also typically inadvertent violations that occur because decision makers are not aware of the problems associated with pre-employment option grants.

“SPRING LOADING” AND “BULLET DODGING”
The “spring loading” of a stock option grant involves the grant of options in advance of the release of material information that is likely to cause the company’s stock price to increase. The recipients of these options can expect to get a “bump up” in the value of their options once the market absorbs the favorable news. A related practice, sometimes called “bullet dodging,” involves the intentional delay in granting options until shortly after the release of negative news to take advantage of the anticipated stock price decrease. In general, there are fewer legal and other issues associated with these practices than with the backdating scenarios discussed above. Nevertheless, many institutional investors and shareholder groups have sharply criticized these practices as inappropriate and contrary to good corporate governance.

What are the possible adverse effects of backdating and other improper stock option granting practices?

ACCOUNTING ISSUES
Under APB 25, the stock option accounting standard that was in effect for most public companies prior to 2006, the grant of an in-the-money option resulted in a corresponding compensation charge that was required to be expensed over the vesting period of the option. It has been alleged that while APB 25 was in effect, some companies improperly accounted for backdated options as if they were granted at-the-money. Under the current option accounting rule, FAS 123-R, all options must be expensed, even if they are at-the-money at grant. Even under FAS 123-R, if it is discovered that the “date of grant” was not properly determined, adjustments may be required in the amount of compensation expense associated with the options. If the required adjustments are material, restatement of prior year results may be required.

TAX ISSUES
If options are granted with an exercise price that is less than the grant date fair market value of the optioned stock, at least three possible tax issues may arise:

Lost Tax Deductions:
If the options were intended to qualify as “performance-based compensation” exempt from the $1 million deduction limit under Section 162(m) of the Internal Revenue Code, they may fail to qualify as such and the company may lose tax deductions upon the exercise of options by top executives. This may be a material item as a company’s option-related tax deductions can reach into the millions, or even tens or hundreds of millions of dollars.

Violation of Deferred Compensation Rules:
At-the-money stock options are generally exempt from the deferred compensation rules under Section 409A of the Internal Revenue Code. If the options are determined to have been granted in-the-money as a result of backdating, the options, to the extent they were not vested on or before December 31,
Loss of Incentive Stock Option Status:
If the options were intended to be incentive stock options (ISOs), they may fail to qualify as such and the employees may lose the possible tax benefits associated with ISO status.

SECURITIES LAW AND CIVIL LIABILITY ISSUES
The inclusion in publicly filed reports of financial statements that are erroneous due to option backdating may constitute a violation of the CEO and CFO financial statement certification requirements of the Sarbanes-Oxley Act, resulting in the personal liability of the CEO and CFO. In addition, proxy statements, filed stock option plan documents and other reports may state that the company grants all options at-the-money and/or that all option compensation will be tax deductible by the company. If, due to backdating, such statements prove false, issuers and their officers and directors may be subject to securities fraud liability for misleading disclosure. In some cases, backdated options may also present securities registration issues, such as claims under section 11 and/or section 12(a)(2) of the Securities Act seeking rescission or damages for the securities purchased on the basis of a false and misleading registration statement or prospectus. Moreover, even in private transactions, lenders or institutional investors may be able to accelerate the due date of debt instruments or securities or otherwise recoup proceeds paid for securities if, as in the typical case, representations and warranties contained in the loan or purchase agreement concerning the accuracy of the issuer’s public reports and financial statements prove false or misleading.

CORPORATE LAW AND SECURITIES LISTING ISSUES
Most state corporation laws contain requirements with respect to the manner in which option grants may be authorized. In addition, a company’s option plan typically includes procedural requirements for option grants. By-laws, committee charters and board resolutions may also contain relevant provisions. Some companies are not as meticulous as they should be in following the prescribed procedures in approving option grants. If options are not properly approved, the options may be voidable. If options were granted outside of plan-mandated procedures, the non-plan grants may present NYSE or Nasdaq shareholder approval problems.

What are the SEC disclosure requirements applicable to stock option grants?

The SEC’s executive compensation disclosure rules have long required disclosure of information, mostly in tabular form, about option grants to the top executive officers of the company. The current requirements do not, however, focus particular attention on the option grant process or the timing of option grants. This is about to change. At an open meeting held on July 26, 2006, the SEC adopted sweeping changes to its disclosure requirements for executive and director compensation, including the addition of rules designed to ferret out backdating and other potentially manipulative option practices.

Effective for proxy statements filed on or after December 15, 2006, most companies will have to provide certain tabular and narrative disclosure about option grants and the company’s option grant policies and procedures, including the timing of option grants in relation to the public disclosure of material information, positive or negative, about the company. The SEC has issued a press release providing an overview of the new rule (visit http://www.sec.gov/news/press/2006/2006-123.htm to view the press release). The actual text of the final rules is expected to be published shortly.

The tabular disclosure with respect to option grants will be required to include:

- The grant date fair value;
- The date of grant as determined under the financial accounting rules set forth in FAS 123-R;
- The closing market price of the stock on the grant date if it is greater than the exercise price of the option; and
The date the compensation committee or full board of directors took action to grant the award if that date is different than the grant date.

If the exercise price of an option is not the grant date closing market price per share, the disclosure must include a description of the methodology used for determining the exercise price. Additional narrative discussion will be required in the Compensation Discussion and Analysis (CD&A) section of the disclosure with respect to the reasons the company selects particular grant dates for awards and the methods the company uses to select the exercise prices and other terms of stock options. The company will be required to address the following questions with regard to option grant timing:

- Does the company have a program, plan or practice to time option grants to its executives in coordination with the release of material non-public information?
- How does any program, plan or practice to time option grants to executives compare to the company’s program, plan or practice, if any, with regard to option grants to employees more generally?
- What was the role of the compensation committee in approving and administering such a program, plan or practice and how did the board or compensation committee take the timing of disclosure of material nonpublic information into account when determining whether and in what amount to make those grants? Did the compensation committee delegate any aspect of the actual administration of a program, plan or practice to any other persons?
- What was the role of executive officers in the company’s program, plan or practice of option timing?
- Does the company set the grant date of its stock option grants to new executives in coordination with the release of material non-public information?
- Does the company plan to time, or has it timed, its release of material nonpublic information for the purpose of affecting the value of executive compensation?

Similar requirements will apply if the company has a program, plan or practice of setting option exercise prices based on the stock’s price on a date other than the actual grant date or if exercise prices are set using formulas based on average prices (or lowest prices) during a specified period.

**What should we do to ensure that our stock option grant procedures and practices are adequate?**

Internal controls over financial reporting have been a primary focus of publicly-traded companies since the passage of the Sarbanes-Oxley Act. Public companies should have already designed and implemented internal controls that eliminate the ability to manipulate option grant dates. If so, those internal controls should be tested periodically. If not in place, such controls should be established immediately. Here are some key points to consider:

**Ensure Consistency with Corporate Documents:** The initial point of reference for internal control should be the company’s option plan document, compensation committee charter and other organic documents, as well as the option grant requirements of applicable state law. It is of paramount importance that all option grants be made in strict compliance with these corporate documents and legal guidelines. A written option grant protocol should be established and all parties involved in the option grant process should be familiar with this protocol and follow it to the letter.

**Appoint a Gatekeeper:** In some companies, the stock option program is the “orphan stepchild” of corporate administration. While the involvement of several corporate departments (HR, finance, etc.) is undoubtedly required, it is critical that the ultimate responsibility for the program be in the hands of specific individuals who are familiar with the operation of such programs. One or more of these individuals should be appointed to serve as a gatekeeper responsible for reviewing all option grant
documentation to ensure that the date of grant in the option grant letter or agreement corresponds to the date of the completion of the corporate action approving the grant (date of compensation committee meeting, unanimous consent execution, etc.).

**Set a Regular Schedule for Option Grants:**
Establish a regular schedule of grants to avoid the appearance of manipulation. For example, many companies grant options once a year, once a quarter or once a month, at regularly scheduled board or compensation committee meetings. Ideally such meetings should occur during an “open window” period for insider trading in the company’s stock. If at the time of such a meeting insiders actually possess market-moving inside information about the company, consider delaying the grant until the information has been publicly disclosed.

**Do Not Backdate Option Grants to Hiring Dates:** Employment offer letters should be clear that promised option grants will not occur until at or after the first day of actual employment. Rather than backdating option grant letters, companies should consider granting more options to the new employee to make up for any potential loss in value resulting from an option grant authorization occurring subsequent to the date of hire.

**Focus on Option Documentation:**
Ensure that detailed, contemporaneously created documentation (i.e., board/committee minutes) of the award process exists, and that the documentation reflects all material terms of the grants. Option award agreements and notices should be prepared and distributed to grantees within a relatively short time following the grant date. Immediately take all necessary steps to preserve all potentially relevant option-related documents in the custody and control of the company, including electronic documents and, to the extent possible, relevant documents that are in the hands of third parties.

**If our investigation determines that we have problems, will we be covered under the company’s D&O insurance policy?**

Directors’ and officers’ (D&O) liability insurance offers a potentially valuable resource for companies or individual directors and officers facing claims related to the backdating of stock options. The terms of D&O policies vary widely, so policyholders should carefully review their existing D&O policies to analyze the potential for coverage and to determine whether they should take steps now to preserve their rights. It should be anticipated that insurers will assert all available defenses to such claims based on the specific policy language at issue, controlling case law, and the specific facts at issue. Despite the anticipated insurer reaction, policyholders appear to have strong arguments for coverage under many D&O policies for defense costs and potential settlement payments for the types of investigations and lawsuits that are currently pending. Of particular note, many D&O policies define the term “claim” broadly to include many types of regulatory investigations, including the cost of complying with SEC subpoenas, and certain criminal matters. It also should be emphasized that most D&O policies not only afford coverage to directors and officers when they are not indemnified by the company, but also require the insurer to cover defense costs and settlement payments when the company indemnifies the individual insured. In addition, certain D&O policies cover claims filed directly against the company or its employees.

Insurers may attempt to rely on certain exclusions commonly found in D&O policies, such as exclusions that bar coverage for any remuneration paid to insureds without appropriate approval, dishonest conduct, or for profits obtained by a director or officer to which he or she was not legally entitled. Many of these exclusions, however, only apply if the excluded conduct is established via a “final adjudication” or “non-appealable judgment.” As such, insureds may be entitled to coverage for defense costs and for any claims that are settled prior to a final adjudication. In addition, severability provisions in many D&O policies may preserve coverage for innocent directors and officers, even if insurers meet their burden in establishing that such exclusions bar coverage for so-called bad actors.
Policyholders should pay particular attention to the notice provisions in their policies to determine when and if they are required to provide notice to their insurers. In many cases, even if no claim has been filed, policyholders are permitted to provide notice of “circumstances” or “potential claims” in order to preserve their rights to coverage for claims that may be filed after the policy period. Policyholders may wish to consider this option, particularly if they have been informed that their insurers may add new exclusions related to options to any renewal policy.