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## Stock Option Backdating-- How Big Are The Problems And What Should You Do?

### I. Background

Recently, over 40 public companies have come under investigation by the SEC or the Justice Department for improperly backdating options, and it is likely that more public companies will come under investigation in the future. At issue is whether option grants to executives and others were backdated to coincide with dates when a company's stock price was low, thereby increasing the potential profits realized by the holders of the options if and when exercised. Specific practices currently under scrutiny include (i) using a grant date that is prior to the date of the compensation committee meeting or other meeting at which the option awards were actually authorized, (ii) if awards were approved by unanimous written consent in lieu of a meeting, using a grant date that is prior to the date all signatures were actually received, (iii) using an "effective as of" grant date that is different than the actual award date, and (iv) changing the date of a board or committee resolution or option agreement to a date that is different than the actual award date. The SEC has also launched investigations where options were granted immediately preceding the announcement of good news relating to the company that caused the company's stock price to rise.

The impetus for these investigations was an academic study indicating that certain companies consistently awarded stock options on a date coinciding with the lowest trading price of the year. Most of the ongoing investigations focus on option grants prior to 2002 and the adoption of the Sarbanes-Oxley Act, which shortened the period for reporting stock option grants from 45 days after the end of a company's fiscal year to two days after the date of grant and thereby made backdating difficult. Note that improper backdating may be intentional or a result of faulty corporate procedures. In either event, serious accounting, tax, and disclosure issues result.

### II. Propriety of Backdating Options

Backdating is not per se illegal. Because of adverse tax and accounting consequences, however, the practice has been not to backdate. For backdated options to be legal,

- The plan under which the options were issued must permit backdating.
- The Company's earnings must be properly reported in the company's SEC filings to reflect the grant of in-the-money options, which requires a charge to earnings.
- Options must be issued at fair market value (FMV) at the actual date of grant to avoid the adverse tax consequences of the new deferred compensation tax rules and to be considered performance-based compensation for deduction purposes in certain circumstances. The tax consequences also must be reported properly in the company's financial statements filed with the SEC.
- Backdated option awards must be disclosed in the company's SEC filings.

### III. Consequences of Improper Backdating

- **Earnings restatement.** Options granted at less than fair market value at the date of grant (so-called "in-the-money options" or "discounted options") create an immediate compensation expense, even though not taxable to the employee until the option is exercised. If this compensation was not properly reflected in a company's



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financial statements, depending upon materiality a restatement of prior years' compensation expense would be required.

- **Delayed filings.** The inability to restate earnings in a timely manner can lead to delayed filings with the SEC and ultimately delisting of shares. The discovery of improper backdating would constitute a significant deficiency in a company's internal controls relating to stock option plan administration and accounting for and disclosure of stock options, causing further filing delays. In addition, at least one company has disclosed that it was unable to file its latest, quarterly report on time because of an on-going audit committee investigation into past option grant practices.
- **Corporate disclosure issues.** Stock options are required to be described in a company's SEC filings including its proxy statement. If such descriptions are false or misleading, disclosure, including the company's financial statements, may violate Section 10(b) of the Securities Exchange Act of 1934. Moreover, Section 906 of the Sarbanes-Oxley Act requires CEOs and CFOs to certify that the company's periodic reports filed with the SEC fairly represent the financial condition of the company, and there are criminal penalties for willfully violating this provision. Section 302 of the Sarbanes-Oxley Act also requires certifications with respect to the disclosure in a company's SEC filings and violations of this provision likewise can result in criminal penalties. In addition, executive officers and directors are required to properly report option grants in their Section 16 filings.
- **SEC, grand jury and other criminal investigations.** As noted above, the SEC and the Justice Department have already initiated investigations into backdating by issuing letters of "informal inquiry" or subpoenas, and it is likely that the Internal Revenue Service will as well. An array of penalties is at the government's disposal, which include disgorgement and civil penalties, criminal liability for fraud or income tax evasion, and injunctive relief.
- **Class action and derivative lawsuits.** Numerous class action and derivative lawsuits have been filed on behalf of shareholders and corporations, respectively. These lawsuits primarily target the officers and directors who authorized the option grants and/or received backdated options. They variously allege breach of fiduciary duty and violations of Section 10(b), among other causes of action, and have called for disgorgement for unjust enrichment, rescission, and restitution. Depending on the circumstances of each particular case, defendants are likely to file motions to dismiss based on arguments such as the running of the statute of limitations, lack of a duty to disclose, failure to plead demand futility, and the existence of independent Board investigations. It remains to be seen which theories of liability will survive these challenges.
- **Ratings adjustments.** Moody's and S&P have indicated they may lower ratings on companies that are under investigation for backdating stock options as a result of the uncertainties related to potential payment of regulatory fines and lawsuit settlements, accounting restatements, corporate governance and control issues, and possible negative effect on the company's business reputation. A ratings downgrade could trigger covenant defaults and impede a company's ability to borrow money or raise capital.
- **Tax issues.**
  - **Code Section 409A**

Internal Revenue Code Section 409A, which governs the taxation of nonqualified deferred compensation, provides an exception for stock options, but only if the exercise price is set at an amount that can never be less than the FMV of the company's stock on the grant date, and the option does not include any additional deferral feature. A discounted option, therefore, is subject to Section 409A, which means, among other requirements, that the option must specify in advance when it will be paid. To the extent a discounted option does not provide for a fixed payment date, the employee is subject to substantial taxes, penalties and

interest from the date of the original grant. Because options have traditionally allowed the employee to determine when to “pull the trigger” and receive the taxable benefit, Section 409A has effectively eliminated the utility of discounted options.

If an option is backdated so that the stated exercise price is less than the FMV of the company’s stock on the date that the option right is actually established, the IRS may determine that the option is discounted. This will cause the employee to be subject to Section 409A’s adverse tax consequences if the option does not satisfy Section 409A’s requirements. Section 409A is effective for amounts deferred after December 31, 2004; amounts earned and vested before 2005 are not subject to Section 409A. Thus, for options (a) granted and exercised or (b) granted, vested and exercisable before 2005, Section 409A should not be an issue. However, options granted after December 31, 2004 and options granted before 2005 that were not vested and exercisable by December 31, 2004 will be subject to Section 409A if they are discounted. Such options will need to be modified by the end of 2006 in order to comply with Section 409A and avoid punitive taxation to the employee. It is important to note that Section 409A applies to all companies, not just those that are publicly traded. Thus, although the SEC investigations have caught the attention of public companies, all companies must consider the backdating issue.

- **Code Section 162(m)**

Internal Revenue Code Section 162(m) limits the deduction of compensation paid by a publicly-held corporation to certain executive officers to \$1,000,000 per year, unless that compensation is, among other exceptions, performance-based. In the case of stock options, so long as the other requirements of Section 162(m) are met, stock options are excepted from Section 162(m) as performance-based compensation, so long as the exercise price is equal to the FMV of the stock on the date of grant (i.e., the options are not discounted options). Thus backdated stock options that become discounted options may limit a public company’s tax deduction associated with the exercise of those options.

- **Consequences to employees.** In addition to the tax consequences described above, a finding of improper backdating could lead to the suspension of the company’s S-8 registration statements and incentive exercises/awards under the plan, which would have an adverse impact on all employees.

#### IV. Action Going Forward

It is advisable for all companies to review their past and current stock option award procedures to ensure that there are no instances of option backdating, inadvertent or not. In the event a company finds it is being investigated for backdating or otherwise suspects it may have an issue with respect to improper backdating, the following actions are advisable:

- Undertake an independent investigation by the audit committee, independent directors or other appropriate committee of the board whose members were not involved in administering the company’s stock option plans.
- Ensure that the review process is well documented.
- Hire independent counsel to assist with the investigation.
- Ensure electronic and other records relating to the company’s stock option practices are retained.
- If improper backdating is discovered, be proactive in reporting and remediating it.

## V. Preventative Measures

There are certain actions a company may consider to minimize the risk that it will be exposed to a claim of improper backdating:

- Establish precise internal controls regarding stock plan administration and ensure that they are followed.
- Document the award process carefully. If awards are approved by meeting or conference call, document the minutes and awards that day. If awards are approved by unanimous written consent, ensure that all signatures are received by the intended grant date.
- Avoid making grants “as of” a date in the past.
- Ensure that all material terms of an award are set by the date of board or compensation committee approval.
- Award options on fixed dates every year. With respect to new hires, plans generally permit awards to employees only. Accordingly, options promised as part of a compensation package should not be granted until the date of hire, and the exercise price cannot be determined as of a date earlier than the date of hire.
- Avoid granting options prior to the announcement of positive news.
- Be prepared. The SEC has been crafting significant revisions to executive compensation disclosure required in a company’s proxy statement and 10-K. As a result of the backdating investigations, the SEC recently stated that it intends to significantly increase disclosure relating to stock options and the granting process.

Haynes and Boone has created a team composed of members from our Corporate/Securities, Securities Litigation, White Collar Criminal Defense, and Employee Benefits/Executive Compensation Practice Groups to address the various issues and concerns arising from the stock option backdating disclosures. For further information regarding the issues associated with these matters, please contact any of the listed representatives of these Practice Groups.

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