Benefits Practice Center **ISSN 1544-0575**

EXECUTIVE COMPENSATION LIBRARY
JOURNAL REPORTS: LAW AND POLICY
2006

Investigating Potential Allegations of Backdating Option Grants

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September 2006

The press recently has reported about several high profile companies that, either intentionally or unintentionally, treated options as granted at an earlier time than they actually were granted, resulting in greater profit potential for executives. Several academics have produced studies that the authors say demonstrate that backdating is prevalent in many companies.[1] Plaintiffs' attorneys have instituted suit against companies for apparent backdating problems and government attorneys have filed criminal charges against corporate officers due to option backdating.[2] Clearly, option backdating is something that corporate counsel should be aware of.

What is Option Backdating?

Options provide the option holder with the ability to acquire stock at a certain price at some time in the future. Essentially it gives the option holder the ability to own the stock in the future without having the financial risk of the decline in the value of the stock during the time period before the option exercise. Typically the option holder will recognize gain when the option is exercised in the amount that the fair market value of the stock when exercised is greater than the option exercise price.[3]

Companies frequently use stock options as incentive devices for their executives as well as the rank and file employees. When an option is granted and the option exercise price is at the fair market value of the stock at the date of grant, then the executive will be rewarded if he or she exercises the option when the stock price increases after the grant. Such an incentive compensation tool works well for the company and its shareholders: executives are rewarded when the stock price rises and the value of the shareholders holdings is increased by the increase in share price. Companies award executives this form of incentive compensation because it rewards the executive only if overall shareholder value increases.

Options are typically granted to executives with exercise prices equal to the fair market value at date of grant. There are more favorable accounting and tax consequences that occur when the option exercise price is at least equal to the fair market value of the underlying stock at date of grant. Option backdating occurs when, either intentionally or unintentionally, the grant of an option is deemed to have been made in the past at an option exercise price that, while equal to the fair market value of the stock at the earlier date, is lower than the fair market value on the actual grant date. When the backdating of stock option grants occurs, it removes that linkage between the value delivered to the

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executive and the value the shareholders receive for increase in the stock's market value after the date of the grant, since the executive has already been given a “leg-up” on the stock's future appreciation.[4]

Causes of Backdating

Backdating can be inadvertent. It may happen because all of the approvals and authorizations that are necessary to grant an option have not been met so that when the option becomes legally binding, a period of time has elapsed between the date that the option exercise price was determined and the date the option was legally granted. For example, assume that the compensation committee of the board of directors approves the grant of a fair market value option on the date of a meeting held via a conference call but that the approval is not legally binding until all the compensation committee members execute the unanimous written consent of the committee. If that unanimous consent is not executed by all the members of the compensation committee until the following month, but the option exercise price remains based on the fair market value as of the date of the conference call, that option could be said to be backdated.

Backdating can be deliberate. This occurs with executives or directors who know the adverse tax and accounting consequences of using an option with an exercise price that is lower than the fair market value at date of grant. Nevertheless they deem the option to be granted at an earlier date when the fair market value is less and treat the option as if granted with an exercise price equal to the fair market value. Such actions may be taken in order to “lock in” some portion of gain or eliminate some element of risk to the option holder. Backdating the option may be done to hide that the option exercise was below fair market value so as not to trigger the adverse tax and accounting consequences of a below fair market value option grant. In addition, many stock option plans require that only stock options with an exercise price that is at least equal to the stock's fair market value at date of grant can be granted, so backdating may be used as effort to avoid that restriction.

Consequences of Below Market Value Options

There is nothing illegal with granting options with exercise prices below fair market value at the date of grant. There are reasons for such a compensation strategy and there is nothing under the tax and securities laws or under the accounting rules that makes below market value option grants illegal or impermissible. However, pursuing that compensation strategy has certain financial reporting and tax ramifications, which backdating attempts to circumvent.

Under the old accounting rules for compensatory stock options,[5] stock option grants were treated as an expense to the extent that the fair market value of the option was greater than the option exercise price at the date of grant.[6] Since options granted at fair market value would not be charged against earnings, there was an incentive to make sure that the option exercise price equaled the fair market value of the stock at date of grant.

There are a number of tax considerations with an option granted with an exercise price below fair market value. First, the favorable tax treatment accorded to an incentive stock option (“ISO”) of no taxation upon option exercise is only available if, among other things, the option has an exercise price equal to the fair market value of the stock at date of grant.[7] Without that, the option will not be considered an ISO and upon the exercise of the option the employee will be taxed at the difference between the option exercise price and the fair market value of the stock at the time of exercise.

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Another tax consideration is whether the corporation receives a deduction at the time of option exercise. Under general tax rules, the corporation that grants the option (other than an ISO) will be entitled to a compensation deduction equal to the amount the employee includes as income upon the option exercise.[8] However, publicly traded companies are limited to a $1 million annual deduction for the amount of compensation paid to certain executives.[9] This deduction cap only applies to the chief executive officer and the next top four executives in terms of compensation.[10] As an exception to this $1 million compensation cap, payment of any performance-based compensation can be deducted by the company.[11] Included in the definition of performance-based compensation are stock options granted with an exercise price no less than the fair market value of the stock at date of grant. Options granted with exercise prices below fair market value at date of grant cannot be considered performance-based compensation, and therefore, the company could lose deduction they would otherwise be entitled to upon exercise of the option.[12]

Finally, options are not considered nonqualified deferred compensation under the new rules under §409A of the Internal Revenue Code ("409A") as long as, among other things, the option exercise price is no less than the fair market value of the stock at the time the option is granted.[13] Options granted with exercise price less than fair market value of the stock at the grant date will be considered deferred compensation and will be subject to strict rules on when the proceeds of the option grant can be realized by the option holder. Generally this means that the option holder cannot freely exercise his or her options without violating the rules under §409A. Violation of those rules because of backdating or otherwise will mean that the option holder is taxed on the value of the option (most likely calculated as the option spread) at the time the option becomes fully vested and subject to an additional 20 percent tax as well as imputed interest.[14] Unlike the rules dealing with the deduction loss on compensation in excess of $1 million that apply only to the top five officers of a publicly traded company, the 409A rules apply to all employees of all types of companies. Clearly, companies and the executives do not want to be subject to the 409A rules with regard to their options.

What to Do Now

The backdating of option grants may be less of an issue now than it was previously. Under the Sarbanes-Oxley Act of 2002 ("SOX"), the grants of options to top executives must be disclosed within two business days. The short time frame between grant date and the filing deadline does not give much room to backdate the option grant. Compare the new filing deadline under SOX with the pre-SOX filing deadline of within 45 days of the end of the corporation's fiscal year and you can see that there is less room for intentional backdating of option grants. However, for corporations that are not publicly traded and subject to these federal securities law disclosure requirements, there still may be the incentive and ability to backdate options.

The board or the compensation committee may want to examine the company's grants of options to make sure that there are no backdating issues. Internal counsel may want to start such an investigation, but, if evidence of backdating is uncovered, it might be best for an independent outside counsel to be engaged by the board.

The first thing that should be examined is the company's internal procedures with regard to option grants. The following outlines what should be examined:

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× *Plan Documentation*. Confirm that the actual administration of the plan follows the terms of the underlying document. Does the option grant documentation conform to the underlying document? Even if there is no evidence of option backdating, it is always important to have legal documentation and the administrative practices conform.

× *Approval of option grant*.

- Board of Directors or Compensation Committee—What level of involvement does the Board or Compensation Committee have with regard to who is granted options, how many options are granted, and the timing of the option grant? If there is little direct involvement by the Board or the Compensation Committee, especially with regard to large option grants made at nonrecurring times, a higher level of scrutiny of the timing of the grant is warranted.

- Subcommittee of the Compensation Committee — To avoid having the Board or the Compensation Committee get involved in numerous option grants made at nonrecurring times, some companies have delegated the option granting authority to a smaller group or to a "committee of one," where the action of just one individual will result in options being granted.[15] In these circumstances, a higher degree of scrutiny would be warranted since it would be easy for the proper documentation not to occur or for someone to try to manipulate the option grant date.

× *Timing of option grant.*

- Are the options granted on a regular basis at a regularly scheduled time? If regularly scheduled option grants, determine whether any grants have occurred outside that time; these option grants may be more susceptible to manipulation of the grant date.

- Are option grants usually part of compensation agreements for new employees? If so, then the option exercise price must be examined closely. Many times, the intent of the grant of options at the commencement of employment is to make up for stock option value at a previous employer and the terms of an option grant (number of options, exercise price) may be set before the employment actually commences and the employment contract is effective. That may result in options being granted with an exercise price less than the fair market value of the stock on the date when the new employee has a legally binding right to those options.

× *Documentation of the option grant*.

- Terms and Conditions — Are all the terms and conditions (number of options granted, option holder, grant price, date of grant) of the option addressed *in* the documentation or can they be determined by reference to other documents? The clearer the documentation of the option grant the less chance there will be of inadvertent backdating.

- Employee Communication — What is the documentation given to the employee of his or her option grant? Does it clearly reflect the option exercise price and the term of the option? Is the

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- o documentation given to the employee is a timely manner after the option is granted? The more information given the employee in a timely fashion the less likelihood that the option grant date was manipulated.

× *Chain of control of documents identifying the terms and conditions of the option.*

- o Who is in charge of option administration and do they understand the legal significance of what they do? Often option administration falls between the corporate secretary's office and the human resource department, with little thought given to the legal significance of what an option is. This could result in inadvertent option backdating since the administrator may not know the proper terms of the option or it could facilitate deliberate backdating since the administrator may not understand when and how the option grant should be made in a correct manner.
- o If option administration is outsourced, is the option administrator getting information from the company in a timely basis?

While it may turn out that a company does not have an option backdating problem, periodic review of these important processes is a good thing to do. This is especially true in this time of increased scrutiny of option grants by the government, shareholders, plaintiff's attorneys, and the press.

Footnotes

[1] Eric Lie of the University of Iowa and Randall Heron of Indiana University have published a few papers dealing with the timing of stock option awards and possible backdating.

[2] Brocade Communications Systems has recently settled a shareholder lawsuit regarding backdated options and criminal charges have been filed against Brocade's former chief executive officer and former vice president of human resources.

[3] I.R.C. §83(a). However, if the option is an incentive stock option and it is exercised and the stock received is not sold within the time periods prescribed, then the option holder will not be taxed upon grant but rather when the stock is subsequently sold. I.R.C. §421.

[4] It is important to note, however, that the backdated option has no value to the optionee unless the stock price exceeds the exercise price upon vesting which typically occurs at least one year after the grant date.

[5] Accounting Principles Board Opinion (ABP) No. 25.

[6] Under current accounting rules, the fair value of the option is reported as a change to earnings regardless of whether the option was granted with an exercise price equal to fair market value at grant or not. Statement of Financial Accounting Standard No. 123 (revised 2004).

[7] I.R.C. §422.

[8] I.R.C. §83(h).

[9] I.R.C. §162(m)(1).

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[10] I.R.C. §162(m)(3). This will likely be revised to reflect the change in executives covered by the SEC's revised proxy rules.

[11] I.R.C. §162(m)(4)(C).

[12] Treas. Reg. §1.162-27(c)(2)(vi) (1995).

[13] Prop. Treas. Reg. §1.409A-1(b)(5)(A) (2005).

[14] I.R.C. §409A(a)(1).

[15] Such delegation normally does not apply to grants to officers of public companies.

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