

Stock Options Backdating

How the Latest Corporate Scandal Could Affect You

The practice of backdating stock options has recently come to the forefront of the news, as the Securities and Exchange Commission and Department of Justice are currently investigating at least 80 companies in connection with such backdating. There are numerous issues that public companies should be considering in the wake of recent increased scrutiny of stock option practices and the issuance of new SEC disclosure rules that will become effective later this year.

Backdating, Spring-loading and Bullet-dodging

A stock option is a right to buy stock at a given price (the strike price or exercise price) during a set period of time. Employee stock options typically have a strike price that is equal to the fair market value of the stock on the day the option was granted.

“Backdating” refers to a situation in which the strike price of an option is less than the fair market value of the stock on the day the option was awarded.

“Spring loading” involves the granting of options just before the public disclosure of material, positive news, which will presumably raise the stock price shortly following the grant date. This practice may raise issues related to insider trading.

“Bullet dodging” involves waiting for unfavorable information to be disclosed before making an option grant. The recipient benefits from the depressed stock price on the date of the grant. Insider trading could also be an issue here.

Issues to Consider

Many companies are considering reviewing their option granting procedures to identify areas of exposure from past practices and to improve practices for the future. The following list summarizes the areas that companies may wish to include in such reviews:

Tax Issues – When the strike price of an option is equal to the stock’s market price on the date of the grant, such option is eligible for favorable tax and accounting treatment. “Backdated” options may, if not properly treated, result in the taking of incorrect tax deductions which may lead to requirements to revise prior returns and subject the company to penalties. Individual recipients similarly may have additional tax liability or owe penalties. Amendments may be necessary prior to December 31, 2006 in order to avoid additional taxes and penalties to option recipients under recently adopted tax rules related to deferred compensation.

Accounting Issues – If compensation expense is not recorded or under recorded, then historical financial results may need restating.



Disclosure/Securities Laws – If “Backdated” options are not properly disclosed in the periodic reports to shareholders required by the SEC, companies could face shareholder class action or pension plan lawsuits which could include charges of fraud, insider trading, or claims related to stock price drops. Restatements of financial results often precipitate shareholder claims.

Criminal and Civil Liability – Securities fraud for inaccurate reporting to the SEC, document forgery, or conspiracy charges are possible results of improper treatment of stock option grants. The SEC has authority to investigate companies and option recipients and may seek civil or criminal penalties. Spring-loading and bullet-dodging may raise risks of criminal and civil liability under laws prohibiting insider trading.

Fiduciary Duty – Officers and directors may be sued in derivative lawsuits for breaching their fiduciary duties in connection with the granting and improper reporting and other treatment of backdated options. Depending on the facts and circumstances, company indemnification and D&O insurance may not cover such liability.

New SEC Rules

New rules applicable to SEC reporting companies governing executive compensation disclosure will take effect December 15, 2006. Required disclosures will include the grant date of options, fair market value on the grant date, the closing market price and the strike price of an option on the grant date if the latter is lower, the date the committee or board took action to grant the option (if different from the grant date), and a description of the methodology for determining the option price if it varies from the closing market price on the grant date. Narrative disclosures written in plain English about the compensation of the principal executive and financial officers will also be required.

What About Private Companies?

While the current focus on employee stock option practices is of greatest concern to “public companies” (i.e., companies with stock trading on a national exchange or quotation system who are subject to SEC disclosure rules), private companies may be wise to review their own practices. Among other things, the tax rules regarding deductions and other treatment of options are the same for private companies in that options must be granted at fair market value to qualify for favorable treatment. Private companies have an additional burden of often having to determine such fair market value without reference to any public market for their shares. Directors and officers of private companies are also subject to fiduciary duties which may be implicated by option granting practices.

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