

Backdating Controversy Likely to Encourage Development of Option Grant Best Practices

By Paul J. DeRosa

The timing was perfect. As if further impetus for reform were required, the option timing controversy erupted in the midst of the comment period for the Securities and Exchange Commission's ("SEC") new rules for disclosure of executive pay.

The public outcry has been loudest around the issue of backdating (fabricating an option grant date prior to the relevant approval date to a low point in the company's stock price so that the option is immediately "in-the-money"), but other more subtle practices have emerged too. These include "spring loading" (granting options just before the public announcement of positive corporate news) and "bullet dodging" (granting options after the public announcement of negative corporate news).

The practices appear to have been common. One recent study estimates that 18.9% of "unscheduled, at-the-money" options granted to executive officers between 1996 and 2005 were backdated or otherwise manipulated. Dozens of companies are currently under investigation by the SEC or are the subject of shareholder lawsuits.

Notwithstanding the public outcry, there is nothing inherently illegal in choosing a particular date as the basis for an option's exercise price. The wrongful action is the failure to disclose, account for or tax the relevant transaction properly. This can result in the following problems, among others:

- The potential understatement of compensation expense under applicable accounting rules which may require companies to restate their earnings;
- Potential securities law fraud based on the falsification of financial records and the filing of materially misleading financial statements and compensation disclosure with the SEC;
- The loss of potential tax deductions because discounted options do not qualify as performed-based compensation under applicable tax rules;
- Potential tax liabilities for the recipient under new laws that tax discounted options as they vest and impose an additional 20% tax; and
- Potential breaches of the company's stock option plans and violations of applicable stock exchange rules.

It already seems clear that recent changes in the law limit the potential for these types of manipulative practice in the future. According to one recent report, the two-day accelerated reporting requirement for insider option grants that became effective in August 2002 has reduced the occurrence of options backdating by half. Likewise, the heightened liability provisions of the SEC's new rules on executive pay and the greater transparency they will bring to the compensation process will force boards, compensation committees and the company's certifying officers to pay much closer attention to this type of issue in the future. For example, the new rules include a specific requirement that companies discuss and analyze their policies with respect to the timing and exercise prices of option grants.

The financial impact of the controversy on companies may turn out to be small compared to the reputational damage inflicted. Its effect over the long term will likely be the development of option grant best practices to mitigate future risk as well as to create a framework for disclosure in a company's proxy statement under the new rules on executive pay.

Some of the practices companies might consider include:

- Developing written procedures to ensure that the program is administered in accordance with all relevant documents;
- Granting options on a predetermined basis at regular intervals to eliminate the element of discretion that potentially gives rise to manipulative timing practices;
- Limiting grants to the company's "open window period", and avoiding grants if the company is otherwise in possession of material information;
- Taking all required corporate action at meetings and eliminating the use of written consents which create discount issues if executed consents are not received until after the purported grant date;
- Ensuring that the compensation committee has adequate time to review the proposed grants in advance of the approval date; and
- Documenting decisions and preparing the necessary grant instruments promptly following grant approval.

The irony is that it takes a scandal to remind us what should have been done all along in the first place.

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