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Stock Option Issues Lead to SEC Investigation, Restatements and Litigation

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Introduction

The practice of backdating a stock option's grant date was first brought to widespread public attention in a November 11, 2005 article in *The Wall Street Journal*. The article followed the resignation of three officers at Mercury Interactive Corp. for manipulating stock option grant dates. The article also identified three other companies who had publicly disclosed that their stock option grants were being investigated by the SEC. Since that time there have been several other articles in *The Wall Street Journal* and several studies by financial research centers, including the Center for Financial Research & Analysis, which identified additional companies who granted stock options on days particularly beneficial to the grant recipients. Although these articles and studies do not affirmatively state that backdating occurred, they have been sufficient to cast doubt on the identified companies. The issue has grown to involve over forty companies, with at least thirty-eight disclosing investigations by the SEC and/or the United States Justice Department and at least six companies announcing executive or director departures because of improper stock option grant dates. In addition, many companies and their directors have been sued in civil actions, and just recently the California Public Employees' Retirement System sent letters to twenty-five companies asking them to investigate allegations of backdating stock options and respond publicly. So how did the dating of stock option grants become the next big corporate scandal, and just how important is it to public companies to understand the ramifications of the scrutiny of grant practices?

How Does Backdating the Grant Date of Stock Options Work?

Stock options are commonly given by a company to an employee or a director in addition to their regular salary. An option gives the recipient the right to buy stock at a fixed price, which is called the strike price. If the market price of the stock is higher than the strike price, options are "in the money" and the holder of the options can buy the stock at a lower price than available in the market. "Out of the money" options have a strike price that is higher than the market price.

Stock options are designed to tie the financial gain of an individual employee or director to the financial gain of the company's shareholders, thereby giving employees or directors an incentive to perform their jobs well. Granting stock options became more popular and widespread during the internet boom when cash-poor companies used stock options to compensate for lower salaries. As the stock market boomed in the mid-to late 1990s, many of these stock options became extremely valuable.

The strike price of stock options is usually set as the opening, closing or average price of the stock on the day of the grant. By backdating a stock option's grant date, recipients are able to cherry pick an earlier date when the stock was trading at a lower price, thus creating a lower strike price and an instant paper gain on the actual date of grant. This practice, while not *per se* illegal, can produce serious financial statement and tax consequences and violate the securities laws depending on how the stock option grants were disclosed and accounted for.

The backdating furor has extended to the granting of stock options on the eve of favorable news relating to the company. In these cases, the stock option has an exercise price that is arguably at-market on the grant date, but option recipients have received a benefit as a result of favorable timing. This practice could trigger allegations of corporate waste and insider trading, as well as tax and accounting consequences if the timing supports a determination that the exercise price was below-market on the grant date. According to statements by SEC officials, undisclosed compensation to stock option recipients may lead to violations of the securities laws.

Sources of Liability

As the investigation into dating of stock options has unfolded, the press, not the government, has led the way. Newspapers and financial research groups conducted mathematical studies of companies that consistently granted stock options with a strike price very favorable to the recipient, often near lows in the stock's price. The names of these companies were then published. While a particular company may have done nothing improper, the higher the correlation between the dates of stock option grants and the lows in a company's stock price, the greater the suspicion that backdating was involved. The government investigations and civil lawsuits (both shareholder derivative actions and securities class actions) have followed quickly on the heels of publication. In such circumstances, an internal review of option granting practices with the aid of independent counsel and forensic accountants often is required. This course of events presents a special difficulty to companies because the imprimatur of scandal, and corollary decline in share price, may occur before there is time to react to the problem.

Accounting for Stock Option Grants

As mentioned above, backdating a stock option's grant date is not *per se* illegal, nor is timing option grants before favorable news. Companies get into trouble because of the way they account for it and how they disclose it. Granting stock options to employees or directors is a cost to the company and affects its net revenue. If a company bases its net revenue calculations on the incorrect grant date, *i.e.* the backdated date instead of the actual date, or the grant date is correct but is timed to occur before favorable news, it runs the risk of overstating its net income (because the full value of any below-market exercise price counts as financial expense). If this overstatement of income is a quantitatively material amount, or there are qualitative factors present stemming from misconduct that require the overstatement to be treated as material, the company will have to restate its past financial statements. This calculation may be the difference between a company that escapes relatively unscathed and one that will have to endure government investigations and civil lawsuits.

For example, Analog Devices announced that using the proper grant dates would have reduced its net income over a several year period by $21.8 million. However, the company concluded this was not a material amount given its net revenue of $2.5 billion over the same period and therefore past financial statements would not have to be restated. Analog Devices announced a tentative settlement with the SEC pursuant to which it will pay a $3 million penalty and submit to an investigation by the Department of Justice. It has not announced the filing of any lawsuits against the company.

On the other hand, Vitesse Semiconductor Corporation announced that it would have to restate over three years of financial statements due to improperly accounting for stock option grants. Since that time numerous lawsuits, both derivative actions and securities class actions, have been filed against the company and its directors, its CEO and CFO have been fired, and the SEC and Justice Department have launched an investigation.

Public Disclosure of Stock Option Plans, Grants, and Practices

In addition to public statements and filings that disclose the cost or value of a stock option grant, many companies publicly file their stock option plans as attachments to SEC filings, including their annual reports and registration statements, and otherwise disclose grants in required proxy statement disclosure. If stock options were not granted in compliance with those plans, there may be liability under the securities laws for misrepresentations. SEC Chairman Christopher Cox has warned that its disclosure rules will extend to the details of the dates on when options were granted and priced. In a speech before the New York Financial Writers Association, Chairman Cox said, "[w]e propose to tell Compensation Committees to release all material information regarding their decisions, and we mean all." He also said that "[w]hile I can't comment on the SEC's ongoing investigations of specific companies, I can tell you what the Commission's position is. Back-dating must be fully disclosed. And the granting of back-dated options must be properly accounted for."[1]

There may even be grounds for invalidating the grants, if the backdating involved fraud or if the underlying plan did not authorize grants with a below-market exercise price. Just last week, the special litigation committee that Mercury Interactive Corp.'s Audit Committee formed to investigate option backdating announced its recommendation that vested and unexercised option grants to the Company's former Chairman and CEO should be voided "to the extent such options are found by the Special Committee to have been dated improperly."[2]

Tax Problems

Stock options whose backdating results in a deemed below-market exercise price would be disqualified from otherwise available exemptions from Internal Revenue Code section 409A and 162(m). An IRS staff attorney identified precisely these two risks in a June 6 speech at the American Institute of Certified Public Accountants' executive compensation conference. Specifically, the loss of a 409A exemption would subject the option holder to additional taxes for as long as the option remains outstanding. The amount of those taxes would start at 20% of the option's in-the-money value that is attributable to each year. On the other hand, the loss of an IRC section 162(m) exemption would deprive a public company of a tax deduction to the extent a named executive officer (for proxy statement purposes) receives taxable income exceeding $1 million in a calendar year as a result of exercising the stock option.[3]

D&O Insurance

Insurance companies have also reacted to the scandal. AIG and Marsh have separately been notifying insured companies about the importance of allaying concerns about backdating problems. They are looking for disclosure of option grant practices, including:

- whether a company's procedures preclude backdating or have resulted in past backdating;
- whether there are consistent dates for grants, such as at the annual meeting (thereby reducing the likelihood of manipulation); and
- whether the company has engaged in an internal review of its grant dating, both before and after the Sarbanes-Oxley Act.

These inquiries promise to reward companies for proactive measures, and to create awkwardness and risk for those that have engaged in questionable practices, are not forthcoming, lack solid structures, or have not reacted diligently in response to the backdating furor.

What Can Companies Do?

While the government investigations and the civil actions are at their beginning stages, there is evidence that even the mere suspicion that a company backdated its stock option grants is enough to cause a decline in the company's share price. It is paramount that companies avoid even the appearance of impropriety. At a minimum, companies should consider the following steps to minimize their risk:

- Review how it grants stock options and make sure that stock option grants are accounted for and disclosed properly;
- Alert audit and compensation committees of steps they can take to identify past problems and to avoid future ones;
- Avoid granting stock options immediately prior to the release of favorable news that may raise the share price; and
- Establish regular dates throughout the year for granting stock options.

While backdating stock options may not ultimately lead to criminal trials and bankruptcy, it is clear that it is a serious issue that many companies face. It is also clear that the government investigations and civil lawsuits will be expensive and time consuming for many companies – and that companies should now be taking the initiative to evaluate and contain their risk.

NOTES

[1] Speech by SEC Commissioner: Address to the New York Financial Writers Association by Chairman Christopher Cox, June 8, 2006.
[2] See SEC Form 8-K filed by Mercury Interactive with the SEC on June 9, 2006.
[3] "Final Section 409A Regulations to Include Expanded Guidance on Stock Rights" (BNA Pension & Benefits Daily, June 9, 2006).

If you have any questions or concerns about how SEC options issues can affect your business, please do not hesitate to contact any of the following Paul Hastings lawyers:

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