Backdating Stock Options: In the Money And Under Investigation

What the Government Is Doing and What You Should Do in Response

By William B. Mateja, Esq., and Lezlie B. Willis, Esq.*

With the recent criminal and civil cases filed against former executives of Brocade Communications Systems Inc. and Comverse Technology Inc., the backdated-stock-options inquiry has reached new heights. But with more criminal charges expected against other companies, these cases are just the beginning of the federal government’s concerted efforts to enforce proper reporting of and accounting for certain companies’ past practices.

The Securities and Exchange Commission is investigating more than 80 public companies, and the Internal Revenue Service is auditing as many as 40 businesses for improperly reporting backdated stock options. The SEC and the IRS are only beginning to coordinate their efforts in investigating the scope and breadth of the backdated-stock-options scandal. In other words, the storm is only beginning to brew, so the consequences for public companies are difficult to quantify just yet.

How Did This Problem Arise?

To protect yourself and your company, you first have to understand what the phrase “backdated stock options” means. It is simply a shorthand term for various practices that companies allegedly engaged in that could have adverse legal consequences. Generally speaking, it refers to any practice that results in the exercise price of the shares at the time of the grant being less than the fair market value of the shares at the time of the grant.

This circumstance can arise in many different ways, but the practices currently drawing the attention of the SEC and the IRS include:

- Selecting an exercise price that is based on a market price existing before the date of the option grant;
- Awarding options that permit the holder to exercise them at the lower of the price on the grant date or the stock’s lowest price during a certain period of time after the grant date;
- Preparing or modifying option documents to show a lower exercise price than the market price on the actual grant date;
- Treating a date as the grant date when all the prerequisites to a grant had not occurred by using an “effective as of” grant date;
- Using a grant date that is prior to the date of the compensation committee meeting issuing the options; and
- Using a grant date that is before all signatures were received if the options are granted via unanimous written consent in lieu of a meeting.
Any of these practices are likely to trigger the interest of the IRS and the SEC. It must be noted though that backdated stock options that have been properly reported and accounted for are neither illegal nor improper. What the companies embroiled in the current investigations share is that they may have fallen short of the proper accounting and reporting standards of the SEC and IRS. This happens primarily because properly reporting and accounting for backdated stock options is generally detrimental to the granting company as well as to the executives and employees receiving the options.

What Exactly Is the Problem?

To be completely free from scrutiny, an option’s exercise price should be the same as the fair market value on the day of the grant. When this happens, the option does not have any inherent value. In other words, it is not “in the money.” By contrast, when options are granted at an exercise price that is lower than the fair market value of the option at the time of the grant, the option already has some intrinsic value and is, consequently, “in the money” or “discounted.”

This makes for a staggering difference in the amount of gain a person can obtain when exercising an option. For instance, if an executive is granted 10,000 options of stock at a strike price of $20 and exercises the option a year later when the stock has risen to $50 a share, that would net the executive a profit of $300,000. If the grant date is altered to show it was a month earlier when the price was just $10, exercising the options would yield an additional $10,000 profit. So the stakes are high, and for many executives, the amount of money at issue is significant.

From an accounting perspective, this creates an immediate compensation expense for the company that should be reflected in its financial statements filed with the SEC. If the options are not included as an expense, the company’s earnings could be inflated, which creates a myriad of securities law problems.

From a tax perspective, an option that is “in the money” or “discounted” exposes the executive to adverse tax consequences. These include substantial additional taxes as well as penalties and interest under the terms of the Internal Revenue Code accrued from the date of the grant or the date of vesting, even though the executive does not actually exercise the option until years later. Likewise, “in the money” options may cause the company to exceed the limits on deducting expenses for executive compensation.

Facing the Consequences

The two primary legal problems that backdated stock options create arise from both securities and tax laws. The problems can be addressed in various contexts, including administrative and regulatory actions, civil lawsuits brought by the government or by individual plaintiffs, or criminal investigations and prosecutions for securities and tax fraud. For publicly traded companies under investigation, there is little doubt that the consequences will include action by the government as well as stockholders, creating a high-stakes situation with a hefty price tag.

Consequences Under U.S. Securities Laws

Perhaps most obviously, backdated stock options almost always cause an overstatement of a company’s earnings, with compensation expenses understated. Depending on how significant the overstatement, investors can be misled about a company’s financial condition.

Companies faced with concerns raised by backdated stock options may find a restatement of their earnings is necessary. Of course, this is not an easy task that can be completed quickly. Slow progress on correcting misstatements, coupled with ongoing investigations, can result in significant delays that could even affect a company’s ability to file current reports and disclosures with the SEC. Delayed filings can lead to the delisting of a company’s shares, a most troubling development for any business.

Misstatements can also lead to a violation of Section 10(b) of the Securities Exchange Act of 1934. And, assuming a company’s CEO and CFO have certified the accuracy of the financial statements, they may have violated Section 906 of the Sarbanes-Oxley Act of 2002. Similarly, Section 302 of Sarbanes-Oxley requires certifications of disclosures in SEC filings. Violating either Section 302 or 906 carries the possibility of criminal penalties.

Certain options practices could also give rise to a colorable claim for insider trading. If an executive is granted options right before the company announces favorable information that causes a spike in stock price, this could logically lead the SEC to believe that there was insider trading afoot.

The government might not be these companies’ only concern. They might be addressing these issues with private litigants as well. Misstatements and accounting irregularities can lead to class actions and shareholder derivative lawsuits that claim damages arising from the misstatements on behalf of shareholders and the corporations themselves. Already, companies under investigation have
been faced with this reality. Investors’ lawsuits can be difficult to deal with when a company is simultaneously addressing the government’s concerns and working to avoid civil and criminal penalties.

Consequences Under U.S. Tax Laws

While investigations into backdated stock options appear to have been spearheaded largely by the SEC, tax concerns are part and parcel of the inquiry. Because of this, the IRS is beginning to investigate the facts and circumstances of stock-option grants and how they may have affected tax filings. No actor is immune from examination, as this situation creates problems for companies, executives and employees alike.

Under Section 162(m) of the Internal Revenue Code, a public company may deduct up to $1 million for compensation paid to the CEO and the four highest-paid officers other than the CEO. An exception to this is if the compensation is, generally speaking, “performance-based.”

Stock options are exempted from this limit as long as the exercise price is equal to the fair market value of the stock on the day of the grant. In other words, if the compensation is performance-based, as stock-option compensation generally is, the compensation arising from exercise of the options is exempt from the $1 million limit and is fully deductible.

It must be pointed out, however, that to be exempt from this limit, the stock options cannot be “in the money.” If they are, the compensation attributable to such options may not be considered “performance-based” as that term is interpreted. Consequently, if options are “in the money,” at least the “in the money” value of the options will be counted toward the $1 million limit on a company’s deduction for executive compensation. Companies that have backdated stock options face audits and a disallowance of the large deductions attributable to the stock-option grants, as well as potential interest and penalties.

Section 409A of the Internal Revenue Code governs how nonqualified deferred compensation is taxed. Most stock options currently under scrutiny will be considered “nonqualified deferred compensation” under the Internal Revenue Code. Section 409A excludes these types of stock options from taxation but only if the exercise price is set at an amount that cannot be less than the fair market value of the stock on the date the option is granted. Unless an “in the money” option fixes the payment date, which would generally be inconsistent with giving the holder the right to choose when to exercise, it is not excluded from taxation. Under Section 409A, the recipient of a discounted option is subject to significant taxes, penalties and interest from the date of option vesting.

Furthermore, this provision applies to all companies, not just publicly traded ones, which makes compliance with Section 409A a concern for all businesses, regardless of whether they are regulated by the SEC.

Governmental Response

One thing is for sure: The government is not sitting by idly. Anxious to regain some of the momentum lost in the waning days of the corporate-fraud investigations, the government is attacking this problem with full force, as recent developments show.

Securities and Exchange Commission

The SEC voted July 26 to adopt changes to the rules on how executive compensation is reported in a company’s filings. These changes were prompted in significant measure by the current spate of backdating investigations and were part of a broader change regarding the rules about disclosing executive compensation. SEC Chairman Christopher Cox said in a recent press release that “with more than 20,000 comments, and counting, it is now official that no issue in the 72 years of the [c]ommission’s history has generated such interest.”

Under the new rules covering executive compensation, companies will be required to disclose, in tabular form, certain information about option grants, including the fair value of the stock on the grant date, the grant date under Financial Accounting Standard 123R, the closing market price on the grant date if the price is greater than the exercise price, and the date the compensation committee or the full board of directors took action to grant the options, if the date is different than the grant date.

Also, the new rules require companies to describe the methodology used to determine the exercise price if the exercise price of an option is not the closing price per share on the grant date. In the narrative portion of a company’s disclosures, there must be an analysis and discussion of certain material information, including why the company selects certain dates for awarding stock options and how it determines the exercise price of the options it grants.

Further, companies will have to answer a number of specific questions about their policies and practices regarding granting stock options, including, but not limited to:

• Does a company have a program to time option grants in coordination with the release of material, nonpublic information?
How does the company's plan for granting options to executives fit in with its plan for granting options to employees?

What role did the compensation committee have in making the grant? and

What role did the executive officers have in the company's timing for granting options?

Public Company Accounting Oversight Board

The Public Company Accounting Oversight Board, a private corporation under the SEC's jurisdiction, was created by the Sarbanes-Oxley Act of 2002 to oversee the auditors of public companies to protect investors and the integrity of audit reports. Recently, the PCAOB said it would issue “audit practice alerts” to “highlight new, emerging or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the PCAOB standards and relevant laws.”

The first alert was issued July 28 and directs auditors to be particularly aware of the possibility that a company might not have properly accounted for stock-option grants. The PCAOB has directed auditors to be mindful of how discounted options should be accounted for under various established accounting standards, whether any accounting might be considered a material issue, and whether the company or its executives engaged in illegal acts surrounding the grant of stock options. The alert further reminds auditors that if improprieties are found, the auditor must adequately inform management and the audit committee.

Notably, the alert requires auditors to take certain actions if they become aware of information relating to previous financial statements that could affect their accuracy. The same is true if the auditor comes across information that, if known at the time of the prior financial statements, would have caused the auditor to reach a different result or to investigate further.

This provision in the audit practice alert is likely to cause auditors and their clients some consternation as more facts about specific companies' practices come to light and as auditors make it clear that they must raise the historical issue in their reports. Consequently, this provision will likely encourage most companies to engage in an independent investigation and report the issue to auditors and regulators instead of forcing an auditor to issue an unfavorable report about historical practices.

Internal Revenue Service Task Force

The IRS announced on July 31 that it had formed a five-member task force to audit companies and executives who may have granted and received backdated stock options. The agency has reported that between 30 and 40 businesses are under examination as a result of public reports by companies and the SEC. The IRS said its examinations will likely focus on nonqualified stock-option plans. IRS Commissioner Mark Everson made it clear that the agency will work hand-in-hand with the SEC, so companies under SEC scrutiny should expect a call from the IRS as well.

Department of Justice

Recent reports indicate that the Department of Justice has issued subpoenas to at least 35 companies regarding their option-granting practices. In what promises to be the first of many criminal actions, the U.S. attorney for the Northern District of California brought a criminal complaint against former executives of Brocade Communications Systems in late July.

According to the criminal complaint, the defendants allegedly:

- Backdated meeting minutes so it appeared that the compensation committee met and granted stock options when Brocade's stock price was low when in reality, there was never a meeting and the options were not granted on that date; and

- Backdated employment offer letters so that certain employees could be given stock options when the market value of Brocade's stock was relatively low, even though the certain employees were not actually employed by Brocade on the grant dates.

What Should You Do?

In hindsight, trouble spots are fairly easy to identify. The key is how to move forward. Many companies have engaged, or are in the process of engaging, counsel to investigate their past option-granting practices. Obviously, this investigation should be independent so that government regulators and outside auditors will be more likely to rely on the results of the inquiry.

The investigation should be undertaken with outside counsel and directed by the audit committee, independent directors, or other members of the board who were not involved in administering or granting stock options. Optimally, the outside counsel should be a firm that was not previously involved in providing legal advice to the company and certainly should be independent from counsel who may have advised the company about its
stock-option practices. This is perhaps the best way to build credibility with the SEC.

The investigation should be a well-documented inquiry into the company’s historical policies and procedures of granting stock options. This should include general information about a company’s policies and practices, as well as the facts and circumstances surrounding the grant of options to specific individuals. One of the biggest issues emerging in this kind of investigation is that while a company may have had specific and proper policies, they simply were not applied, or if applied, done so in an inconsistent manner.

To prepare for a possible inquiry, companies should immediately take steps to ensure that all documents and electronic records relating to the granting of stock options are protected so they are neither destroyed nor altered in any fashion. Because this problem can arise in many different ways, any investigating agency is likely to review all corporate and financial documents relating to the grant and will be interested in the contemporaneous understanding of the various executives and other corporate managers. A company should be prepared to address these topics as necessary.

Should an investigation reveal questionable option-granting practices, careful consideration should be given to the appropriate response, as there is no one response that will fit all cases. Some companies are choosing to voluntarily report problems and make appropriate filings with the SEC, particularly if the practices may have led to material misstatements. Others might choose not to disclose if the option practices did not have a material effect on the historical accuracy of SEC or IRS filings. As in most cases, determining the best medicine depends upon how sick the patient actually is.

Moving forward, all companies — even those that have not engaged in any historical backdating of options or any other questionable behavior relating to their option-granting practices — will benefit from improved policies and practices on options. Specifically, although not necessarily required under the law, companies should consider implementing the following kinds of recommended best practices:

- Implement clear policies for granting stock options and follow them precisely;
- Keep precise, timely records of granting stock options;
- Avoid granting stock options by consent in lieu of a meeting, which makes it very difficult to ensure that all signatures are obtained properly. Instead, if an in-person meeting is impossible, grant options through conference calls, and document the minutes and awards that same day;
- Do not grant stock options before the date of an employee’s hire;
- Do not grant stock options on an “as of” basis in the past;
- Do not grant stock options on the eve of any news announcement that will favorably affect the market for the company’s stock;
- Avoid delegating the authority to grant options to one or more of the company’s officers. That authority should stay with the compensation committee or the board;
- Give notice of the option grant to the recipient as soon as possible;
- Implement a compliance plan that includes training to ensure that all affected members of management and employees understand the company’s policies and at least the fundamental legal concepts on which they are based; and
- Consider examining other equity-based types of executive compensation. While stock options are in the headlines today, similar issues may arise for other equity-based forms of compensation in which the timing or value of the grant is connected to the value of the award.

Every day it seems that new companies are being added to the ranks of those that have publicly admitted to questionable stock-option practices. Some pundits are predicting that this spate of investigations is the next big corporate shake-up, while others disagree.

Only time will reveal the magnitude of the problem and the consequences. In the meantime, companies should closely consider how the scandal might impact them and what the best response should be.
Notes


* Bill Mateja is a principal in the Dallas and Washington law offices of Fish & Richardson, where his practice focuses on white-collar defense, government investigations, securities litigation and business litigation. He previously spent 13 years with the U.S. Department of Justice. His last position was as senior counsel to the deputy attorney general in Washington, where he oversaw the Justice Department’s white-collar-crime efforts, including its corporate and health care fraud efforts.

Lezlie Willis in an associate in Fish & Richardson’s Dallas office, where her practice focuses on all types of complex white-collar criminal defense and commercial litigation.