Corporate and Securities Update — August 18, 2006

Employee Stock Option Grants: Emerging Issues and Best Practices

Introduction

Following intense media scrutiny of so-called “backdating” of employee stock options and other issues regarding the timing and pricing of stock option grants, both the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) have brought civil and criminal actions against several public companies and individuals. Additionally, the SEC recently adopted new executive compensation disclosure rules, which include additional disclosure requirements concerning the granting of options. In light of this spotlight on stock option grant practices, public and private companies should examine their stock option granting and pricing practices with a critical eye to ensure the legality and propriety of their practices and procedures in this area. This Client Alert provides background on the practices that have been called into question, explores issues that arise from these practices and suggests best practices that companies can follow to address or avoid these issues.

Background

Stock options, which are often granted to directors, executives or employees as part of their compensation packages, are simply grants of the right to purchase stock at a particular price (typically called the “exercise price” or “strike price”). When a company grants an option, it usually sets the exercise price at the open market price of the underlying stock on the date the grant is made. In that case, immediate exercise would yield no value and the option is considered “at the money.” When the market price of the stock exceeds the strike price, however, the options are “in the money”; if this occurs when the option is granted, a benefit has been conferred on the grantee of the option that exceeds the grant of an option at the fair market value of the stock. If the market price is even higher when the option becomes exercisable, the grantee will reap a greater benefit upon exercise than if the exercise price had been the same as the market price at the date of grant.

Practices in the area of stock option granting and pricing that have been called into question typically fall within four general areas:

**Backdating:** Stock option backdating involves the assignment of a grant date to an option that is earlier than the actual date of the option grant (i.e., the effective date of the corporate action granting the option). As a result of grant date manipulations, the exercise price can be below market (a “discounted option”) and in the money. Backdating can result from any number of practices (some intentional and others not), such as:

- the designation of a prior or “as of” date as the exercise price in the option grant;
- the retroactive change of the grant date assigned to an option after the date of the actual grant;
- the selection of the lowest price in a designated period (such as any time during the prior 30 days or the current quarter) as the grant date for an option;
- the circulation of a unanimous written consent that assigns a grant date that is prior to the date that the last signature is obtained (thus creating a period of delay between the assigned grant date and actual date that the grant is formally authorized under some state corporate laws); or
- lack of proper procedures or oversight with respect to the exercise of delegated authority that creates or exacerbates issues such as those above.

**Spring-Loading:** Like backdating, spring-loading involves the potential manipulation of the strike price to ensure that options almost immediately become “in the money” after the grant, even though the grant date accurately reflects proper corporate action. In spring-loading, the date of the actual option grant or the effective date for the grant of the option is set at a date shortly before the public announcement of favorable information concerning the company. The option-holder thus receives the benefit of an immediate upswing in the market price of the stock once the information is released.

**Bullet-Dodging:** A practice similar to spring-loading, bullet-dodging involves waiting for the public announcement of unfavorable information concerning the company before granting options or setting the exercise price for an option.
prospectively as the price on a date that follows the release of negative information. In this case, the option strike price is tied to a market price depressed by the bad news announced by the company, thereby avoiding an immediate “out of the money” status that was foreseen.

Procedural Failures: In addition to these specific practices, attention has also been focused on more general failures of companies to follow board and committee procedures by misdating or modifying board or committee resolutions or consents, grant notifications or option agreements or a breakdown in oversight of the committee or individual who grants options. These shortcomings may be the result of sloppiness or be deliberate manipulation of grant dates.

The Issues

Many of the practices swept within the general description of option backdating standing alone are not illegal. However, there are a host of issues in numerous areas of the law that arise from the manner in which a company authorizes, discloses and accounts for such actions. The failure to understand and take account of these issues can lead to substantial risks of liability and litigation. Following are some of the major issues relating to the timing of option grants:

Accounting and Financial Reporting Issues:

Restatement Risks: Until they were superseded in 2006 by FAS 123(R), most companies accounted for stock options under Accounting Principles Board Opinion 25 (APB 25) and Financial Accounting Standards Board Interpretation 44 (FIN 44). Under these rules, a company was not required to take a charge against earnings at the time of an option grant if the exercise price was not less than the market price of the stock on the date of the grant. However, the granting of options at a price below fair market value creates an immediate compensation expense that the company must charge against earnings. If compensation expense resulting from options backdating has not been properly reflected in a company’s financial statements, depending on the materiality of the resulting charge against earnings, the company could be required to restate its compensation expense numbers or other financial statements for prior years to reflect such charges. Moreover, because such compensation expense is recorded over the applicable vesting period of the option, a single occurrence of improper dating for which compensation expense has not been recorded could impact financial statements that covered several years.

Audit Issues: Companies should be aware that in connection with their prior year audits and quarterly reviews, they were likely required to make representations in their management representation letters to auditors regarding compliance of financial statements, lack of fraud or sufficiency of internal controls, which could be called into question if material issues concerning backdating come to light. Auditors are likely to focus more sharply upon option issues in their audits of company financials. It is possible that independent accounting firms may begin routinely asking companies to make additional representations concerning their option granting practices or to represent affirmatively that they have not granted any backdated options. On July 28, 2006, the Public Company Accounting Oversight Board (PCAOB), an oversight board created by the Sarbanes-Oxley Act, made timing and accounting for option grants the subject of its first staff audit practice alert. The alert provides guidance to auditors of public companies on how to handle audits of financial statements and internal controls if improper accounting of options grants is discovered. It urges auditors to examine the effect on ongoing or future audits of matters relating to options, the auditor’s involvement in registration statements when option issues are present and the effects of option-related issues in previously issued opinions.

Corporate Governance and Authorization Issues:

Potential Invalidity under Stock Option Plans: Many stock option plans require that stock options be granted with an exercise price no lower than the fair market value of the stock on the date of the grant. Improperly dated option grants resulting in an exercise price lower than that required by the terms of the applicable option plan could be characterized as grants made outside the plan or as an effective amendment of the option plan itself to allow for such discounted options. This in turn could lead to claims that the issuance of the options may not have been properly authorized by the company, the issuance may have violated securities law registration requirements and the issuance may have violated the stock exchanges’ rules requiring shareholder approval of option grants. Alternatively, it could be claimed
that the plan provisions requiring the fair market value exercise price were incorporated by reference into the grant and thus require an upward adjustment of the exercise price to the stock price on the actual date of grant. This could give rise to a claim of damages by the applicable employee based on his or her reliance on the terms of the grant.

**Corporate Governance Issues Generally:** Backdating, misdating and other associated irregularities in the granting of stock options could lead to claims that a company’s corporate governance suffers from general deficiencies and can signal potential problems with its internal controls. As discussed further below, such deficiencies can in turn be the source of further liability under the securities laws and expose the company to the risk of shareholder derivative litigation.

**Investor and Rating Agency Relations Issues:** In this highly charged environment, companies must be vigilant in planning for potential questions and challenges from investor groups and other constituencies with respect to their options practices. Several institutional investor groups, such as the Counsel of Institutional Investors and the AFL-CIO, have issued letters to a large number of public companies requesting information and assurances concerning option granting practices. Another risk arising from investigations, civil and criminal proceedings, restatements of financial statements and related issues under the securities laws is the potential for ratings agency downgrades. A ratings downgrade could trigger defaults under a company’s key debt and financing agreements and adversely impact the company’s borrowing or capital raising activities.

**Securities Disclosure Issues:**

**Potentially False or Misleading Disclosures:** Information concerning a company’s stock option plans and grants under those plans are required to be disclosed in various filings with the SEC, including a company’s proxy statement and periodic reports. If inaccuracies or irregularities in the option granting process cause such disclosures to be false or misleading, particularly if accounting or other issues require restatements of historical financials, the company could be in jeopardy of violating the antifraud prohibitions of Section 10(b) of the Securities Exchange Act of 1934. Additionally, under Sections 906 and 302 of the Sarbanes-Oxley Act, a company’s CEO and CFO are required to make certain certifications concerning the financial condition of the company and the sufficiency of its internal controls. Irregularities in the option granting process can call into question the accuracy of those certifications. Willful violations of these Sarbanes-Oxley provisions can result in criminal penalties.

**SEC Filing Delays and Current Reports:** If a company is required to restate its financial statements because of inaccuracies in its accounting for backdated options or is the subject of an investigation by the SEC or other governmental agencies, the company may not be able to file its Annual Report on Form 10-K or its Quarterly Reports on Form 10-Q in a timely manner. Restatements of historical financial statements generally require the filing of a Current Report on Form 8-K notifying the investing public that certain historical financial statements of the company may not be relied upon. Such restatements and the failure to timely file periodic reports can also lead to delisting of stock if the events violate the listing rules of the applicable stock exchange, or at least the need for a waiver from the exchange.

**New Disclosure Rules:** On August 11, 2006, the SEC released final rules requiring extensive disclosure of executive and director compensation, related-person transactions, director independence and various other corporate governance matters. The new rules require disclosure of company practices concerning the granting of options, including in particular the timing of option grants in coordination with the release of material nonpublic information and the selection of exercise prices that differ from the underlying stock’s price on the grant date. The required disclosures also include tabular presentations of the grant date, the approval date if different from the grant date, pricing data concerning option grants and a discussion of the methodology for determining the exercise price when it differs from the market price on the date of grant. Finally, the new rules require enhanced narrative disclosures about option grants to executives and company methodologies in selecting grant dates, terms of awards and exercise prices. (For a complete discussion of the Adopting Release and the revised disclosures, please refer to Schiff Hardin’s forthcoming Client Alert Memo on this subject.)
Tax Issues:

Granting discounted options can have various adverse tax implications, some of which are summarized here:

_**Incentive Stock Options:**_ An option granted for an exercise price of less than fair market value cannot qualify as an incentive stock option under Section 422 of the Internal Revenue Code, and is thus ineligible for favorable tax treatment accorded this type of option. An option mistakenly treated as an incentive stock option results in improper tax treatment for the optionee at exercise and underwithholding of taxes by the company.

_**Section 409A:**_ A discounted option will most likely result in a violation of Section 409A of the Internal Revenue Code, which means that vesting of the option could result in an income and excise tax liability imposed on the optionee and a withholding obligation imposed on the company.

_**Section 162(m):**_ A discounted option is not considered performance-based compensation and thus is not exempt from the $1 million cap on deductible executive pay. Thus, income recognized by the optionee at exercise will be counted as compensation for purposes of determining whether compensation exceeded the $1 million cap and may result in non-deductible compensation paid to one of the top five executives. An improper deduction could result in underreporting of taxes, subject to interest and penalties.

A company’s failure to properly treat an option under these tax provisions could result in a misstatement of income tax expense by the company for financial reporting purposes.

Litigation Risks:

_**Federal and State Agency Investigations and Associated Civil and Criminal Liability:**_ In recent months, the SEC, as well as the DOJ and the Internal Revenue Service, have been very active in initiating investigations into potential wrongdoing by companies in the area of stock option granting. The number of companies that are the subject of ongoing investigations by one or more of these agencies likely approaches one hundred at this point. Additionally, some state attorneys general have begun their own investigations concerning option granting practices. Discovery of improper accounting practices and misleading financial statements can be prosecuted under numerous federal and state statutes, as well as under various financial reporting and anti-fraud provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933. Conspiracy and mail and wire fraud prosecutions are also possible. Penalties under these prosecutions can include a wide variety of sanctions, including disgorgement of profits, civil monetary penalties and criminal fines, incarceration and bar from service as an officer or director of a public company.

_**Class action and shareholder derivative lawsuits:**_ Not surprisingly, class action and shareholder derivative lawsuits have often followed closely behind federal and state investigations and associated civil and criminal charges against companies and their executives. These private lawsuits allege breaches by company officers and directors of fiduciary duties and violations of anti-fraud provisions of the securities laws, and have sought disgorgement of profits, rescission, and restitution. Additionally, the inaccuracy of financial statements caused by backdating can result in claims by those who purchased the stock in the open market in claimed reliance on the earlier financial statements that now must be restated.

Best Practices

In view of the numerous issues arising out of option grant irregularities, we recommend that companies, executives and board members pay special attention to how they administer stock option plans. In particular, companies should consider adopting the following “best practices” procedures in this area:

_**Establish specific option granting policies and procedures and investigate practices:**_ If a company has not done so already, it should establish specific policies and procedures concerning the granting of stock options under its option plans and put in place internal controls to ensure that those policies are followed. Companies should undertake a review of their own stock option practices to ensure that there has been and will be compliance with existing policies. If a review raises red flags regarding option timing, it may be prudent to create a special committee of the board of directors comprised of outside directors with the
assistance of separate outside counsel to conduct an independent review of these practices. Many companies that have discovered problems have taken a pro-active approach and self-reported to the SEC before the SEC initiated inquiries.

Avoid Certain Practices Likely to Raise Concerns: Perhaps the most obvious practice to avoid is the backdating of an award grant or granting an option with an “as of” date that precedes the actual grant date. Additionally, companies should ensure that all material terms of an option grant (including the grant date and exercise price) are established at the time of board or compensation committee approval. Do not “fill in the blanks” at a later point or circulate a consent for signatures with the details of the option grant to be completed later. As a matter of established policy, the grant date should be the same as the authorization and approval date and companies should require that the strike price of options be “at the money.” There should be strict compliance with the terms of the applicable option plan.

Consider Instituting Regularly Scheduled Grant Periods: Adhering to a pattern of making grant awards in the same time frame each year, such as the regular annual meeting of the compensation committee (with the meeting date scheduled well in advance), reduces any implication of impropriety to the extent that grants coincide with disclosures of material information concerning the company. Exceptions could be made for new hires, for which individualized option grants would be necessary, but the company’s practice in this regard should be consistent. For example, these grants could always be made at the first compensation committee meeting following hire with the grant date and exercise price determination date being the date of the meeting.

Consider Instituting Open Window Periods for Option Grants: Option grants in advance of favorable news or following unfavorable news can be made as long as the grants are made in accordance with the stock option plan and the company complies with the other legal requirements discussed above, such as proper accounting and tax treatment and appropriate securities disclosures. However, given the current environment in which even the slightest implication of impropriety can spark media scrutiny (or worse, investigations by governmental agencies), companies should consider timing the grant of options to decrease the likelihood that they will closely precede (spring-loading) or follow (bullet-dodging) a disclosure that is likely to affect the company’s stock price. For instance, to avoid granting options at stock price lows that might occur prior to an earnings announcement or other disclosure, a company could establish that grant dates will occur during “open window” periods immediately after annual or quarterly earnings announcements, when the amount and timeliness of material public information is likely at its greatest.

Record Keeping: Diligent creation and maintenance of records evidencing corporate actions in the options granting area is more important than ever. Particular attention should be paid to the due execution or authorization of grant awards by the board or committee making such grant awards. Companies should take extra care to ensure that grant agreements comply with the terms of the applicable option plan. If awards are approved by meeting or conference call, document the minutes and awards promptly.

Eliminate or Closely Monitor Officer or Single Director Grants: Companies should very carefully evaluate the extent to which option granting authority is delegated by the compensation committee or board to a single director or officer. If there is delegation, it should be closely monitored and the delegation should be subject to very specific conditions, parameters and record-keeping procedures, including written grants with a witness of signature. Authority should be delegated narrowly, it should be explicitly subject to the various rules and policies set by the company and the delegated actions should be subject to reasonable safeguards such as witness requirements. Additionally, executives should be prohibited from deciding for themselves the key terms of the options they receive.

Consider Eliminating the Grant of Options by Unanimous Written Consent: Companies should consider limiting the authorization of option grants to board or committee meetings, instead of authorizing grants by the circulation of unanimous written consents. This practice could assist in evidencing that the grants were made on an informed and deliberate basis, and may assist in satisfying enhanced disclosure requirements contemplated by the new disclosure rules discussed above. Under most state laws, actions taken by unanimous consent may not be deemed effective until the last director has signed the consent and other procedural requirements have been completed. Thus, to the extent that a company uses written consents as the means of authorizing option grants, there should be extra care to ensure that the effective date be the date of the last required signature and require that such signatures be witnessed.
Conclusion

The options backdating controversy has created a flurry of media attention and agency action. This Client Alert has given background on the practices that are currently being scrutinized, explored the various issues arising from those practices and provided some suggested “best practices” to assist in identifying and preventing these types of issues within an organization.

Schiff Hardin has organized an Options Task Force to assist clients in addressing the various options granting, dating and pricing issues that may arise. The Task Force is made up of experienced attorneys from multiple disciplines including Corporate and Securities, Employee Benefits and Executive Compensation, Tax, Securities and White Collar Litigation. The Task Force is ready to provide additional information and assistance in analyzing and resolving any issues that may arise with respect to a company’s option granting process.
For Further Information

If you would like to learn more about the subject matter of this memorandum, please contact any of the following attorneys or any member of the Corporate and Securities Group:

Darren C. Baker dbaker@schiffhardin.com 312.258.5538
Lauralyn G. Bengel lbengel@schiffhardin.com 312.258.5670
Allan Horwich ahorwich@schiffhardin.com 312.258.5618
Robert R. Pluth Jr. rpluth@schiffhardin.com 312.258.5535
Robert J. Regan rregan@schiffhardin.com 312.258.5606
Peter L. Rossiter prossiter@schiffhardin.com 312.258.5579
Michael K. Wolensky mwolensky@schiffhardin.com 404.437.7030

About Schiff Hardin LLP

Schiff Hardin LLP was founded in 1864. In the past 142 years we have grown to more than 350 attorneys, with offices in Chicago and Lake Forest, Illinois; Washington, D.C.; New York, New York; Atlanta, Georgia; and Dublin, Ireland.

This publication is for the general information of clients and friends of our firm. It does not provide legal advice for any specific matter. Readers should consult a lawyer directly for such advice. This publication, or parts of it, may be considered advertising material under professional conduct rules applicable to lawyers.

For more information visit our Web site at www.schiffhardin.com.

This article is also available on the Schiff Hardin Web site at www.schiffhardin.com/media/news/media.600.pdf.