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Client Alert

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for clients
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of the firm

July 2006

The Stock Option Controversy – The Scrutiny Escalates

The number of public companies subject to governmental scrutiny regarding their stock option granting practices increases every day. Even more companies are examining their practices at the urging of management, the board of directors, outside counsel or outside auditors. As the issue becomes dominant in companies across America, it is becoming clear that all companies should review and examine their stock option granting and pricing practices from the past and assure the legality and appropriateness of them prospectively. Companies must understand the potential consequences of, and the issues relating to, any stock option granting irregularities and be prepared to confront them.

Much of the attention has been focused predominantly on the "backdating" of stock options, but is expanding to an overall focus on the timing and pricing of stock option grants, including the use of unanimous written consents for approvals of options (and the date the option is granted in such case), "springloaded" option grants and the "as of" dating of stock option grants. It remains to be seen whether these practices are as pervasive across corporate America as suggested by the media and whether they are the result of intentional conduct or pure inadvertent "sloppiness" on the part of certain boards and management.

The Securities and Exchange Commission, the U.S. Department of Justice, federal prosecutors, and other regulators are all increasing their investigation efforts. Institutional investors and other shareholders are voicing their concerns and are likely to jump on the stock option bandwagon through civil lawsuits and increased activism in the executive compensation area. Many companies that have not yet addressed potential stock option issues will likely face stock option inquiries from their auditors in connection with the preparation of their June 30, 2006 Form 10-Q. As a result, virtually all companies need to consider now what actions, if any, should be taken with respect to their past and current stock option practices, regardless of whether the company is currently the subject of a probe.

This Client Alert will explore the nature of the stock option controversy and highlight the potential issues arising from the controversy. Answers to many of the questions that have arisen are still unknown and may vary greatly from company to company depending on the particulars of the plans involved, the actual circumstances regarding the prior grants and who was involved in the stock option process. While the focus has been on public companies, private companies may now have to confront many of these issues as well.

The Nature of the Stock Option Controversy: Timing and Possible Manipulation

As a result of various tax, accounting, corporate governance, institutional investor and other considerations, many stock option plans provide that options must be granted with a per share exercise price that is not less than the fair market value of a share of the stock subject to the option on the date of grant. Stock option "backdating" involves selecting a date of the option grant that occurs prior to the actual grant date (that is, the date of corporate action). While at times this occurs because of "sloppiness," it may have occurred in order to provide the option holder with an exercise price that is lower than the price of the stock on the actual grant date. This practice results in the grant of "below-market" or "discounted" stock options that are "in-the-money" on the actual date of grant, thereby delivering additional value to the option holder on the actual grant date.

There are numerous variations of backdating (which may or may not be intentional and may or may not raise issues depending upon the applicable facts) including:

- the intentional blatant use of a prior date for determining exercise price;
- the use of a prior date on an "as of" basis for determining exercise price;
- the circulation of a unanimous written consent that uses a date for determining exercise price that is prior to the date the last director/signatory signs the consent (this practice may result in a short delay between the designated grant date and actual grant date);
- the selection of the lowest price in a pre-designated period (such as in a 30-day period or a calendar quarter);
- a grant process that starts on one date and is completed on a later date when the details are worked out; and
- the delegation of option grant authority to a director or a member of senior management (typically, the chief executive officer) without any definitive or established practice evidencing the actual date of grant.

Another practice that is beginning to receive considerable attention is the granting of stock options prior to a favorable public announcement (such as a better-than-expected increase in earnings) or immediately following the public announcement of bad news (such as the loss of a key customer or contract or failure to obtain necessary governmental approvals).

This practice, referred to by certain commentators as "springloaded" options, generally raises fewer technical legal issues than those raised by backdated options but, again, the scope and nature of any potential problem depends upon the applicable facts surrounding the option grants. For example, while certain corporate governance and disclosure issues may arise in connection with certain forms of springloading, if the compensation committee or other entity making the option grant is fully informed regarding all facts that may affect the stock price at the time of the grant, it is likely that no insider trading occurred.

Further, given the focus on stock option practices generally, issues may also arise (particularly, tax issues) in connection with the determination of the exercise date of an option. Accounting and disclosure issues may also arise with regard to grants of restricted stock and other equity grants where the timing of the grant is not correct or is unclear.

Potential Issues Surrounding Backdating and Other Option Irregularities

While there is no *per se* prohibition on granting stock options with a per share exercise price that is less than the fair market value of a share on the date of grant, there are numerous issues that should be considered in connection with a grant of a below-market option.

While, as explained above, a backdated option issued at less than the fair market value is, in effect, a below-market option, the consequences of making a backdated grant may be significantly greater than an initial below-market grant unless it has been treated as a discount option from the time of grant. The key potential issues include:

- **Accounting**. Under APB 25 (the accounting rules in effect prior to recently adopted FAS 123(R)), any difference between the stock price on the actual grant date and a lower exercise price triggers a compensation expense that is required to be charged against company earnings over the applicable vesting period. Depending upon the materiality of the generated charge, companies may be required to restate their prior financial statements for several fiscal years to reflect the discount attributable to backdated options. In addition, certain stock option irregularities may trigger adverse variable accounting treatment, which requires the continued remeasurement of the earnings charge as the stock price increases.
- **Authorization/Plan Document Issues**. As noted above, many stock option plans provide that the per share exercise price of an option must be no less than the fair market value of a share of stock on the date of grant. It is possible, depending upon applicable facts, that any backdated/discounted option grant may be viewed as: (i) being granted outside of the plan (which raises, among other things, stockholder approval issues under stock exchange/Nasdaq and tax rules as well as issues as to the availability or validity of a registration statement); (ii) requiring the upward adjustment of the exercise price to the stock price on the actual date of grant due to the incorporation of the plan provisions by reference in the grant (which may give rise to employee claims based on reliance, but resolves the accounting issues); (iii) authorizing a plan amendment permitting discounted options (which may also raise stockholder approval issues); or (iv) being issued without the necessary corporate authority (but employees may have issues as to reliance and apparent authority). The potential issues concerning plan provisions will vary based on the terms of the plan, the specific option agreement and other option-related documentation (*e.g.*, prospectuses), the state in which the company is incorporated, as well as other relevant facts.

- **Securities Laws**. Various securities issues may need to be evaluated including:
  - **SOX**. Option irregularities (particularly those that generate retroactive accounting charges) may raise issues under the Sarbanes-Oxley Act of 2002 relating to the adequacy of internal controls, validity of CEO and CFO certifications, disclosures to auditors and potential executive disgorgement of compensation.
  - **Disclosure.** Prior disclosures relating to backdated options may be inaccurate or misleading including disclosure in annual reports under Form 10-K and quarterly reports under Form 10-Q, executive compensation disclosure in a company's proxy statement or reports required under Section 16(a) of the Securities Exchange Act of 1934 (*e.g.*, Forms 4).
  - **Registration**. If option grants are viewed as having been granted outside of a company's standard option plan, the shares underlying the non-plan options may not be covered by a valid registration statement (such as Form S-8) and, instead, any sales of such shares must comply with other exceptions (which may not have occurred). Also, if prior financial statements are required to be restated to reflect the discount attributable to backdated options, issues may arise surrounding the ability to use registration statements (*e.g.*, Forms S-3 or S-8) during certain periods.
- **Potential Litigation/Enforcement Actions.** The potential for civil and criminal litigation or regulatory enforcement action is high. More than 60 companies have disclosed the pendency of investigations into their options granting practices. These include grand jury investigations, United States Attorneys' Office investigations, and SEC investigations. Private plaintiffs may bring federal securities fraud claims as class actions on behalf of all purchasers of a company's stock during periods when the company's financial statements allegedly were materially misstated. These cases may allege that the company's expenses were understated, and its income overstated, because a material compensation expense, equal to the difference between the stock price on the date of the actual grant and the price on the lower, earlier grant date, was not reflected on the company's financial statements. In addition, derivative actions may be brought in the company's own name seeking disgorgement of the difference in price between the earlier and actual grant dates, or even to "recapture" grants that were not made according to the alleged requirements of the stock option plan in question.
- **Tax Considerations.**
  - **Loss of Tax Deductions**. The grant of a below-market stock option does not comply with the performance-based exception to the $1 million limit on deductible compensation under Section 162(m) of the Internal Revenue Code. Depending upon the applicable facts, prior deductions taken with respect to backdated options exercised by named executive officers while employed may be disallowed and future deductions expected to be taken with respect to future option exercises may be prohibited.
  - **Treatment of Below-Market Option as Deferred Compensation**. If any portion of the backdated/below-market option was not vested by January 1, 2005, that portion of the option will be subject to the deferred compensation rules under Section 409A of the Internal Revenue Code. Unless such option is timely redesigned to comply with these rules, the option holder will be subject to income tax, a 20% excise tax and possible penalty interest at the time the option vests (and possibly thereafter if the stock price continues to rise). The company issuing such option will have reporting and corresponding wage withholding (not excise tax withholding) obligations.
  - **Retroactive ISO Disqualification.** As incentive stock options must be granted with an exercise price that is no less than fair market value on the date of grant, the designation of a backdated (discounted) option as an ISO violates the ISO rules under the Internal Revenue Code. Although such option may be possibly treated as a nonqualified stock option (rather than being invalidated), the recharacterization of the option may trigger, on a retroactive basis, income and employment tax liabilities on the option holder as well as reporting and withholding issues for the company issuing the option. Such recharacterization may trigger corporate tax deductions for prior years that were not taken while the company thought the option was an ISO.
- **Corporate Governance.** If a company's stock option timing and pricing practices are problematic, whether as a result of intentional or inadvertent conduct, questions surrounding the existence of proper corporate governance and procedures may arise. Certainly institutional investors are pushing for stronger corporate governance policies and procedures and increased oversight by individual directors and the entire board of directors. Certain general counsel have already been terminated over their involvement with stock option practices and related corporate governance matters.

- **Stock Exchange/Nasdaq Requirements**. As noted above, if the backdated option is viewed as being granted outside of the company's standard stockholder-approved plan, such option grant may not comply with stock exchange and Nasdaq stockholder approval requirements governing option grants.

- **Employee Issues**. Depending upon applicable facts, employees may have claims as a result of the recharacterization of options. Terminations for cause (or otherwise) of employees involved in option-related matters may be warranted in certain circumstances.

- **Insurance Considerations**. Depending on the nature of the claim, insurance coverage may exist for claims involving alleged stock option irregularities, including private securities civil actions and costs of governmental investigations. The existence of insurance coverage will depend upon the terms of a company's insurance policies and the facts of the particular claim. Companies facing claims or potential claims involving stock option irregularities should review their insurance coverage (including directors and officers insurance policies and insurance coverage for securities claims). Consideration should be given to providing notice of claim or potential claim to the appropriate carrier or carriers. In addition, disclosure issues may need to be considered in connection with insurance procurement or renewal applications.

- **Investor Relations/Public Scrutiny.** Option "backdating" (and practices involving many more shades of gray) are constant front page business section news. The tone of the stories (and of quotes from institutional investors and others) tends to be accusatory. Companies will be faced with balancing legal, public relations and other considerations relating to disclosure in this area, often in the face of incomplete information.

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The stock option controversy is sweeping corporate America. Because of the intentional backdating issues, even pure sloppiness in grant issuing practices will have significant impact on companies. The best way to deal with them is to be prepared – determine whether there are problems and confront them with the solutions before being compelled to by the government, lawsuits or accounting requirements.

The Proskauer Stock Options Task Force will be conducting a Webinar "The Stock Option Controversy – What You Need to Know" on Tuesday, July 25, 2006 12:00 - 1:00 pm (EDT) Details will be provided shortly.

For more information on this seminar, please visit www.proskauer.com

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The Proskauer Stock Options Task Force is a multi-disciplinary team set up to assist companies and their boards with the many issues arising from the intense regulatory and public scrutiny of the practice of granting and exercising options. The Task Force is comprised of more than 25 senior lawyers with experience in all key areas related to stock option issues, including corporate investigations/governance, securities law, executive compensation, accounting and tax. For more information, contact the co-chairs or any Task Force member, who can be found on the Firm's website. Contact information for the co-chairs is:

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