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Option Grant Practices: A Trap for the Unwary – Spring-Loading and Bullet-Dodging

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A potentially overlooked but important issue that public companies should have in mind when granting option or option-like awards is avoiding the unintentional appearance of "spring-loading" and "bullet-dodging," both of which have been a recent focus of the SEC and shareholders and viewed as potentially poor corporate governance practices.

"Spring-loading" is when a public company grants option or option-like awards shortly before the release of positive material nonpublic information, which is expected to increase the company's stock price. The grantee of a spring-loaded award immediately benefits from the increase in the stock price. For example, if stock options are granted with an exercise price of $10 per share before market trading, and a positive earnings release causes the stock price to close the same day at $15 per share, each option would already be $5 in-the-money.

The converse of spring-loading is "bullet-dodging," which is when a public company grants option or option-like awards shortly after the release of negative material nonpublic information, which is expected to decrease the company's stock price. Again, the grantee immediately benefits from the decrease in the stock price. For example, if stock options are scheduled to be granted before market trading with an exercise price of $15 per share, but the grant is made after a negative earnings release, or more significantly if it is delayed until after the negative earnings release, and the stock price has since closed at $10 per share, the company would have avoided granting options that would each be $5 out-of-the-money.

Companies that have allegedly engaged in spring-loading or bullet-dodging have been the subject of SEC investigations as recently as a few years ago. Additionally, in November 2021, the SEC indicated its concern and scrutiny of spring-loaded awards, by issuing accounting guidelines in Staff Accounting Bulletin (SAB) No. 120, explaining how companies should properly recognize and disclose compensation cost for spring-loaded awards. The SEC stated in a press release that "non-routine spring-loaded grants merit particular scrutiny by those responsible for compensation and financial reporting governance at public companies. SEC staff believes that as companies measure compensation actually paid to executives, they must consider the impact that the material nonpublic information will have upon release. In other words, companies should not grant spring-loaded awards under any mistaken belief that they do not have to reflect any of the additional value conveyed to the recipients from the anticipated announcement of material information when recognizing compensation cost for the awards."

More recently, in December 2022, the SEC has continued to show its increased scrutiny of spring-loaded and bullet-dodging awards by finalizing new Item 402(x) of Regulation S-K, which requires both a discussion of companies' policies and practices on the timing of awards of options and option-like awards in relation to the disclosure of material nonpublic information and tabular disclosure of stock options and option-like awards granted to named executive officers in the four business days before and one business day after disclosing material nonpublic information. The SEC is therefore requiring companies to clearly outline to investors when such awards are granted close in time to major events which may affect the company's stock price. Companies are required to comply with the new Item 402(x) disclosures in their Form 10-K (or proxy statement incorporated by referenced into the Form 10-K) for the first filing that covers the first full fiscal period that begins on or after April 1, 2023, and for smaller reporting companies, this date is October 1, 2023.[1] For companies that have a fiscal year that is the calendar year, this means the Item 402(x) disclosure will need to be in the Form 10-K (or proxy statement incorporated by referenced into the Form 10-K) filed in 2025.

In addition to SEC scrutiny, shareholders are also taking notice of companies granting apparent or alleged spring-loaded and bullet-dodging awards. Shareholders have brought claims of breach of duty of candor, breach of fiduciary duty of loyalty, waste of corporate assets, and unjust enrichment. Claims may also be predicated on alleged materially false statements about spring-loaded and bullet-dodging option practices in a proxy or other public statements under the proxy anti-fraud rule or other general fraud rules under the federal securities laws.

In light of increased SEC and shareholder scrutiny, it remains important for companies to discuss their specific equity-granting practices with their legal and accounting advisers to avoid unintended liability issues that can result from ordinary course timing of awards. While the issues discussed above technically relate to option and option-like awards, similar legal and accounting considerations may apply to other types of non-option-like equity awards, such as restricted stock and RSUs, and indeed the new SEC rules may garner attention from the plaintiffs' bar on these issues. Companies should review, evaluate and/or develop equity grant practices and policies to address the timing of equity grants (especially options and option-like awards) and should seek advice on how to navigate non-routine off-cycle option, option-like, and non-option-like awards.

Summer Associate, Breanna Keane, assisted with writing this post.

[1] See SEC Compliance and Disclosure Interpretation Question 120.26.

View original.

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