

Stock Option Backdating—What Investors Need to Know

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Over the past several months, investors have watched with dismay as dozens of companies—*The Wall Street Journal* pegs the total at 46 as of June 14, and many observers expect that number to grow—have come under civil and criminal investigation for backdating executive stock options or have begun internal reviews of the issue. Although academic studies had long noted suspiciously favorable patterns related to option granting, it was not until a 2005 study by Erik Lie and follow-up analysis by *The Wall Street Journal* earlier this year that regulators and investors began to entertain the notion that companies or executives might be choosing option grant dates on which the stock's price was lowest in order to maximize the options' value to the executives.

This unfolding scandal already has spurred action from investors and regulators. It has prompted Council members to seek additional information from portfolio companies, demand independent reviews of option granting practices, ask companies to reform their policies and, in a few instances, begin litigation. SEC Chairman Christopher Cox recently indicated that the Commission was considering changes to its proposed executive compensation disclosure reforms to ensure that investors have complete information about grant practices and any backdating.

This memorandum addresses three questions:

1. What is backdating and how did it happen?
2. What are the consequences of backdating for affected companies?
3. What steps can investors take to address backdating issues at portfolio companies?

WHAT IS BACKDATING AND HOW DID IT HAPPEN?

The term “backdating” is being used to describe a range of behavior related to the granting of stock options. The most culpable conduct encompassed within the term involves intentionally changing the date used to set an option's exercise price to one on which the stock's price was at a low. Because the backdating investigations are still ongoing, it is not clear how often such intentional misconduct took place. A few companies have already discovered evidence of intentional wrongdoing: **McAfee** fired its general counsel last month after finding irregularities relating to one of his option grants; **Vitesse Semiconductor** terminated its CEO, CFO and an executive vice president after suspending them on concerns over the “integrity of documents”; and a special board committee at **Mercury Interactive** found that the company's former CEO “should be treated as having been terminated for cause” as a result of stock-option-related matters.

Although frauds involving insiders can be difficult to detect under any legal or disclosure regime, the staleness of insider transaction reporting until August 2002 clearly abetted intentional backdating. Before that time, when new SEC rules mandated by the Sarbanes-Oxley Act took effect, stock option grants were not reportable on Form 4 filings, which disclose transactions in an issuer's securities by insiders. The first that investors learned of an option grant was in a Form 5 filing, a summary of all changes during the fiscal year, which was not due until 45 days after the fiscal year end. A grant in January of one year was thus not reportable until February of the following year, assuming a December 31 fiscal year-end. Compounding the delay was the fact that Form 5s were not filed electronically, so investors had to order a hard copy from a document retrieval service or inspect filings at the SEC's offices in Washington, D.C.

This long delay before public disclosure of a grant meant that insiders had more time to watch stock price trends, identify the date on which the price was lowest and take the necessary steps to ensure that this date was used to establish the exercise price for the stock option, all before the terms of the grant (including the exercise price) were disclosed outside the company. Backdaters would have to worry about covering their trail internally, but not about the possibility that someone outside the company would notice the discrepancy between the exercise price disclosed in a filing and a lower price that appeared on the filing reporting the eventual exercise of the backdated option.

In addition to intentional backdating of the kind described above, backdating is also being used to refer to company actions and policies that had the effect of causing an option to be granted with an exercise price that was lower than it should have been under applicable rules. Press accounts and company filings indicate that sloppy documentation, delays involving the grant approval process and other undesirable practices may have caused the granting of options with exercise prices that were lower than the market price on the grant date.

Disclosures to date suggest that a major cause of inadvertent backdating was the misapplication of the accounting standard, APB 25, which governed stock options until 2005 when companies began having to expense all employee stock options. APB 25's intrinsic value method, which was used by nearly all public companies, required companies to recognize compensation expense for stock options only if the exercise price of the option was less than the market price of the stock on the measurement date. Many investors have assumed that the measurement date was always the same as the grant date, but under the intrinsic value method that was not necessarily true. Instead, the measurement date, which could not be earlier than the grant date, was the date on which the number of shares and exercise price were fixed. If a company incorrectly recorded the measurement date for an option grant, the exercise price could be lower than appropriate even absent any intentional wrongdoing.

An example, based on practices described by **Michaels Stores** and **Affiliated Computer Services**,¹ illustrates one way this could happen. Board committees sometimes use a written consent process, in which a document describing an action is circulated serially to committee members for their signatures, to take certain kinds of routine actions such as granting stock options. Under state law, the action is not deemed approved until the last director signs the consent.

¹ See 10-Q filed by Michaels Stores on June 13, 2006; Form 12b-25 Notification of Late Filing filed by Affiliated Computer Services, Inc. on May 10, 2006.

If a written consent purports to approve an option grant and sets the exercise price at \$10, which is the market price on the date the consent is sent to the first director, but the last director does not sign the consent until later when the stock price is \$15, the price on the measurement date is \$15. As a result, the \$5 difference between the exercise price and the stock price on the measurement date constitutes compensation expense and the options are considered in-the-money. In the pre-expensing accounting regime, companies had a strong incentive to avoid recognizing this \$5 because it would reduce reported earnings. It remains to be seen whether companies and their auditors made honest mistakes applying accounting standards or if companies aggressively interpreted the standards in an effort to avoid recognizing compensation expense.

Administrative glitches, such as reallocation of grants made to a number of different employees from an authorized pool, are another possible cause of inadvertent backdating because they could delay the fixing of option terms and cause the measurement date to differ from the grant date. Misspecification of the measurement date could also occur in the new-hire context. Under APB 25, neither the grant date nor the measurement date could fall before the date on which someone becomes an employee of a company.² Specifying some earlier date, such as the date on which the executive accepts an offer of employment, as the grant and measurement date, could cause option exercise prices to be lower than they should be.

Finally, some discussions of backdating have also included the practice of timing option grants to take advantage of stock price moves expected as a result of not-yet-public company developments. For example, earlier this month a securities analyst accused **Cyberonics** of granting executive stock options during an evening board meeting the same day in 2004 that an FDA panel recommended approval of a medical device made by the company. The next day, Cyberonics' stock price rose by 78 percent. The SEC has begun an informal investigation. Although such timing—like backdating—gives executives windfalls and can undermine the effectiveness of options as a motivator of future performance, it has different legal and corporate governance implications for companies and is not addressed in this memorandum.

WHAT ARE THE CONSEQUENCES OF BACKDATING FOR AFFECTED COMPANIES?

Although granting in-the-money options does not itself violate any law—it may, however, violate the terms of a company's equity compensation plan—a finding that stock option backdating occurred at a company may trigger a raft of potentially serious accounting, legal and reputational problems. Regardless of whether backdating was intentional or inadvertent, financial statements must be adjusted to reflect compensation expense resulting from the difference between the stock price on the measurement date and the option's exercise date. If the impact of a misstatement is material—and the SEC has cautioned that misstatements that increase management compensation may be material even though they involve a “quantitatively small misstatement”³—the company will be required to restate its financial statements. The

² Pat McConnell et al., “Digging up Dinosaur Bones: 20 Frequently Asked Questions on Stock Option Backdating,” Bear Stearns Equity Research & Tax Policy report (May 25, 2006).

³ Staff Accounting Bulletin No. 99—Materiality (Aug. 12, 1999).

process of sifting through data and restating financial statements can take so long that a company may be unable to make annual or quarterly filings on time; in extreme situations like the one Mercury Interactive faced, a company's shares can be delisted from the exchange on which they trade.

The most important tax consequence for companies of finding that options have been backdated relates to section 162(m) of the Internal Revenue Code, which permits companies to deduct compensation in excess of \$1,000,000 only if it is performance-based. At-the-money options—but not in-the-money options—are considered to be performance-based compensation. Reclassification of options from at the money to in the money could result in the loss of the tax deduction and liability for additional taxes, interest and possibly penalties.

Companies found to have engaged in option backdating could face several different kinds of legal liability. Companies and certain insiders may be liable for violations of the federal securities laws on the grounds that the companies' SEC filings contained material misrepresentations regarding option grants. Individual officers and directors—especially option grantees and compensation committee members—may be sued by shareowners derivatively on behalf of the corporation, asserting claims for breach of fiduciary duty and other claims arising under state law. Current compensation could even be affected by these cases: One group of litigants against **United Health Group** has asked the court to enjoin certain United Health executives from exercising outstanding stock options while the case is pending.

Finally, companies may suffer reputational harm if backdating is found to have occurred. Although intentional backdating attracts the most media attention and will likely create greater legal liability than inadvertent forms of backdating, backdating caused by inadequate internal controls will also raise red flags.

WHAT STEPS CAN INVESTORS TAKE TO ADDRESS BACKDATING ISSUES AT PORTFOLIO COMPANIES?

Investors may want to discuss option backdating with portfolio companies to reassure themselves that the companies are taking appropriate steps to address the issue and to understand better the companies' practices around stock option grants. Bear, Stearns has identified characteristics of companies that may present a higher risk of option backdating and thus should move to the top of the list for investor engagement. These traits include: allowing executives to choose their option grant dates, granting options many times each year, having a non-standard pattern of option grants from year to year, having internal controls weaknesses (though Bear, Stearns noted that many of the companies already targeted by regulators received unqualified Sarbanes-Oxley section 404 internal controls opinions), small size, short history as a public company, being a high-growth or highly-acquisitive company and having weak corporate governance.⁴

High on many investors' lists of concerns is whether backdating is still occurring. The most recent study by Professor Lie and Randall Heron, which focuses on company and overall stock price movements both before and after option grant dates, found a return pattern consistent with substantially reduced backdating after the SEC adopted the new Form 4 filing requirements in August 2002. Those grants that were not

⁴ Bear, Stearns report, supra note 2, at 12.

reported within the required two-day period, however, continued to be associated with return patterns more suggestive of backdating, and the magnitude of the return pattern was greater the longer the delay in reporting. Lie and Heron found that one-fifth of the grants during the study period from August 29, 2002, through November 30, 2004, were not reported within the two-day timeframe.⁵

It may therefore be useful for investors to focus their engagement efforts on companies that disclose in their proxy statements that one or more Form 4s were not filed on time. Investors can ask these companies:

- Whether they have performed an analysis of past grants to determine if there is a pattern suggesting backdating;
- Whether options are granted on a fixed schedule and when that schedule was adopted;
- If there is no fixed schedule, how the frequency and dates of grants are determined, including the extent to which management participates in the decisions;
- Whether policies have been adopted to ensure future compliance with insider transaction reporting requirements; and
- What procedures are in place to ensure adequate documentation of actions related to stock option grants.

⁵ Erik Lie, "Backdating of Executive Stock Options (ESOs)," undated (available at www.biz.uiowa.edu/faculty/eliel/backdating.htm); Erik Lie & Randall Heron, "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?" (available at www.ssrn.com).