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Beyond Backdating: Stock Option Grant Self-Assessment Guide

In recent weeks, corporate stock option practices have come under extreme regulatory and media scrutiny. The U.S. Securities and Exchange Commission initiated investigations of more than 80 companies for potential accounting and disclosure problems relating to the dating of their stock option grants. Companies and individuals have been targeted with grand jury subpoenas, and federal indictments in this area have made front-page news. The plaintiffs' bar has filed dozens of derivative and class action lawsuits against executives and directors, challenging option grants. Options granted as far back as the 1990s are being closely examined, and companies face severe consequences if their historical practices failed to meet the then-current accounting and taxation requirements.

In this turbulent environment, we at Pillsbury Winthrop Shaw Pittman, LLP believe it prudent for all public companies to evaluate their historical option granting practices and procedures, and many companies have already done so. Our Stock Option Task Force has prepared the following checklist to assist clients in performing such a self-assessment. The checklist identifies areas that have drawn regulatory interest or public scrutiny, and is intended as a guide to identify issues that may require further analysis.

Stock Option Grant Self-Assessment Checklist

Review the Authority and Process for Granting Options

- Who does the plan authorize to grant options–Board of Directors, Committee(s), or Executive(s)?
    - Is the Committee properly authorized to make the grants?

    - Is the Committee that makes grants to executives comprised of: (a) "independent directors" for purposes of stock exchange or stock market listing requirements, (b) "non-employee directors" for purposes of the Rule 16b-3 exemption from the short swing profit provisions of section 16(b) of the Securities Exchange Act of 1934 and (c) "outside directors" for purposes of the performance-based compensation exemption from the $1 million deduction limit of section 162(m) of the Internal Revenue Code?
    - If an Executive grants options, is there appropriate delegation of authority from the Board or Committee to the Executive? Does the delegation meet the requirements of applicable state corporation law and the Company's charter documents?
- Does the plan under which the options are granted:
    - Define a method for determining fair market value of the Company stock (e.g., closing price)?
    - Permit the Company to grant options at a discount from fair market value on the date of grant?
- Process and practice issues:
    - Are the company's internal controls adequate?
        - If an Executive is authorized to grant options, how are option grants by an Executive evidenced?
        - How are option grants prepared, documented and recorded, and by whom?
    - How are option grants made–by a resolution approved by the Board or by Committee at a meeting, or by unanimous written or electronic consent?
    - In the case of unanimous written consents, what evidence is kept to show the date(s) on which the decision was made and the signatures affixed?
    - Does the Company have a practice of granting options immediately before a positive news release or immediately after a negative news release?
- If options have been granted outside of a shareholder approved plan, have those options complied with the applicable stock exchange or market listing standards that were in effect at the time of the grants?

Review Past Grants of Options

- Pricing issues:
    - Did the Company's option exercise prices comply with the plan-provided method for determining fair market value (e.g., closing price)?
    - If there was no plan provided method, how was fair market value determined?
    - Did exercise prices correspond to the reported market price on the dates of grant?

- Measurement date issues:
  - Review actual grants to determine if there was a delay between the "option grant date" shown on the minutes (or other documentation) and the date the Board, Committee or Executive completed the approval process, i.e., the "measurement date." What evidence exists to show that those two dates were the same or were different? If different, how is the difference explained?
    - If a unanimous written consent was used, what does the evidence show as to the date(s) on which the decision was made and when the signatures were affixed?
    - Were the schedules or spreadsheets listing the employee optionees and the amounts of the grants included at the time of the approval?
    - Was there any significant delay between the date of grant and notification to the optionee (either in hard copy or electronically) and, if required by the terms of the grant, signing of an option agreement?
    - Were options granted in accordance with pre-employment offer letters providing for a fixed date of grant or date of grant based on the occurrence of an event (e.g., date of hire) which grant date actually preceded the required Board, Committee or Executive action to approve the option award?
    - In the case of options granted without a fixed date of grant being designated at the time of the required Board, Committee or Executive action, were such options treated as granted on a date selected by the optionee?
  - If any of the above occurred, was the option exercise price less than what it would have been if it had been priced at the fair market value on the "legal" date of grant?
- Other issues regarding past grants:
  - Have the stock options of departed employees been "transferred" to new hires on the same terms?
  - Have the independent auditors expressed any concerns about the option grant process to the Audit Committee or in their work papers?

Analyze Securities Law, Tax and Accounting Issues

- Securities law issues:
  - Were the Forms 3 and 4 filed with the SEC in accordance with the deadlines under then applicable law and regulations?
  - Has the Company properly disclosed option grants, including any special arrangements, in its proxy and periodic reports?
  - Were there side agreements or special vesting arrangements regarding option grants not disclosed in the proxy statement or other SEC filings?

- Were options granted to executive officers and directors properly approved for purposes of the exemption under Rule 16b-3 or, if not, are there any section 16(b) short-swing profit recapture issues with respect to exercises of options and sales of stock by those individuals (e.g., if an option was not properly approved under the Rule 16b-3, any share withholding to pay the exercise price or taxes upon exercise might not be exempt)?

- If the Company is not listed on the New York or American Stock Exchanges or the Nasdaq Global (formerly National) Market, have the Company's grant prices and options complied with applicable state securities laws?

- Accounting issues:

  - If discounted options were granted, intentionally or unintentionally, were appropriate financial accounting charges taken by the Company?

  - If not, were the differences material? Are restatements required?

- Tax issues:

  - If options issued at a discount to fair market value were granted, have the tax consequences under Internal Revenue Code section 162(m) been considered?

  - Did the report of the Company's compensation committee included in the Company's annual proxy statement include a statement of position with respect to loss of deductions under Internal Revenue Code section 162(m) triggered by the grant of discounted options?

  - If discounted options were granted that were intended to be incentive stock options (ISOs) under Internal Revenue Code section 422, has the loss of ISO status been considered?

  - If discounted options were granted that were not vested as of December 31, 2004, have the tax consequences under Internal Revenue Code section 409A, which deals with nonqualified deferred compensation, been considered?

  - If restatements are required, have the tax issues been addressed in calculating those restatements?

We have posted Client Alerts on our Web site that address these issues, and we will continue to update you on these topics as issues arise.

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