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STEPS CORPORATE COUNSEL SHOULD TAKE
IN LIGHT OF THE CONTROVERSY
REGARDING
BACKDATING AND OTHER ISSUES RELATING TO THE TIMING
OF STOCK OPTION GRANTS

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in Light of the Controversy
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In recent months, the business press has been dominated by a substantial controversy regarding the timing of option grants.² Over 80 companies have announced either that they plan to restate their financial statements or that they are the subject of inquiries being conducted either by the SEC or by an Office of the U.S. Attorney. These include some of the biggest names in corporate America.³

Both the Home Office and several regional and district offices of the SEC are conducting inquiries regarding the timing of option grants. The U.S. Attorney's Office for the Southern District of New York has issued numerous grand jury subpoenas to companies seeking records and other information regarding possible backdating of options. Numerous other U.S. Attorney's Office have also become active.

This whitepaper has two parts. The first part discusses the scope and nature of the controversy, including some of the issues that can arise in connection with the timing of option grants. The second part identifies steps that companies should consider taking in light of the controversy.

I. SCOPE AND NATURE OF THE CONTROVERSY

There is a widespread public perception that all of the companies implicated in this controversy fall within the following scenario, which has been widely condemned as fraud:

¹ The authors represent entities and individuals in connection with this controversy. This update is intended for information purposes only. Individuals and entities seeking legal advice or services should consult with an attorney. The authors gratefully acknowledge the assistance of Brooke Clarkson, a summer associate.

² The controversy was triggered by an article authored by Erik Lie of the University of Iowa. A copy of this article is available at <http://www.biz.uiowa.edu/faculty/elielie/Grants-MS.pdf>.

³ A scorecard regarding the companies implicated in the controversy can be found at <http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html>.

- The companies backdated stock option grants by looking back over the prior weeks and months and, with the benefit of hindsight, selecting as the disclosed grant date a date when the company's stock price was at a low point.
- The companies retroactively made that date the option grant and pricing date, thereby creating a stock option that was "already in the money" (i.e., on the date when the company authorized the options, the exercise price is below the related current stock market price of the shares underlying the option).
- The companies then disclosed as the actual date of the grant the purported grant date, rather than the date on which the options were granted.
- The company then accounted for the options as if the options had been granted on the purported date of the grant (i.e., as if the options were not in the money when granted).

For quarters ended on or before June 15, 2005, many companies followed Accounting Principles Board Opinion No. ("APB") 25 in accounting for compensatory stock options.⁴ APB 25 provided that "[c]ompensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay." APB 25 further provided that "[t]he measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any." APB 25 also stated that "for purposes of this Opinion, the unadjusted quoted market price of a share of stock of the same class that trades freely in an established market should be used in measuring compensation. . . . If a quoted market price is unavailable, the best estimate of the market value of the stock should be used to measure compensation."

In addition to this "look back" backdating of options, the press has swept a number of other timing issues under the rubric, "backdating." These issues include:

- Granting options in anticipation of the company's public disclosure of material information that is likely to increase the price of the company's stock. This practice is sometimes referred to as "front running" or "spring loading." Although some critics argue that this practice constitutes insider trading, a strong argument can be made that the practice is perfectly lawful, especially if the person approving the option grant is aware of the information and is not participating in the option grant. In addition, stock option plans, including the Compensation Committee's compensation policy and objectives, are described in a company's SEC filings, and some critics argue that this practice poses a potential disclosure issue unless the description included specific disclosure of this practice. A strong argument can be made, however, that specific disclosure is

⁴ Under GAAP, companies could choose between applying Statement of Financial Accounting Standard ("SFAS") 123 and Accounting Principles Board ("APB") 25.

unnecessary, especially if the company disclosed retention of employees as an objective of its option program.

- Issuing negative information before the grant date. This practice also is sometimes referred to as “spring loading.” Some critics argue that this practice also poses a potential disclosure issue unless it was specifically disclosed. Again, a strong argument can be made that specific disclosure was unnecessary, especially if the company disclosed retention of employees as an objective of its option program.
- Using the wrong measurement date in connection with mass grants to employees. Some companies used the wrong measurement date in connection with the mass grant of options for employees. For example, at some companies, the Compensation Committee approved a grant of options to non-executive and authorized top management to allocate the options. Top management then allocated the options among the non-executive employees. The company might have misstated its compensation expense if the company measured the value of the options based upon the date that the Compensation Committee approved the options, rather than on the date that they were allocated. This appears to be at least part of what happened to Broadcom Corp., which announced on July 14, 2006 that it expected that problems with its measurement date would result in a restatement of non-cash stock based compensation expense in “excess of \$750 million.”⁵
- Setting the official hire date of a new employee for a date other than the actual start date. Some companies have a policy of setting the official stock start date as the date at which the stock was at its lowest price during a specified amount of time (e.g., 30 days) after the employee’s actual start date. Sometimes, the employee’s official hire date is negotiated prior to the employee’s actual hire date and is set at a date before the employee’s actual hire date.
- Flaws in the option granting process such that as a matter of state law the options were not granted on the date that the company thought the grant had occurred. These flaws can take a number of forms and can vary depending on state law, the terms of the relevant option plans, the terms of the corporation’s charter and by-laws, and the language in relevant corporate resolutions. For example, if senior management selected the grant date pursuant to an apparent delegation of authority from a board committee, the grants might be ineffective if the delegation of authority was invalid.
- Modifying the vesting schedule, the exercise period, or the exercise price. Repricing options, extending the exercise period, or modifying the vesting schedule can have accounting consequences. See APB 25 and FIN 44. A company might have legal issues if it was unaware of these accounting consequences or deliberately ignored them.

Until August 29, 2002, executives did not have to disclose options until 45 days after the end of the company’s fiscal year. Companies therefore theoretically had an opportunity to “look back” over their prior fiscal year to select as the “grant date” a date on which the stock had

⁵ A copy of this announcement is available at <http://www.broadcom.com/press/release.php?id=882176>.

traded at a relatively low price. After August 29, 2002, the Sarbanes-Oxley Act of 2002 required that executives file a Form 4 with the SEC within two business days of date on which they received a stock option grant. At least for companies that comply with this reporting requirement, this requirement makes it much harder for a company deliberately to look back over the prior weeks and month and backdate the grant of options to senior executives to a date with a relatively low closing price. This reporting requirement does not, however, necessarily address the other issues.

Issues relating to the timing of option grants can give rise to a number of state law, accounting, tax, and disclosure implications, including:

- Violating the related stock option plan if the plan does not allow the granting of options at a discount to the company's stock price on the option grant date. Thus, an otherwise appropriate grant of options might be invalid under the terms of the plan if on the date of the grant for the purpose of the plan the price of the stock was higher than the exercise price set forth in the option agreement.
- Issuing financial statements that misstated the company's compensation expense. For example, under the GAAP rules in effect until recently, the grant of options to directors, officers and employees did not produce any immediate compensation expense for the company if the exercise price was set at, or above, the fair market value of the stock as of the measurement date. An award of "in-the-money" options, on the other hand, arguably constituted a current compensation expense to the company and a company that treated the grant of the options as if the exercise price was not in the money at the date of the grant may have understated its compensation expense.
- Filing false tax returns and avoiding tax payments. For example, Internal Revenue Code §162(m) limits a publicly-held corporation's deduction for compensation paid to its chief executive officer or to one of its next four highest compensated officers to \$1 million per employee per year, except for payments that qualify as commissions or as "performance-based" compensation. Ordinarily, a stock option qualifies as "performance-based" compensation under §162(m) if its exercise price was no less than the fair market value of the stock on the date of the grant and therefore does not count against the \$1 million compensation cap (assuming that the other requirements of §162(m) have been satisfied). If, however, the stock option was misdated and as a result was granted with an exercise price that was less than the fair market value of the stock on the date of the actual grant, all of the income resulting from the exercise of the option (including the income recognized by the executive upon the exercise of a non-compliant incentive stock option) counts against the \$1 million cap under §162(m). Consequently, a company that mistakenly believed that the stock option qualified for the performance-based exception under §162(m) may have underpaid its taxes and could be subject to interest and penalties in addition to the underpayment of income tax.
- Failing to make required withholding of federal income tax and FICA. For example, companies are not required to withhold federal income and FICA taxes upon the exercise of an employee stock option if the option qualifies as an incentive stock option ("ISO"). A stock option ordinarily does not qualify as an ISO if it was in the money when it was

granted. Accordingly, if a company failed to withhold federal income and FICA taxes on the basis that the options were ISOs, but the options were in the money on the date they were granted for tax purposes, the company and certain company personnel may be liable for the amount not withheld, plus penalties and interest. In addition, if the options were in the money when granted and were earned or vested on or after January 1, 2005, the Company might have an obligation under § 409A of the Internal Revenue Code to withhold federal income taxes and employment taxes when the options vested.⁶

- Issuing financial statements that misstated the company's tax expense. For example, the issuer might have misstated its income tax expense because for tax purposes it did not account for the option grant pursuant to §162(m).
- Failing to adequately disclose in the company's proxy disclosures and in the company's Registration Statements on Form S-8 the company's practices with respect to option grants and including a false disclosure.
- Making false disclosure regarding the company's accounting for stock options. The registration statement and periodic reports of some companies contained disclosures regarding the company's accounting policy for stock options. For example, the company's annual report might state that the company does not record any expense for stock options because the exercise price for the options always is set equal to the fair market value of the stock.
- Misleading auditors. Auditors routinely require members of management to provide management representation letters in connection with audits and quarterly reviews. Management representation letters often contain representations that the financial statements comply with GAAP, management had provided all financial records and data, there were no instances of fraud involving management, and there were no significant deficiencies in the design and operation of the company's internal controls. In addition, some management representation letters contained representations to the effect that stock related awards to employees had been accounted for in accordance with GAAP.
- Failing to maintain books and records that adequately reflect the grant of the options.
- Material weakness in the company's internal control and/or disclosure controls with respect to the grant of options.
- Violations of the NYSE or Nasdaq rules that require shareholder approval of stock option plan terms.
- Breach of fiduciary duty. The directors and officers involved in the option grants might be accused of breach of fiduciary duty. A number of derivative actions have been filed in which such violations are alleged.

⁶ This issue can also pose substantial tax issues for the employee. In addition to being subject to income tax when the options are no longer subject to a substantial risk of forfeiture, the employee might be subject to a 20% excise tax.

Although no criminal charges have been brought as of July 17, 2006, the SEC Staff reportedly has made a number of “Wells Calls” on the topic.⁷ In addition, a number of corporate officers have been terminated in connection with the controversy.

Problems with the timing of option grants also can potentially give rise to significant legal liabilities for the company, its officers (especially the CEO, the CFO and the General Counsel) and directors (especially the members of the Compensation Committee), and individuals who received the option grants. Depending on the facts, the SEC might bring civil enforcement actions against the Company, the CEO, the CFO, the General Counsel and members of the Compensation Committee of the Board of Directors, alleging violations of the antifraud provisions, the reporting provisions, the proxy provisions, the CEO/CFO certification provisions, the books and records provisions, and the internal control provisions of the federal securities laws. The Department of Justice might bring criminal charges. The most likely charges are conspiracy, mail fraud, wire fraud, securities fraud, and tax fraud. The IRS might also bring a civil action based on underpayment of taxes by the issuer and by recipients of the options. In addition, shareholders might bring securities claims based on allegedly misleading financial statements and disclosures and derivative actions based on alleged breaches of fiduciary duty by officers and directors.

II. STEPS TO BE TAKEN

A number of commentators have advised that a company should initiate an internal review if the company thinks it might have a problem with its option grants. If there is reason for concern, Board members, especially Audit Committee members, should consider asking senior management if the company has a problem with its option grants and, senior managers, including the Chief Legal Officer and/or head of Internal Audit, should initiate a review of the company practices regarding the grants of options. Moreover, auditors are increasingly likely to question the company’s past practices with respect to granting options.

While the review should be tailored to the companies circumstances, reviews often include a number of steps. In addition to looking at grants to top executives and directors, the company should also look at other areas of relatively high risk (e.g., mass grants, and grants in connection with hiring). An internal review will often include the following steps:

- Assessing whether the company made the option grants on fixed dates or on variable dates. If a company consistently made option grants only on the date of the annual meeting, there is less risk that the options were back-dated or were not properly authorized. If the company varied the grant dates from year to year, the risk may be greater.

⁷ In a Wells Call, the Staff advises an individual or entity that the Staff has tentatively decided to recommend that the Commission authorize an enforcement action against the individual or entity and offers the individual or entity an opportunity to make a submission responding to the contemplated recommendation.

As this memorandum was being finalized, the SEC and the U.S. Attorney for the Northern District of California announced civil and criminal charges in connection with the practices and disclosures by Brocade Communications Systems. The charges related mainly to option practices with respect to new hires.

- Analyzing past option grants to determine if grants have been repeatedly made on stock price dips. The analysis could be graphic, preparing a chart showing the price history of the stock and the disclosed option dates. The purpose of this analysis is to assess the risk that certain option grants were deliberately backdated in order retroactively to select a relatively low price. This risk assessment can then be considered in the planning of the remainder of the review (e.g., extra attention can be paid to the circumstances relating to those option grants that occurred at a dip in the market price).
- Looking at the company's procedures for mass grants of options to employees and officers who were not executive officers of the firm. Specifically, it might be appropriate for the internal review to consider whether the "measurement date" used by the company complied with GAAP.
- Looking at options awarded to new hires. Specifically, the interview should look at whether the options were granted before the employee was hired and whether the options were misdated.
- Reviewing state law, corporate charters and by-laws, and stock option plan provisions to ascertain the authorized procedures for granting options and who legally has authority to grant options (i.e., whether the plan authorizes the board or board committee to delegate to a member of management the power to make stock option grants).
- Comparing the disclosed grant dates to the dates of announcements of positive and negative news. If there is a pattern of announcing negative news in advance of option grants or granting options in advance of announcing positive news, the company should consider whether the timing of the grants and the timing of the announcements were related.
- Interviewing individuals likely to have relevant knowledge. It is not unusual for the chief executive, the chief financial officer, the general counsel, members of the human resources department, the secretary to the compensation committee, and the members of the compensation committees and others to be interviewed. For example, if (with the benefit of hindsight) the timing of the option grants to the chief executive officer looks suspicious, the CEO, the general counsel, and members of the Compensation Committee, as well as individuals with more ministerial roles, might be asked whether the options were backdated. Similarly, if it appears that the company granted options to senior officers shortly before the announcement of favorable news, the chief executive officer, chief financial officer and others might be questioned as to what officers and directors, if any, were aware of the information at the time of the option grant and whether management had informed the members of the Compensation Committee before the Committee granted the options.
- Considering whether you should publicly report your historical stock option grant practices and rationale in your next annual meeting proxy statement (or immediately on your investor relations web page) to pro-actively allay any shareholder concerns or questions. These types of disclosures likely will be required next year by the SEC's pending new executive compensation rules anyway.

In deciding whether to initiate a review of a company's accounting practices, it is important to realize that flaws in a company's accounting for stock option grants can affect numerous accounting periods. For example, when Broadcom announced that it expected to restate, Broadcom explained that it "will record as deferred compensation the intrinsic value of each affected stock option grant valued as of the new accounting measurement date and amortize that value as non-cash stock-based compensation expense over each employee's respective service period." Similarly, when Rambus announced that it expected to restate, it stated that it expected to record the additional non-cash stock-based compensation expenses over the vesting period of the options.

In some circumstances, it is appropriate for the internal review to be conducted by the company legal department and/or internal audit department. Reliance on the employees to conduct the internal review is especially likely to be appropriate when there does not appear to have been fraudulent conduct and Board members can reasonably rely on the expertise and integrity of the individuals conducting the investigation. Even in such circumstances, the Audit Committee should consider retaining outside counsel who is familiar with the issues relating to the timing of option grants and can provide assurance regarding the reasonableness of the procedures performed by the employees who conducted the internal review. Identifying and resolving the issues raised by a review of a company's option granting practices can tax the multi-disciplinary resources of a national law firm, much less the resources of a relatively small legal department or internal audit department.

If the evidence indicates fraudulent conduct, the Board should consider retaining a team of independent counsel and forensic accountants and requesting a committee of independent directors to direct the investigation. Taking these steps might increase the reliability of the company's fact finding. In addition, these steps might be viewed by the SEC and criminal prosecutors as evidence that the company is a good corporate citizen. While these steps might not prevent the SEC, and perhaps federal criminal prosecutors, from taking action against the company, these steps might affect the relief sought by the Government. In addition, counsel experienced in dealing with the SEC and federal prosecutors should also be retained to advise the company as to the steps that the company should consider taking in light of the likely interest of the SEC and/or criminal prosecutors, including corrective disclosure, self-reporting, and other remedial measures (perhaps including employment actions).

Whether characterized as an internal review or an internal investigation, the fact-finding process poses potential risks for a company's directors and for members of the company's senior management. A number of senior officers and directors have lost their positions as a result of the controversy. The SEC Staff has notified specific officers and specific Compensation Committee members that the Staff has tentatively decided to recommend that the Commission authorize enforcement actions against them. On July 17, Chairman Cox announced that charges in connection with at least one company were imminent. Accordingly, individuals with potential exposure should consider consulting with counsel before submitting to the interview. The company might agree to indemnify officers and directors for the cost of retaining counsel, and even if the company is unwilling to provide such indemnification (or the individual is reluctant to request such indemnification) the stakes involved might warrant the expense.

III. CONCLUSION

The controversy regarding the timing of option grants has generated a great deal of commotion. It threatens to sweep up a number of companies that accounted for their options in good faith. Under these circumstances, it is important for corporate counsel to provide calm and informed advice to companies that will enable them to address the issues in an effective manner and emerge from the controversy with a minimum of disruption and expense.