Backdating Options: What You Should Know

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At the time of this writing, approximately 40 companies have stated that they are under Securities and Exchange Commission (SEC) or internal investigation for a practice now commonly known as stock option backdating. Executives have already been terminated for their alleged involvement in this practice, and if research conducted by several academics and investment banks as recently reported in *The Wall Street Journal* and other business media is accurate, there may be many more such instances identified in coming weeks.

Option backdating occurs when a company issues a "discount" stock option without formally recognizing the award as such. A discount option is an award in which the exercise price is set below the fair-market value at grant, which is generally the date the award is approved by the compensation committee of the board of directors. For example, if the stock price was $20 on the grant date, but the award is priced at $15, the recipient has an immediate paper profit, or head start, equal to $5.

Discount options are not illegal or inappropriate, and prior to recent tax-law changes were sometimes used as effective incentives. The problem occurs when the award is treated as if the exercise price was set at the fair-market value on the grant date and the discount is not recognized by the issuing company.

There are a variety of ways to backdate options, some of which involve intentional manipulation of the exercise price or the grant date without recognition of the inherent value being delivered to the recipient. For example, awards may be approved on a specific date but recorded as if they were granted at a subsequent date when the stock price is lower. Conversely, awards could be granted retroactively to a date when share price was lower. In any case, backdating violates a variety of laws and related technical requirements, as well as the basic principles inherent in a pay-for-performance compensation system.

When used appropriately, stock options create a symbiotic relationship between shareholders and executives, each of which respectively provide the financial and human capital necessary to run the business. Options do this by enabling management to share in a portion of the increase in shareholder value without having to contribute financial capital to the business. Backdating is an egregious abuse, because it violates the foundation and implicit contract inherent in options by rewarding management at the expense of shareholders without creation of value or recognition of the cost.

Executives and the directors who are charged with oversight of executive compensation need to address this issue. The implications for companies and individuals who are found to have backdated options are significant and include, but are not limited, to the following:

1. **Potential stock exchange delisting, fines or other penalties** — Backdating results in the granting of "discount" stock options, which is a practice that is prohibited by many company stock plans. As a result, the grants may be invalid or determined to have been made from a plan that was not approved by shareholders, either of which is a violation of the New York Stock Exchange (NYSE) and NASDAQ listing requirements.
2. **Incremental accounting expense and possible financial restatement** — Discount stock options entail an accounting charge that likely was not recorded under the pre-FAS 123(R) rules (i.e., APB Opinion 25). The recognition of this previously unreported expense may require an earnings restatement. If the CEO and CFO had knowledge that the expense was

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not recorded for backdated options, they could be held personally accountable under the Sarbanes-Oxley financial certification rules.

3. **Loss of corporate tax deductions and penalties** — Because discount stock options do not qualify as performance-based compensation under IRC Section 162(m) ($1 million cap on deductible compensation for officers who appear in the proxy statement), inappropriate deductions may have been taken. This could result in liability for back taxes, including interest and penalties, and also require restatement of prior financials.
4. **Tax penalties for executives** — Backdated options that were intended to be Incentive Stock Options (ISOs) may have income and FICA tax-liability implications to recipients for gains realized at exercise because the favorable tax treatment available to ISOs is not permitted for discount options. In addition, discount options are treated as deferred compensation amounts under the recently enacted IRC Section 409A rules. Options determined to be deferred compensation may result in immediate taxation to executives when the options become exercisable, plus an additional 20-percent penalty over the ordinary income tax rate. The company could also be held accountable for underwithholding on amounts deemed taxable to the executives.
5. **Fines and potential imprisonment** — Because backdating is a violation of federal and state laws, the companies and the responsible executives may face SEC liability and other potential penalties for filing inaccurate disclosures in their proxy statements, Form 10-Ks, Form 4s, etc., and for violation of insider-trading restrictions.
6. **Shareholder lawsuits** — Shareholder lawsuits have already commenced. Given that backdating is effectively stealing from shareholders, it is expected that more suits will be initiated in the near future. The directors who may have unwittingly enabled backdating are likely to be implicated in these suits.

Given the potential consequences associated with backdating, board compensation committees would be well advised to adopt safeguard policies to protect against potential abuse. Recommended safeguards include the following:

- Granting the majority of options on a common date each year to protect against the appearance that timing was intended to take advantage of artificially low prices
- Keeping comprehensive minutes of committee meetings, both in-person or telephonic, at which option grants are approved
- Auditing the grant practices to ensure an exact reconciliation of the exercise price indicated on the Form 4 filings, grant agreements and the fair market value (as defined in the plan from which the awards were granted) as of the date the committee minutes indicate the awards were granted
- Requiring that all grants made to senior executives be formally approved by the compensation committee, even if not technically required by Section 162(m) provisions and other tax, accounting, SEC or stock exchange rules
- Imposing a per-person *and* aggregate quarterly limit on the number of options that may be granted by the CEO or head of human resources to lower-level employees (which most companies permit under committee-delegation procedures)
- Requiring two levels of sign-off (e.g., CEO and general counsel or HR head) for any awards made under the committee-delegation procedures.

Two forces lie at the foundation of virtually every corporate scandal and most shareholder concerns related to executive compensation — an entitlement attitude among executives and lax oversight on the part of board compensation committees. These forces are certainly at work with backdating, and as the story unfolds in the business media we are likely to discover that some companies backdated options intentionally and others fell into the practice by accident, perhaps even with the concurrence of their auditors or legal counsel. The "black cloud," of course, hovers over the unscrupulous executives who illicitly reaped profits from this practice by falsifying corporate records or otherwise manipulating the system for self-gain. These individuals need to be held fully accountable.

Looking forward, it is critically important that compensation committees avoid being unwitting enablers of further abuses by taking proactive steps to ensure integrity in the system. Failure to do so may further taint stock options as a viable incentive tool, result in additional destruction of shareholder value, increase the likelihood of governmental and/or shareholder regulation of executive compensation, and possibly result in financial and other penalties to the committee directors themselves.

ABOUT THE AUTHOR:

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