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Henry C. Blackiston on

Compliance, Executive Compensation, and Option Dating

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One aspect of compliance in the executive compensation area that is crucially important is the timing of stock option grants. A failure to use diligence in this area can result in disastrous consequences such as material misstatements in the disclosed value of equity awards that may lead to shareholder suits, a need to restate earnings, and penalties under section 409A of the Internal Revenue Code (IRC Sec. 409A). In addition, intentional misdating of option grants can result in criminal penalties, and in fact, such penalties have been imposed in the past—for example, in the case of the Chief Operating Officer of Monster Worldwide Inc., where intentional backdating of options resulted in improper accounting[1] (*see* 2009 SEC LEXIS 1612).

The problem has become less severe in recent years because with the passage of Sarbanes-Oxley in 2002 (Public Law 107-204 or 107 P.L. 204), it is now necessary to report stock option grants within two days of the grant date, so that compliance with this requirement minimizes the opportunity to engage in meaningful backdating. However, the grant date of an option award for accounting purposes under FAS 123(R) is not fixed until a company and an option grantee have reached a mutual understanding about its terms. In other words, the fair value of an option award recorded in a company's financial statements is not fixed until it is actually communicated to the grantee.

An award will be deemed to have been communicated to a grantee on the date of board or committee action if it is in fact communicated to the grantee within a relatively short time period in accordance with the company's customary Human Resource practices. However, where an award contains terms to be established at a future date, such as subsequent performance criteria, then the occurrence of future events and the timing of such a communication may create backdating issues if, for example, there is significant price volatility between the date of original board action and the date on which those future terms are determined and deemed communicated to the grantee.

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1. *See* SEC Litigation Release No. 20544, April 30, 2008, *available at* http://www.sec.gov/litigation/litreleases/2008/lr20544.htm. See also SEC Litigation Release No. 21042, May 18, 2009, *available at* http://www.sec.gov/litigation/litreleases/2009/lr21042.htm.

Since there is a five-year statute of limitations for securities fraud, in the years 2006 and 2007 there were an extraordinary number of investigations by the SEC of options back-dating, leading to the firing or resignation, by one count, of more than 50 top executives and directors. Companies caught up in the investigations included Broadcom Corp.[2], United Health Group[3], Converse Technology, Apple, and Dell. Once the statute of limitations tolled in 2006-2007 for actions taken before the rigid reporting requirements of Sarbanes-Oxley, there has been much less press concerning such matters, and probably far fewer examples of improper dating. However, the issue of proper dating is just as important as ever and non-compliance which is more likely now to be inadvertent than previously, still carries dire consequences.

Option Backdating is pretending (documenting) that an option was granted on a date before the grant was awarded, so that in a rising market the exercise price on the stated grant date is lower than the fair market value of the stock on the actual later grant date, giving the optionee an artificial gain as of the actual grant date. If done intentionally, the action is clearly illegal and can carry criminal penalties. If done unintentionally (more likely after the passage of Sarbanes-Oxley in 2002 or in circumstances where fair value is reported based on the date of board or committee action rather than the subsequent date on which an award is communicated to a grantee as described above) there are still dire consequences.

As a compliance matter, avoiding unintentional backdating requires a clear understanding of what constitutes an option "grant." In a letter dated September 19, 2006 from the Office of the Chief Accountant of the SEC ("the SEC letter")[4], guidance was given on what constitutes the measurement date for the grant of an option for accounting purposes, which is, in effect, its grant date. According to the SEC and FAS 123(R), the actual grant date is the first date on which these things are known by both the company and the grantee: 1) the number of options that an individual is entitled to receive; and 2) the exercise price; 3) the identity of the individual optionee and 4) the terms of the award. (The SEC letter, pages 2, 4, 6.) Therefore, to be safe, a compliance officer should be certain that the exercise prices for options are not fixed until those elements are known. In addition, the SEC staff stated in the letter that a grant date cannot occur

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2. *See* SEC Press Release 2008-63, April 22, 2008 *available at* http://www.sec.gov/news/press/2008/2008-63.htm.

3. *See* SEC Press Release 2007-255, December 6, 2007 *available at* http://www.sec.gov/news/press/2007/2007-255.htm.

4. *See* http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm.

until the individual begins performing services, thereby eliminating the practice of some companies to award options in a rising market with exercise prices fixed before the date the individual optionee began employment (the SEC letter, p.8).

In the event that options are improperly dated, so that grants are stated by the issuer to occur at a lower exercise price than the fair market value of shares on the actual grant date, the following consequences can occur:

1. **Shareholder Suit.** Shareholders may have a valid claim that such options violate the terms of the option plan they approved if the plan (as is customary) mandated an exercise price of at least fair market value on the date of grant, resulting in claims of waste, etc.

2. **Accounting consequences**. If an accounting charge is not recognized for the "discounted" options, the company's financials become misleading, because there would be no associated compensation expense charged against earnings, making the earnings overstated.

3. **409A.** Since 409A (IRC Sec. 409A) treats discounted options as deferred compensation, there could be excise taxes and other penalties for the optionee and also the company.

4. **162 (m).** If options were improperly dated such that they are deemed to be discounted, they would lose their status as "performance-based compensation" under section 162(m) (IRC Sec. 162 (m)), resulting in the possible loss of compensation deductions previously taken upon exercise.

5. **SEC Disclosure.** SEC disclosure rules require detailed, annual disclosure of equity compensation awards to a company's named executive officers, which generally consist of its Chief Executive Officer, Chief Financial Officer, and the next three most highly compensation executive officers. A failure to disclose that options were actually granted at a discount, in violation of the above noted accounting rules, 409A and §162 (m) rules, would result in the company's equity compensation disclosures for its named executive officers to be misstated which, if material, could result in a restatement of operational results, shareholder suits, or SEC enforcement action.

Spring Loading and Bullet Dodging. Two other practices that are questionable, although not as clearly in violation of law as intentional back-dating, are "spring loading" and "bullet dodging."

The first practice, "Spring Loading," is the practice of granting options at fair market value when the share value is depressed, but when it is known by management that good news in the near future is very likely to boost the market price of the stock. For example, The Wall Street Journal, on September 25, 2009, reported that the Chief Executive Officer of Marvel Entertainment, Inc., was granted 1.27 million options after confidential negotiations with The Walt Disney Company began, but before Marvel's acquisition by Disney was announced, resulting in a potential profit of more than $34 million.

The second practice ("bullet-dodging") is the opposite—the practice of granting options immediately after an event which causes a severe market drop in the value of shares, but when there is an expectation, based on events known to management, of a significant rise in that value in the near future.

In the Fall of 2006, the staff of the SEC indicated that they may have had little basis for bringing accounting-based enforcement action for the practice of spring-loading, and therefore (by implication) also for the practice of bullet-dodging. (Remarks of Stephen Taub, October 4, 2006).

However, the practice has been condemned by shareholder activists, and in the decision of *In Re* Tyson Foods, Inc., (919 A.2d 563, Del. Ct. Chancery, Feb. 6, 2007), it is clear that at least one renowned court has stated that such practices allow shareholders to state a proper cause of action. In that case, the Chancery Court denied a motion to dismiss by the Company which tried to allege protection under the Business Judgment Rule. The Court stated that a director who authorizes the grant of options at a time when inside knowledge indicates that there will be a significant rise in the stock's value in the near future, acts in bad faith, inconsistently with the director's duty of loyalty, and in a manner that could be considered fraudulent. In effect, the director would be approving a grant which would circumvent otherwise valid shareholder-approved restrictions otherwise mandating that the exercise price not exceed fair market value (*Tyson,* at 575). Therefore, it seems apparent that intentional spring-loading or bullet-dodging based on inside information will give rise to shareholder claims that could well be upheld by a court.

Best Practices. Since the timing of option grants is critical for a corporate compliance standpoint, in view of the rules descried above, the following are suggested best practices to insure there are no grants that result in unnecessary exposure by the Company to litigation by shareholders or others:

1. No grants should be made to employees before they are hired.

2. Establish a subcommittee empowered to execute grants, so that at least one member is available to execute the necessary paperwork on the grant date.

3. Make all grants for new hires or for promotional purposes on regularly scheduled dates, rather than discretionary dates.

4. Even if grants are made on prescheduled dates, check to be sure that there is no inside information regarding imminent "good news" that would cause the market value to rise in a short time period, thereby building in an immediate "profit" for optionees.

5. Adopt a policy to only grant options that comply with the terms of the shareholder-approved plan, and which are granted or fixed-in-advance dates and which are unlikely to have immediate value based upon imminent "good news."

6. Establish clear policies for both the timing and method of communicating option awards to the grantee in a timely manner, including documentation acknowledging the date on which the grantee is notified of the award.

For More Information. *See* Henry C. Blackiston, Executive Compensation 1 Basri, The Corporate Compliance Practice Guide, ch. 34

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