

Walking the Tightrope: Understanding Stock Option Backdating To Avoid The Fall

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Where are we today?

- Approximately 80 companies under some form of investigation related to their stock option practices
- Approximately 80 companies being investigated by the SEC and/or the DOJ
- Approximately 20 companies have restated their financial statements as a result of incorrect accounting for stock options
- Approximately 64 companies have been sued in securities class actions, shareholder derivative suits and ERISA/401k suits
- Senior executives, officers and some directors have resigned, been suspended or fired, and even indicted in connection with this burgeoning scandal

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- I. Chronology of Key Events in Emergence of the Backdating Scandal
 - II. Accounting Issues Relating to Stock Options
 - III. Legal Issues for Stock Plans and Option Grants
 - IV. Different Scenarios Concerning Backdating and How to Address the Problem

Options 101

- Exercise Price (also referred to as “Strike Price”)
- “At the Money”
- “In the Money”
- “Out of the Money”
- Exercise Date vs. Grant Date

What is backdating?

- Practice of selecting an exercise date after the fact when the stock price was lower than the de facto grant date (therefore, the options immediately are “in the money”)

What Is The Problem With Backdating?

- This practice is not per se illegal or improper.
- However, a company may have problems under a number of circumstances:
 - was it properly disclosed?
 - was it properly accounted for?
 - what did the stock option plan mandate?
 - were taxes properly paid?
 - was it properly documented in the company's books and records?

I. Chronology of Key Events in Emergence of the Backdating Scandal

Lighting the fire . . .

- Early SEC investigations (2004-2005)
- Associate Professor Erik Lie of Tippie College of Business at the University of Iowa (May 2005)

Fanning the flames . . .

- Wall Street Journal articles (Spring 2006)
- Analyst reports (“highly suspicious” conduct cited)
- Internet frenzy
 - the Journal’s “Option Scorecard”
 - blogs regarding regulatory inquiries and civil litigation
 - Professor Lie’s website and his follow-up report in July 2006

The brush fire spreads . . .

- Securities and Exchange Commission
- United States Attorney's Offices (NDCA, SDNY & EDNY)
- Internal Revenue Service
- Public Company Accounting Oversight Board
- Private civil lawsuits
- Restatements

The Brocade Case

- USAO/NDCA files criminal charges against Gregory Reyes (former CEO) and Stephanie Jensen (former VP of HR) on July 20, 2006
- SEC files parallel proceeding against Reyes, Jensen and Antonio Canova (former CFO)
- Other cases still to come?
 - “The Enforcement Division is committed to pursuing this type of unlawful stock option manipulation” (Linda Chatman Thomsen Director of SEC’s Enforcement Division)

What is next?

- NASD? NYSE?
- State regulators?
- Non-US regulators?

II. Accounting Issues Relating to Stock Options

- Key Dates in Stock Compensation
- Key Terms and Concepts
- The “Opportunity” for Backdating
- Internal Investigations: The Special Committee’s Challenge

Key Dates in Stock Compensation

- APB 25 “Accounting for Stock Issued to Employees”
- SFAS 123 “Share-Based Payments”
- FIN 44 “Accounting for Certain Transactions involving Stock Compensation”
- SFAS 123R “Accounting for Share-Based Payments”

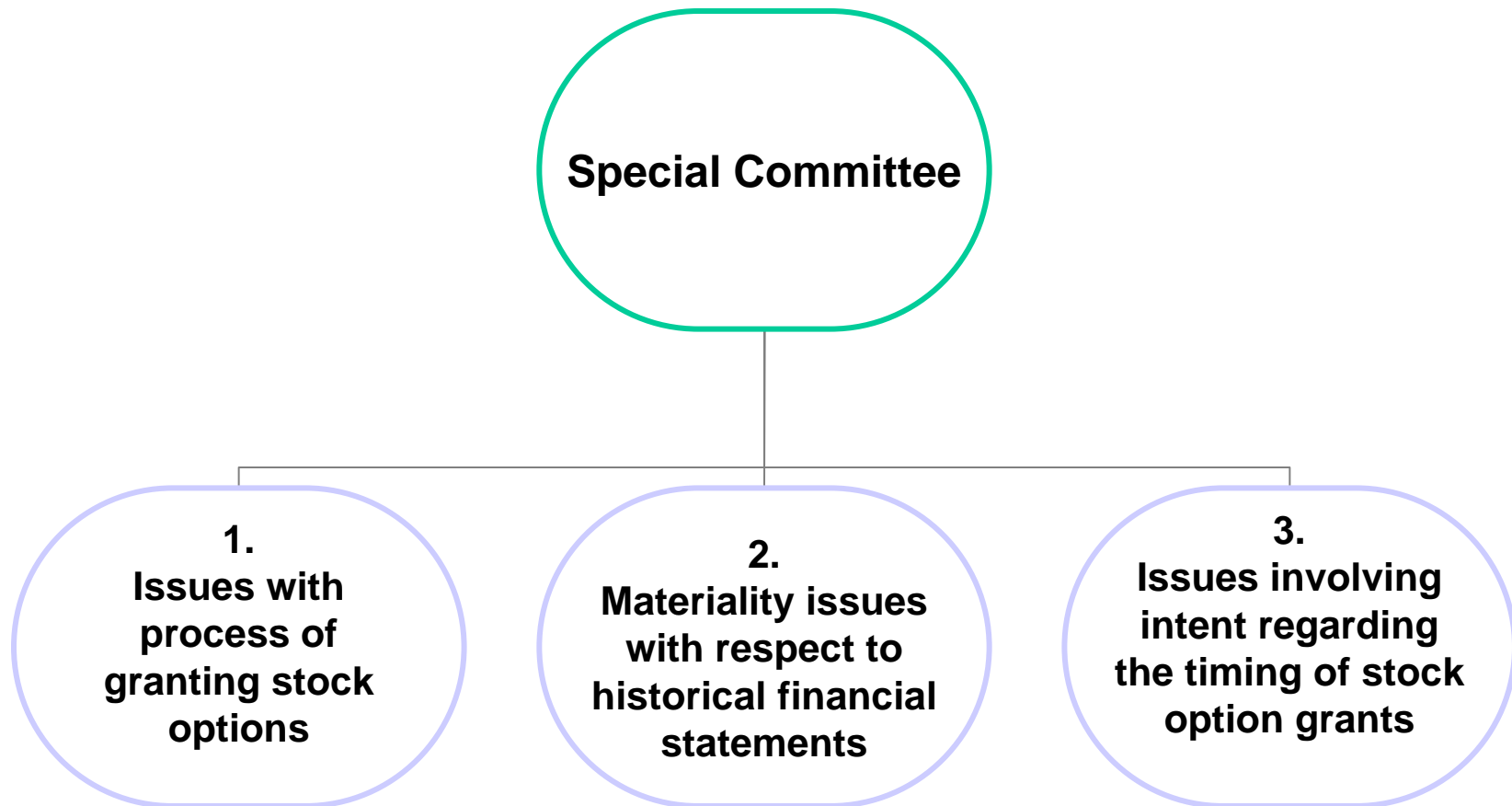
Key Terms and Concepts

- Grant Date
- Measurement Date

The “Opportunity” for Backdating

- The SEC Filing requirements below apply to Directors, Officers, and Principle Stockholders who beneficially own more than 10% of any class of any security (herein together referred to as “Material Stockholders”).
 - Prior to August 29, 2002, Material Stockholders were required to file Form 5 which detailed equity ownership including stock options. Form 5 was not due until 45 days after the Company’s fiscal year end. Since there were no reporting requirements during the year, the Company had the opportunity to look back and select the “grant date” they wanted to use. (Often times, the option grant and exercise information was not filed with the SEC until the Company filed its proxy statement)
 - Effective August 29, 2002, Material Stockholders were required to file Form 4 with SEC before the end of the 2nd business day of a transaction that resulted in “a change in beneficial ownership.” This included the receipt of option grants.

Internal Investigations: The Special Committee's Challenge



III. Legal Issues for Stock Plans and Option Grants

➤ **Tax Issues:**

1. Loss of treatment as ISOs (Incentive Stock Options)
2. Loss of Deduction for Compensation to Senior Executives in Excess of \$1 million (Section 162(m))
3. Potential Taxation on Vesting (prior to exercise) and Additional 20% Tax (Section 409A)
4. Penalties for Failure to Report Income and Withholding

➤ **Issues with Plan Terms:**

1. Invalid Grants - can arise in a number of fashions (e.g., unauthorized grantor, unauthorized recipient, unauthorized price, etc.)
2. Can also lead to argument that non-plan awards violate stockholder approval requirements of stock exchanges

➤ **Corporate Law Issues:**

1. Invalid Issuance of Shares by unauthorized grantor (non-Board member)
2. Invalid Determination of Grant Dates (usually found in awards made by unanimous written consent)

➤ **Securities Law Issues:**

1. All kinds of inaccurate disclosure (e.g., proxy statements, section 16(a) filings (esp. Form 4), periodic filings (Form 10-K/10-Q), missed Form 8-K filings, etc.)
2. Impact on S-8 Registration Statements (both as to previously registered shares and shares to be issued)
3. Disclosure re: changes in internal controls
4. And of course, disclosure changes triggered by the restatement of financial results

IV. Different Scenarios Concerning Backdating and How to Address the Problem

- Scenario #1: Classic backdating allegations
- Scenario #2: Springloading / Bulletdodging
- Scenario #3: Sloppy paperwork
- Scenario #4: Lack of proper authorization

V. Conclusion

- If the SEC/US Attorney already has come calling, what should you do?
- If the SEC/US Attorney has not come calling, what should you do? Or should you do nothing and just wait?

Questions & Answers

CLE Information

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- Attendees who registered for CLE credit will receive their Certificate(s) of Attendance within four weeks of this event.
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