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### **Backdated options putting companies in the crosshairs of government investigations**

***By Mark W. Pearlstein and Joshua A. Munn***

The financial press is full of stories about the Securities and Exchange Commission and the Department of Justice investigating corporate stock option practices.

Approximately 40 public companies face SEC scrutiny, while at least 20 are dealing with criminal investigations. The government's focus is on whether option grants were manipulated to provide executives with unduly favorable strike prices.

This article will briefly examine the government enforcement activity, and provide suggestions to counsel confronting these issues at their own companies.

#### **Tech boom phenomenon**

The current investigative activity largely arises out of the great tech boom of the late '90s. Cash strapped companies discovered they could attract and retain top talent by offering stock options in lieu of higher salaries and bonuses.

Employees were willing to forego cash in favor of the prospect of options for shares of rapidly appreciating stock.

The problem was that when a company's stock price ran up prior to an employee receiving an option grant, the value of that option was reduced, because the "strike price" - the price at which the option holder could purchase the underlying stock - was higher. In that situation, some companies backdated option grants to permit employees to receive options at earlier, lower prices.

Typically stock options are granted with a strike price equal to the trading price on the date the options are granted. If the strike price equaled the market price on the date of the grant, then-existing accounting rules indicated the company did not have to recognize a compensation expense.

If a company wanted to issue options with a lower exercise price, however, it had to recognize as a compensation expense the difference between the strike price and the market price. It now appears that some companies backdated grants to dates - days or months earlier - when the stock was trading at or near a low point for the fiscal quarter. The result was that employees received options at favorable prices and the companies avoided reporting additional compensation expenses.

Backdating option grants is not, in and of itself, illegal. However, failing to account for below-market grants and disclose the nature of the grants may be problematic.

Backdating option grants may also give rise to tax issues for both the company and the employees. Assistant Attorney General Eileen O'Connor of the DOJ's Tax Division recently testified that the DOJ is currently investigating the potential criminal tax implications of backdating.

Finally, such grants may have violated the terms of companies' own stock option plans, which often require that options be granted with an exercise price no lower than the market price on the day the options are granted.

Backdating began in earnest in the late 1990s, but appears to have largely ceased by 2002, not coincidentally the same year Congress enacted Sarbanes-Oxley. The reporting requirements set forth in Sarbanes-Oxley prevent companies from doing what they had previously done - waiting months or even up to a year to report stock option grants. Companies are now required to report stock option grants within two days of making the grant. Thus, backdating options today would require a company and its executives to openly flout Sarbanes-Oxley.

While the reporting requirements of Sarbanes-Oxley now make backdating difficult, some suggest companies might still try to provide favorably priced stock options to valued employees. Academics who first identified the backdating problem have noted that companies may have also sought to benefit employees by awarding stock options shortly before the company reported favorable news or just after the company disclosed bad news, particularly where that news was not expected to have an enduring effect.

Such grants raise concerns evocative of insider trading, and SEC Chairman Christopher Cox announced on June 13 the Commission intends to issue guidance covering this situation.

### **In-house counsel response**

So what should in-house counsel do if he or she receives information of possible options backdating?

Initially, you need to put together a plan that will allow the company to get out in front of any government action. The first step in the plan involves conducting a preliminary, internal review of past stock option practices. In the majority of cases, this preliminary review will rule out whether the company may have backdated options in the past.

If, however, any irregularities are identified during the preliminary review, a more comprehensive - and most importantly, independent - review will be necessary. If possible, an independent committee of the board of directors should be appointed to oversee this review, and separate outside counsel should be retained to conduct a thorough investigation.

Ultimately, the company's auditors must be apprised of any potential backdating issues that may surface during the investigation, and the company must determine whether the findings necessitate restating any of its prior financials.

If the investigation uncovers problems - particularly where a restatement will result - counsel will need to consider voluntarily disclosing the investigative results to the SEC. Both the SEC and DOJ explicitly recognize that timely self-reporting followed by truthful cooperation are factors militating against a corporate enforcement action. From corporate counsel's perspective, disclosure and cooperation will typically be the clear choice.

Cooperation with the government does not, however, suggest demonizing employees who may have been involved in backdating. While mistaken judgments about a company's accounting or disclosure obligations may have been made, standing alone such errors fall short of establishing the intent required for criminal violations.

Employees may have been unaware of or misunderstood the relevant accounting requirements, which underwent an evolution during the critical years. Moreover, it may be difficult for the government to prove that the supposed corporate benefit of backdating - avoiding a non-cash charge to earnings - would have been of any real significance to technology and Internet firms and their investors in the late '90s, when other metrics, such as revenue growth seemed to drive valuations.

Given the number of companies already facing investigations from both the SEC and DOJ, it is clear there will be substantial enforcement activity in the coming years.

In-house counsel at public companies should determine whether any problems involving the backdating of options exist so they can avoid being surprised by and unprepared for a government enforcement proceeding.



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