

# STOCK OPTION BACKDATING — THE LATEST WAVE IN CORPORATE GRAFT

By Alan Ellman

*The examination of several corporate executives' uncanny timing of stock option grant dates has set off a firestorm of scrutiny, litigation and investor losses.*

After the Wall Street Journal printed a front-page exposé of the economic windfall received by executives at several companies including UnitedHealth Group, Comverse Technology, and Vitesse Semiconductor, from stock options awarded to them, most on a date when the companies' stock was near its lowest price, the gloves came off. Executives and directors from at least 43 companies are currently being investigated by federal prosecutors and/or the SEC for backdating options — deliberately and improperly changing the grant date of the option to secure a more favorable price. This practice provides a virtual guarantee that executives profit handsomely regardless of stock performance.

There appear to be few plausible explanations for the likelihood of these executives' extremely lucrative options grant dates, and none of these explanations have been able to pacify the indignation of regulators and the media. Of course, options grants could have been issued at points when executives perceived shares to be undervalued. Or the options grants could also have been timed to precede positive company news—a practice known as “spring loading”—ensuring that the stock would rise thereafter. (Spring loading is also being scrutinized by the SEC, along with backdating.) And then there is the possibility that these executives were just really lucky, although a statistical analysis conducted by the Wall Street Journal found the odds of such propitious timing occurring by chance to be astronomical, in several cases greater than the odds of winning the multistate Powerball lottery — a likelihood of one in 146 million to one in several billion, in some cases.

Backdating is more than just inflammatory to investors. It exposes companies to liability on at least three grounds: (1) for misleading shareholders about the existence of the practice based

on contrary statements in the company's option plan; (2) for violations of accounting rules, which require that “in the money” options be recorded as additional compensation expense; and (3) for violations of the tax laws, which

year and determine when the stock was at its lowest point — and make that the date and price of the option grant. The new rules imposed by SOX 403, however, accelerate the filing deadline to two business days following

**An option is a right to purchase stock that often does not vest for at least one year, and often remains available over a lengthy period. The strike price of the option, mandated by the company's stock incentive plan, is the closing share price on the date of the grant. The lower the strike price, the more likely the chance for future profit. Option grants that are priced below the stock's fair market value on the date of grant are known as “in the money” options.**

allow companies to otherwise deduct the profit generated by employees' exercise of stock options, unless the options were priced below fair market value at the time of grant. A company that did not include the cost of these options as expenses may have overstated profits, requiring a restatement of past financial results.

The companies at the focus of the backdating investigations are alleged to have engaged in the practice during the rise and fall of the tech boom, involving options granted during the 1990s until 2002. Current laws, such as Section 403 of the Sarbanes-Oxley Act (“SOX”) make it much more difficult now — if not impossible — for executives to engage in such chicanery. SOX 403 accelerates the reporting deadline of executive stock option grants to be within two business days after the grants. Prior to the passage of SOX in 2002, the option grants were reportable on an annual basis within 45 days after a company's fiscal year end. This loophole gave executives sufficient time to look back at the previous

the transaction day, without any exceptions.

In addition, the SEC in January 2006 proposed broad changes to its disclosure rules for executive and director compensation. The proposal would include a new “total” column in the Summary Compensation Table that would include the dollar value of stock awards and option grants — a significant change from the current rules, which require disclosure of only the number of securities comprising the awards. A new “options awards” column would disclose the grant date fair value of each award. A key part of the proposed amendments is the treatment of the aforementioned information as being “filed” with the SEC, thereby subjecting the company to liability under the Exchange Act for false or misleading statements contained therein. In the wake of the backdating scandal, SEC Chairman, Christopher Cox, said that the proposed executive compensation rule will be revised to “almost certainly address options backdating.”