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SECURITIES LITIGATION ALERT

OPTION GRANT BACKDATING: WHAT BOARDS, IN-HOUSE COUNSEL AND EXECUTIVES NEED TO KNOW ABOUT THE ISSUE AND ABOUT THEIR OWN COMPANY'S POLICIES AND PRACTICES

Policies and practices regarding the granting of stock options have never been subject to greater scrutiny. Scores of public companies are now subject to investigations by prosecutors and regulators, and plaintiffs' class action attorneys are not far behind, making derivative demands on boards and threatening litigation. Boards, counsel and executives need to understand their own company's policies and practices, determine whether there are any historic issues with respect to the granting of stock options, and ensure that current policies and practices are lawful and properly documented.

BACKGROUND

Triggered by academic research from Professor Erik Lie of the University of Iowa and a series of articles in *The Wall Street Journal*, prosecutors and regulators are investigating the facts and circumstances at scores of public companies relating to the timing and documentation of stock option grants to company executives. In general, the strike price for options is the fair market value on the date of the grant. Accordingly, were a company to issue stock options that have been backdated to a date when the fair market value was lower than the fair market value at the time of approval, it would be possible to create the potential for a larger profit to the grantee by virtue of the increase in stock price that occurred before the grant was actually approved.

A major issue in the current investigations and litigation is whether companies have improperly backdated stock option grants. For example, there have been allegations that companies may have reached back months into the past in order to retroactively set the strike price on the lowest possible stock value date of the year. Although backdating of stock options is not per se illegal, it can lead to a host of potential legal problems with respect to disclosure, taxes, accounting and fiduciary duty obligations.

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KEY ISSUES

Prior to the enactment of Section 403 of the Sarbanes-Oxley Act of 2002 — which requires disclosure by recipients within two days — it was possible for companies to delay weeks or months before disclosing publicly on Form 5 the date stock options had been issued. Thus, prior to 2002 it was possible as a practical matter for stock options to be issued with a retroactive effective date without raising any public attention because there was no expectation that the issuance of stock options would be contemporaneously disclosed.

This possibility — together with the allegations that a disproportionate number of companies issued stock options at particularly favorable times for executive grantees — raises several key questions: (1) What was the company's historical policy with respect to issuance of stock options and the propriety of backdating of options? (2) Was this policy publicly (and appropriately) disclosed? (3) Was the disclosed policy followed in practice? (4) Were the tax obligations of the company and executives met? (5) Were the results reflected accurately in the company's financial statements? (6) If the historical financial statements are not accurate, is a restatement necessary or appropriate? (7) Finally, if such backdating did occur, who approved or had knowledge of the practice?

Turning to current policies and practices, the inquiry is similar. While the disclosure obligations of Section 403 have limited the likelihood that a company can backdate stock options, it is still crucial to determine that current policies comply with the law and that they are being followed in practice. Failure to address these issues proactively can lead to consequences ranging from negative press coverage to governmental investigations followed by class action or derivative litigation.

CONTACT INFORMATION

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