

## SECURITIES LITIGATION ALERT

### STOCK OPTION BACKDATING: NEW STUDY AND DISCLOSURE TO SEC RAISE POSSIBILITY OF ADDITIONAL INVESTIGATIONS AND LITIGATION

Last week, *The Wall Street Journal* reported that two professors at the University of Houston C.T. Bauer College of Business have completed a study which purports to show that the practice of stock option backdating at public companies may have been significantly more widespread than previously believed. Specifically, the study involved evaluation of public records relating to stock option grants at over 4,000 public companies during the past decade. Based on mathematical analysis of grant dates and investment returns, the study identifies a subset of 141 public companies that the authors label “high probability backdating.” The study then notes that a subset of 92 of the 141 companies have not previously been publicly associated with allegations of stock option backdating. The authors of the study have provided a list of the companies to the U.S. Securities and Exchange Commission (SEC). An SEC spokesman is quoted as saying the Commission “appreciated the input.”

In general, the strike price for stock 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 the grant (generally the date on which the detailed terms of the grant were approved), 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. Although backdating of stock options is not per se illegal, the practice often contravenes the terms of company stock option plans and can lead to a host of potential legal issues with respect to disclosure, tax, accounting and fiduciary duty obligations.

This new study and the publicity it is receiving raise the possibility of additional scrutiny of both past and current stock option practices. First, the Department of Justice has already obtained 15 convictions of individuals in connection with stock option backdating and this new analysis could lead to additional scrutiny by federal prosecutors. Second, while the SEC has already investigated scores of companies and brought actions against at least 24 companies and 66 individuals, the fact that

a list of allegedly “undisclosed high probability backdating” companies has been provided to the SEC raises the possibility of additional SEC investigations and actions. It remains to be seen whether the SEC will re-focus on stock option allegations in light its current focus on such priorities as regulation of the financial markets and investigation of Ponzi schemes. Finally, further private litigation by the plaintiffs’ bar is also possible. This is particularly true because the authors of the study have stated that they have a consulting relationship with an undisclosed law firm. While many actions alleging stock option backdating have been dismissed and any additional actions seeking to assert claims based on past conduct will be increasingly subject to applicable statute of limitations defenses, the fact remains that allegations of stock option backdating have serious legal implications and must be addressed by public companies and their boards and executives in a thoughtful and strategic manner.

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