

Stock Option Backdating: Understanding the Scandal and How You Can Avoid it

The recent stock option backdating scandal that has affected many high profile companies has caused a flurry of executive and Director resignations, SEC inquiries, and several announcements of planned financial restatements. The developments in recent days, prompted by an article in the Wall Street Journal, show that option backdating may be standard practice in making executive option grants at some companies.

At DolmatConnell & Partners, we have received several calls and emails from client Compensation Committee and Board members regarding how they can ensure backdating is not occurring at the companies on whose Boards they sit. The following paragraphs explain what option backdating is, discuss the current scandal, and provide steps to take to ensure backdating does not occur at your firm.

The consequences of option backdating are serious and expensive, but Board vigilance and the proper controls in your company can ensure that backdating is one Wall Street Journal story in which your company will not be mentioned.

What is Option Backdating ?

Stock options are generally granted to executives as an incentive. Stock options tie executive pay to shareholder returns by allowing executives to earn compensation equal to the difference between the stock price at the date of grant (known as the strike price) and the stock price on the date of exercise. The executive therefore has an incentive to increase the company's stock price: if the stock price goes up, the executive can exercise his options for a profit. No increase in stock price yields no gain for the executive. Stock options are generally granted at the fair market value of the stock price on the date of grant. This means that an option granted on a given day will carry a strike price equal to the closing price of the stock on that day. This means that, at grant, the option has no in-the-money value.

However, when stock option backdating occurs, a stock option grant is made on a given day, however, the option grant letter reflects a date in the past, when the stock price was lower than the real date of grant. This falsification allows the option recipient to take advantage of an opportune date with a low stock price, which will eventually equal greater income when the option is exercised.

The Scandal: Who is Involved, and What is Happening?

The option backdating story broke when the WSJ looked at companies' grant dates for executives (which are disclosed in SEC filings) and found that at several companies, option grants almost always occurred on days when the stock price was much lower than normal, and in some cases, grants occurred on the day with the lowest stock price of the whole fiscal year. The Journal calculated that the probability that these grant dates were continuously selected by chance was extremely low, in some cases odds of 1 in 6 billion. They were able to conclude that some form of backdating must be occurring, which the SEC is now investigating at several companies.



Since the story broke, the scandal has erupted, affecting a list of companies that has grown each week. As of May 24, 2006, approximately 26 companies are involved in the backdating scandal. Recently, Vitesse Semiconductor Corp announced the termination of three of its top employees, including the CEO, the CFO and one high-profile VP, due to an issue relating to “integrity of documents” concerning stock options. Health insurance mammoth UnitedHealth Group is the largest company yet to be involved in the scandal. United Health has said that it will restate its financials from the past three years due to options backdating, calling into question compensation practices related to its longstanding CEO William McGuire, who holds one of the most lucrative stock option grants of all time. McGuire’s unexercised stock options from a grant in 1999, that occurred on the very day where UnitedHealth’s stock was at its year low, are currently worth over \$700 million. Other grants he received in other years occurred at correspondingly lucrative times. The SEC is holding an informal investigation into the company’s options practices.

Dallas-based Affiliated Computer Services Inc. (ACS) has already admitted to unusual stock option grant patterns in light of an SEC inquiry in the matter, noting that grants often had an “effective date” that predated compensation committee member official approval. ACS maintains that not only did its executives never engage in purposeful backdating, but also their grant pattern did not break the local or national laws. Internal probes and preliminary reviews are being conducted at many other companies. The CEO of New York telecom company Comverse Technology, as well as two other top executives, resigned after a criminal investigation was launched involving backdating. Top executives at chip maker Power Integrations Inc. in California have also resigned following. The scandal continues to grow as more and more companies join the list of targets of investigation for irregular options granting. Currently, approximately 26 firms are involved in the scandal.

What are the Consequences of Option Backdating?

Granting options below the fair market value on the day of grant is not illegal in and of itself—this type of grant is called a discounted grant. However, a stock option grant that has intentionally been altered or misrepresented may be an act of fraud and criminally punishable. Aside from the tax and accounting consequences to the company, the potential penalties for those individuals involved in this scandal range from criminal charges to shareholder lawsuits as well as SEC sanctions and probable termination of employment. Additionally, it should be expected that shareholders will attempt to recover all compensation earned by executives through backdated options, likely including all compensation earned on the option grant (regardless of whether or not directly attributable to the discount of the option).

Additionally, the tax implications for standard (fair-market value) options grants and discounted grants are very different. Discounted grants are not considered “performance-based” compensation under section 162M of the Internal Revenue Code, so any discount provided means that the company cannot receive a tax deduction for any compensation in excess of \$1 million. In the event companies have backdated options and those options are considered discounted, companies will be faced with very expensive refilling of taxes as well as the restatement of financials to account for the value of the discounted option (fair-market-value options have historically been exempt from accounting charges). United Health currently faces this very situation. Current estimates state that option backdating will result in an accounting



charge of approximately \$393 million restated over the past three years. In addition, with executives currently holding a combined \$2.7 billion worth of stock options at United Health, the future tax deductions lost will be costly (likely hundreds of millions of dollars).

How to Ensure Backdating Doesn't Occur at Your Company

In order for option backdating to occur, Boards and Compensation Committees must be deceived by company management or the Board must be complicit in the backdating. In the past, the SEC regulations were less strict, allowing executives to report grants much later than they actually occurred, leaving room for backdating that perhaps Boards did not know about. This is likely the case at the majority of companies under investigation. Currently, under Sarbanes-Oxley, companies now must report grants within two days of their occurrence, but some research has shown that over a quarter of companies do not actually file on time. The board's complicity is likely more necessary today in order for option backdating to occur, by leaving blank option grant letter for executives to fill in the date of grant, or by "inventing" a telephone meeting call in which the option grants were supposedly agreed upon at a conveniently low stock price date.

Companies can follow certain measures in order to ensure proper practices with option grants such that backdating cannot occur. First, we recommend that Boards set the date and price of all option awards they approve, reflecting this data in the Board meeting minutes. The Board should later receive confirmation that the awards were issued on the date and at the price approved.

Boards should ensure their companies are filing SEC form 4 filings within 2 business days of option grant (as required by the SEC). If the filings are not being made within the appropriate timeframe, find out why, as this delay leaves an opportunity for backdating.

Boards should not allow executives to choose the date of their grants, nor should there be flexibility in when the grants are recorded. At some companies, the Board approves executive option grants but then allows the executive to choose the date the options are actually issued. This leaves executives with the opportunity to wait for the option to be issued, either to wait for a favorable price (option timing) or to backdate to a favorable price. Boards should clearly communicate the company's policy regarding option dating to all relevant parties such that there can be no confusion regarding what is and is not allowed.

Lastly, Boards can adopt a policy stating that option grants will be made on the same date each year, or divide annual grants into four grants made quarterly. This will provide a solid defense against any claims of option backdating or option timing.

The consequences of backdating are serious and expensive, but Board vigilance and the proper controls in your company can ensure that option backdating is one Wall Street Journal story in which your company will not be mentioned.

A Final Thought

While option backdating is being exposed today, this backdating may have occurred several years ago under different management teams than now exist. There has been significant management turnover at firms since 2000, especially at firms within the technology industry,



which comprise the majority of firms involved in the backdating scandal. Company management present at many firms today may have had no involvement in the backdating scandal, and are now being punished through significant negative press, the headaches of financial restatements and SEC investigations, and massive stock price plunges that have now made their own stock option worthless.

