

“Options Backdating” Issues Heat Up

June 1, 2006

As you have undoubtedly read recently, *The Wall Street Journal* and other media have been beating the drum loudly over whether public companies have “backdated” their options grants such that executives have reaped improper windfall profits. We previously reviewed many of the substantive issues raised by options backdating in our December 2005 webcast titled “Options Backdating: What to do Before the SEC Comes Calling” (<http://www.morganlewis.com/pubs/OptionBackdatingWebcast-19dec05.pdf>). This LawFlash updates developments in the controversy, proposes initial steps general counsel and other senior corporate managers might wish to consider taking in response, and describes the interdisciplinary team working on these issues at Morgan Lewis.

Background

In the wake of a March 2006 article in *The Wall Street Journal* reporting on a series of “in the money” options grants the *Journal* described as defying probability, nearly 30 public companies have disclosed that they are being investigated by the Securities and Exchange Commission (SEC) or the Department of Justice and/or are conducting their own internal investigations into option pricing practices. Several companies have fired senior officers—including general counsel—as a result of these investigations, an increasing number of civil suits alleging breach of fiduciary duty and other claims are being filed against these companies, and nearly every day results in yet another company disclosing that it is confronting these issues. Finally, given the significant tax effects options backdating can have, it seems likely that the IRS will also investigate.

Although Sarbanes-Oxley effectively limits these issues to pre-2004 years, it is clear that this controversy will rage for some time, as companies seek to determine whether, through inadvertence or otherwise, they have improperly backdated options grants. Indeed, SEC Chairman Cox has called options backdating a “matter of ongoing interest” to the SEC’s enforcement staff, and shareholder interest groups such as Institutional Shareholder Services have expressed serious concerns as well. Business school academics and securities firm analysts have fed the fire by publishing reports suggesting that the potential scope of the options pricing issues is very broad.

Issues for Public Companies

The legal, reputational, and market risks for public companies in this area are substantial. Options grants found to have been improperly backdated can have numerous negative effects, ranging from tax issues (loss of deductions, underwithholding) to accounting issues (restatements of financial statements to account for in-the-money expense) to securities law disclosure issues (failure to disclose backdating conduct). Additionally, improperly backdated options grants can result in substantial negative market impact and even in delisting of the company’s securities. As you would expect, all of these substantive

issues can result in legal challenges, whether from the criminal/regulatory authorities or the private plaintiffs' bar.

Accordingly, public companies that issued stock options prior to 2004 should examine whether, in doing so, options grants were structured such that the strike price was set at an earlier, lower price, rather than at the price as of the actual date of issuance.

Although much attention has been given to the prospect that such conduct may have been intentional, ***serious option backdating issues can arise even in the absence of any intentional manipulative action. Inadequate corporate procedures may create backdating situations.*** For example, a failure to record the date unanimous consent resolutions granting stock options were actually delivered to the corporation could result in the grant being dated *before* it was made. Similar situations can arise in employment situations where, for example, options are priced on the date of hire even though the formal authorization for the grant was not obtained until later.

How We Can Help

Morgan Lewis is currently helping several public companies confronting these issues, and we have formed a multidisciplinary team of lawyers with expertise in relevant areas. Our capabilities include the following:

- **Audits and Internal Investigations of Option Pricing Practices:** Our audit teams, typically composed of employee benefits and securities/white collar lawyers, can assist audit committees, special committees, or other internal investigators in reviewing historical and current option pricing practices while identifying potential issues associated with any deficient procedures. We typically coordinate our efforts with outside auditors and prepare a privileged report for audit or special committees.
- **SEC Enforcement Defense:** We are among the country's leading firms in handling SEC investigations of all types. We have more than 30 former SEC attorneys, including the former Chief Trial Counsel, the Senior Trial Counsel for the Southeast Region, the Chief Counsel to the Chief Accountant, and dozens of former members of the Division of Enforcement. We are adept at successfully resolving high-profile, high-stakes enforcement matters.
- **White Collar Defense:** Our White Collar and Corporate Investigations Practice includes more than a dozen former federal prosecutors, including the original director of the Enron Task Force, and three other Enron Task Force members. We have extensive experience in criminal securities matters and in dealing with highly sensitive issues involving corporate boards and senior executives.
- **Securities Litigation Defense:** Our securities litigators have extensive experience in defending a broad variety of civil claims made against a company and/or its officers and directors, and can also assist with a risk assessment in this area.
- **Insurance Recovery:** Our Insurance Recovery Group has extensive experience in identifying the availability of insurance coverage on behalf of individual directors and officers and companies and working to obtain coverage for the defense and payment of claims under D&O insurance policies.

- Tax Matters: Our Tax Practice has strong capabilities in the areas of tax audits and controversy, and can coordinate with our employee benefits practitioners on issues arising under section 162(m) and section 409A of the Tax Code.
- Employee Benefits: Lawyers in our Employee Benefits Practice work with clients on option pricing issues and have extensive experience in the section 162(m) and section 409A areas.

The following Morgan Lewis lawyers have worked in this area and are available to discuss these matters further—please call us if we can be of assistance:

Chicago

John D. Shugrue 312.324.2535 jshugrue@morganlewis.com

Miami

Christian R. Bartholomew 305.415.3400 cbartholomew@morganlewis.com

New York

Leslie R. Caldwell 212.309.6260 lcaldwell@morganlewis.com

Robert M. Romano 212.309.7083 rromano@morganlewis.com

Palo Alto

William F. Colgin, Jr. 650.843.7270 wcolgin@morganlewis.com

S. James DiBernardo 650.843.7560 jdibernardo@morganlewis.com

Thomas W. Kellerman 650.843.7550 tkellerman@morganlewis.com

Philadelphia

Joseph J. Costello 215.963.5295 jcostello@morganlewis.com

John C. Dodds 215.963.4942 jdodds@morganlewis.com

James W. McKenzie, Jr. 215.963.5134 jmckenzie@morganlewis.com

Brian T. Ortelere 215.963.5150 bortelere@morganlewis.com

Joseph E. Ronan, Jr. 215.963.5793 jronan@morganlewis.com

San Francisco

John H. Hemann 415.442.1355 jhemann@morganlewis.com

William H. Kimball 415.442.1277 wkimball@morganlewis.com

Washington

Christian R. Bartholomew 202.739.6400 cbartholomew@morganlewis.com

Christian J. Mixer 202.739.5575 cmixer@morganlewis.com

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