

# Option Backdating –

- What to Do Before the SEC Comes Calling

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# Why We're Here

- Analog Devices, Inc. announced an agreement in principle with the SEC staff to settle an enforcement action alleging that Analog Devices committed securities fraud by issuing backdated options to its president and other employees
  - No SEC release yet
  - Other companies have announced investigations

# Issue One: Grant Dates

- Date of grant in stock option agreement is prior to date the option was actually authorized by the board or compensation committee
  - Exercise price in stock option agreement is lower than fair market value (FMV) of the shares on the date of authorization
  - Creates a below-market option grant for GAAP purposes – financial statements are incorrect because no recorded compensation expense

## Issue Two: Exercise Dates

- Option exercise is processed on company books as of a date earlier than actual exercise
  - FMV on booked date of exercise is lower than FMV on actual exercise date
  - Company has under-withheld income taxes and underpaid payroll taxes
  - Financial statements may need to have reserve for potential tax liability

# Limited Scope of Issue

- Sarbanes-Oxley requires two-day reporting of option grants and option exercises effective August 2002
- Previously, option grants could be reported on Form 5 reports due within 45 days after close of fiscal year
- Previously, option exercises could be reported on Form 4 reports due by the tenth of the month following the exercise

# Proactive Assessment

- Any public company that thinks it may have an option-backdating issue should consider investigating the issue
- If the problem exists, take the Seaboard steps:
  - Self-policing
  - Self-reporting
  - Cooperation
  - Remediation

# Establishment of a Disinterested Committee

- Outside board members not involved in the alleged option backdating
- Independent counsel
- Keep the audit committee informed

# Impact on Financial Statements

- Below-market option grants result in compensation expense to be charged against reported earnings over the vesting period
- Financial statement reserve for withholding tax liabilities attributable to below-market options exercised as ISOs or backdated option exercises

# Impact on Market Trading

- Potential suspension of listing on stock exchange/NASDAQ until release of restated financial statements
- Prompt notification of stock exchange or NASDAQ and development of comprehensive plan to address situation

# Implicated Officers and Directors

- Leave of absence
- Recoupment of profits
- Repricing of backdated options
- Impact of Sarbanes-Oxley Section 304
- Termination for cause/forfeiture of options

# Impact on Employees

- Suspension of S-8 registration statement
- Suspension of stock option exercises and ESPP purchases
- Implications for RSU awards
- Extended exercise periods for terminating option holders
  - Accounting implications
  - Internal Revenue Code Section 409A issues

# Impact on Holders of Backdated Options

- Section 409A penalty tax
- Option repricing to grant date FMV
  - Tender offer implications
  - Compensation for price increase

# Potential Stockholder Litigation

- Breach of fiduciary duties
- Claims attributable to stock price drop

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