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The Next Big Scandal? Stock Option Practices Under Scrutiny

Over the past year the SEC's Enforcement Division and, recently, U.S. Attorneys' offices have been investigating stock option grant practices of dozens of companies. The number of companies, officers and directors facing scrutiny for these issues is likely to increase significantly as journalists and investors goad investigators to cast a wider net. A May 23, 2006 report on National Public Radio projects that as many as ten percent of U.S. companies may be at risk.

The "fair market value" premise. Companies have discretion to decide when to grant stock options and at what exercise price. Most companies' stock option plans, however, provide that the exercise price of an option will be the fair market value of the company's stock on the actual date of the grant, and companies often say in their public disclosure, including financial statements, that they grant options in accordance with those plans. Options granted with exercise prices below fair market value arguably undermine the goal of option compensation, which is to align employee interests with those of other shareholders and promote creation of shareholder value. Discounted options also result in compensation expense that must be recognized.

Options Practices at Issue

The practices under scrutiny range from sloppy record-keeping to intentionally deceptive option grants that deviate from the fair market value premise.

Dating of Options. Some companies have issued options on one date but claimed an earlier date for setting the option's exercise ("strike") price, one on which the company's stock price was lower than the price on the actual date of the grant. If a company has deviated from its option plan, the company may have to disclose that fact. More importantly, prior to 2005, accounting principles (APB No. 25) required the company to record an expense for most stock options only if the exercise price was lower than the fair market value on the date of the grant. Options that are lower priced because their strike price was set at an earlier date may improperly avoid or reduce the APB No. 25 required expense by using a purported grant date when fair market value was lower.

Reallocation of Options. Some boards or compensation committees make bulk grants of a specific number of options at the grant-date exercise price, but leave the allocation among employees to the discretion of the CEO or other management. Sometimes the discretion is not clearly authorized or well documented. Additionally, stock option plans involving large numbers of employees are prone to allocation errors and adjustments that might not be fully resolved until weeks or months after the purported grant date. Since tax and accounting rules will not recognize a grant until the option terms and optionees are fixed and determinable, reallocations after the date of the board or committee action result in a measurement date different from the purported grant date. This practice may result in some of the same adverse accounting and tax consequences as backdated options.

Unanimous Consents. The same issues may arise when boards or board committees use unanimous written consents to authorize option grants. Under state law, board or committee actions taken by unanimous consent are not effective until the last director has signed the consent. Accordingly, the option grant date will be the date on which last director signed the consent or such later date as may be specified by the resolutions.

New-hire grants. Companies often promise a new employee an option grant when he or she joins the company, but the company does not actually authorize and issue the option until weeks or months later. If the option price set on the employee's hire date is lower than the fair market value of the company's stock when the option is issued, the option must be treated as a discounted option for tax and accounting purposes.

Failure to communicate grants promptly. Both the tax rules and the accounting rules require that an option grant be communicated reasonably promptly after the grant is authorized. If a company fails to notify employees of the option award soon after it is authorized, the option might be deemed to be granted on the notification date rather than on the date when the option was authorized and the strike price was set.

Employee stock purchase plans. Broad-based employee stock purchase plans frequently base the purchase price on the lesser of the stock price at the beginning of the offering or the stock price at the end of the offering. If the plan fails to specify the maximum number of shares the employee may purchase during the offering, the purchase option will be deemed to be granted at the end of the offering, with potentially adverse tax consequences.

Well-timed option grants. The SEC staff has also questioned whether it is proper for a company to grant options shortly before releasing favorable financial results or other positive news.

Statistical analysis reveals suspicious practices

The SEC, U.S. Attorneys' offices, investor representatives and the press have employed simple methods to determine whether they believe a company has an option grant timing issue. They have compared the dates of companies' publicly disclosed option grants with the company's historical stock price data. Companies may be tagged for inquiry if their practices reveal a statistically improbable frequency of grant dates coinciding with the lowest stock price spanning a period on either side of the grant date.

Serious problems stemming from lax or improper option practices

Civil and criminal investigations by government authorities and shareholder lawsuits are obviously serious, costly problems that can consume boards and management teams, result in monetary and other sanctions, and sap investor confidence. Even for companies not facing an investigation or lawsuit, lax or improper option-granting practices can create other serious problems, including:

- Material errors in financial statements requiring restatement
- Significant deficiencies or material weaknesses in internal control over financial reporting and disclosure controls
- Inaccurate executive compensation disclosures in the company's proxy statement or Form 10-K
- Inaccurate Section 16 reports filed by directors and officers
- Voiding of options not granted in compliance with applicable stock plans
- De facto plan amendments in violation of the NYSE and Nasdaq shareholder approval requirements

Lax or improper option granting practices also expose both the company and its employees and outside directors to substantial additional taxes and penalties, including:

- Loss of favorable tax treatment for incentive stock options and for employee stock purchase plans
- Annual recognition of income and 20% additional tax under deferred compensation rules
- Loss of the company's tax deduction for options exercised by top executives
- Penalties and interest for failing to withhold and report income tax correctly, for failing to pay proper amount of income tax and for failing to pay proper amount of employment tax

What to do now

Management or board committees concerned about these issues or wanting to avoid future problems should consider taking the following steps:

- Evaluate stock granting practices and correct or eliminate any lax, improper or risky practices
 - ◆ Document option grants clearly at board or committee meetings
 - ◆ Do not adjust or reallocate grants after the meeting date
 - ◆ Cease use of unanimous consents for option grants
 - ◆ Require that new-hire grants be authorized in advance

- ◆ Communicate all option grants promptly
- ◆ Consider establishing routine, periodic dates for option grants
- Evaluate accounting for historical grants and determine whether financial restatements may be required
- Consider the need to correct prior SEC disclosures
- Consider the need to correct any corporate tax returns or information returns issued to optionees
- Consider whether certain tax problems (for example, the 20% additional tax under the deferred compensation rules) can be corrected by increasing the option exercise price
- Consult with counsel, particularly if there is any indication of intentionally deceptive option practices
- Consider self-reporting any violations to the SEC or IRS

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This information is not intended as legal advice, which may often turn on specific facts. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

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