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How Do I Know If There Is A Back-Dated Options Problem And What Do I Do?

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So, you're a General Counsel of a public company, and you've received one of those "back-dated options" letters from the Council for Institutional Investors – Or maybe CALPERS or another pension fund. Do you call the SEC? DOJ? Outside counsel? The Board? Your shrink?

The letter says benignly, "We are inquiring…" "Are you reviewing your option grants?" (Would you dare say "no"?) "Are you being investigated by the SEC or DOJ?" (Wouldn't you have already told the world so, if you knew?) "Please tell us your policy and how much your executives have been involved in timing of grants…" "Do you grant options at the same time each year?" And, oh, yes, "We will post your response, with others, on our website." And the media calls, and calls, and the stockholders call, and the chat rooms, bulletin boards and blogs are painful to read … And in corporate America the calls for regulatory investigations and prosecutions and private investigations and resignations (and other forms of bloodletting) are everywhere.

So…

As the company's lawyer, where are you? What comes first, and how do you build a process that is efficient, lets you determine if your company has the problem and, if so, how large it is. Can you proceed without a special committee or independent counsel and, if so, where's the point at which you call them in? Must you recuse yourself? How do you maintain credibility in the financial markets while you examine the problem and confirm credibility if you determine you don't have the problem or reestablish it if you find you do?

Certainly many, probably most public companies have *not* inappropriately priced or granted options. And the general counsel's job is to quickly and efficiently ascertain whether her company is one of the sinners in a way that preserves the credibility of the Board and the Company whatever the answer.

It can be done. Tackle the problem in two steps: (1) The straightforward task of finding out if you in fact have the problem, which can usually be done internally; and (2) The more complex task of remediating the situation if you do have the problem.

What Is The Back-Dated Options Problem?

The problem centers around the appropriate pricing of options. The principal form of options in question are incentive stock options and the method of granting and pricing them is well defined. They are granted under a shareholder-approved plan and by a board committee of independent directors. The grants must use a strike price which is not less than fair market value ("fmv") on the date of grant. There are several variations of fmv available but all use a reference point of the market price (closing, an average of bid and asked, for example; Treasury says it must be a "reasonable method") within the very recent past *prior* to or on the grant date – very often the day before. Typically, there is a roster of options to be granted on a certain date with a strike price at the closing market price the day before the grant is approved by the entire board or the compensation committee, or a combination of the two, at or shortly before the grant date. (Since state law began permitting the grant of options for many employees to be delegated to senior management, this has become an added feature – but not one that changes the procedure.)

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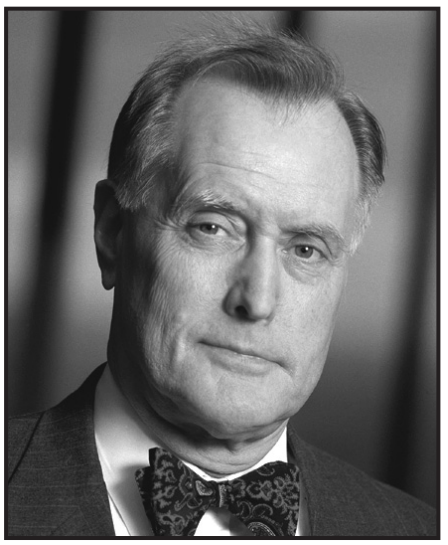

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And What Is Back-Dating?

There are three patterns. The first is common enough and really involves no violation: the grants are made in the manner described above. But the agreements embodying the grants are not prepared until sometime after the grant date. Nevertheless, when prepared they reflect a grant properly authorized with an exercise price determined in accordance with the provisions of the plan (and the law) and not including any change in the number of options or the price from the date of grant.

The other two varieties are more problematic. The first is true back-dating. That is, to determine on a given date to grant options as of an earlier date with a strike price as of an earlier time. This practice essentially allows the granting party to pick a date with a lower price, attach what appears to be an appropriately calculated strike price to the grant, and paper it accordingly. Of course, this eliminates the risk for the employee as to any price increase that occurred between the artificial grant date and the actual date on which the determination to make the grant was made.

The third variety is even more imaginative: it presumes that the strike price can be determined with reference to better pricing within a range of market days (typically 30) before or after the actual grant date in order to give the grantee the lowest price during the reference period.

What Are The Problems?

To start with, granting so-called "in the money" options creates deferred compensation for the grantee and eliminates the option from the benefits of an incentive stock option. The compensation is a deductible expense, which could reduce earnings. It has tax implications for the employee. The effects of exercise on both company and employee are different. Then there is the issue of improper disclosure of the way in which the options were granted and treated. Certainly it will require review of the financial statement presentation and could in some instances necessitate restatement. In any event, it will most likely lead to footnote disclosure.

Next there are the more serious issues of dealing with the regulatory investigations which may well attend the discovery of this behavior. These could be both civil and criminal fraud investigations given the process that appears to have been used. And one must expect shareholder litigation. While fraud civil actions will certainly be filed, whether derivative suits can be fashioned from this conduct, and the attendant "losses" by corporations, seems questionable – given the fact that there was no actual transfer of corporate assets.

Step One — Determining If You Have The Problem

The media has suggested that any number of high-powered investigations would need to be undertaken and law firms are at the ready to oblige. Certainly any general counsel of a public company needs to check his situation. But the preliminary investigation is not tough and can usually be done internally. First, the investigative team (best choice – internal audit) must be comprised of employees whose own options are not suspect. The process of confirming that is identical to that described below – check the options roster against committee and board minutes against the strike price. The investigative team will then review the minutes of the compensation committee and of the board with respect to options against the option program records to confirm the timing of the grants, the recipients, and the method of pricing. Then the terms of the form agreement must be compared to this review – especially for date and price. If there is a problem, it will be evident. If it is clear there is no problem, management can report the same to the Board and, if it chooses, to the inquiring investor and the general public.

Step Two - What To Do If There Is A Problem

But if there is a problem, there is the question of next steps – and they are intricate. It's hard to escape the conclusion that this is an occasion where self-reporting is an important next step. But it is not the first next step. In fact there are two: (1) suspend any document destruction program, and (2) form a Special Committee of wholly-independent directors with no connection to the problem (no management – they undoubtedly precipitated the problem; can't be Compensation – they should have caught it; and probably not Audit – they have enough to do already and may well share some common members with Compensation). And the Special Committee will need its special counsel (can't be regular outside counsel – how'd they miss it in preparing the 10-K/proxy material, including the Compensation Committee report and the financial reporting?). This investigation will begin to look more typical, and at this point, outside lawyers can now contribute value. The new independent investigative team, led by these independent counsel, will be responsible to the Special Committee (and the Board) for getting the Company through the fundamentals of the investigation and remediation with minimal disruption, which in this case are:

- reviewing the results of Step One which defines the scope
- interviewing those with knowledge (which will include both those who conducted Step One and at least some of those who were involved in granting and receiving the back-dated options)
- reviewing relevant e-mails and documents, including, of course, the option plan and policies
- building with the Special Committee a remediation plan that includes:
- managing the media
- developing appropriate policies (and plans) for options
- framing the decision to self-report (if that is the decision)
- recommending terminations and resignations (there will need to be some)
- organizing the response to any regulatory investigation
- addressing the impact on financial statements
- framing a response to civil litigation
- addressing tax issues (reporting, withholding and deferral)
- ultimately building a public relations program to restore public confidence in the Company and its financial reports

Most of corporate America will not have any back-dated options problem. And while some may have bad optics due to lax record keeping, the truth that no substantive abuse occurred will ultimately shine through. Finally, there will be the "too good to be true" opportunists who let greed or indifference tilt their moral compass. All of these situations need to be identified quickly to forestall unfair and harmful clouds of doubt and unwarranted litigation.

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