The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 15, No. 4 April 2007

Compliance Readiness – Law Firms

Backdated Stock Option Issues Continue To Make Headlines

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A company that backdates stock options without disclosure subjects itself, its board of directors and its officers to a multitude of legal issues, particularly in the areas of securities law, federal income tax and fiduciary duty of public company directors. As public concern over backdated stock options has continued to escalate over the past year, the Internal Revenue Service ("IRS"), the Securities & Exchange Commission ("SEC") and the courts have all responded in kind.

"Backdating" of stock options generally refers to the grant of a stock option with a grant date that is earlier than the actual date of grant (i.e., the date that the company's board of directors or compensation committee approves such grant). However, during the last year, the term "backdating" has taken on a broader meaning and may be used to refer to other manipulative stock option grant practices, including forward-dating, spring-loading and bullet-dodging.

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The IRS Compliance Program

Backdated stock options or stock appreciation rights would typically be treated as discounted stock rights under Section 409A of the Internal Revenue Code. Under Section 409A, a discounted stock right would subject the holder to a penalty tax of 20% plus interest (in addition to regular federal income taxes) when the stock right vests. In order to allow companies to alleviate such concerns for employees, the IRS set forth in Announcement 2007-18 a compliance program by which companies could pay the additional taxes and interest charges for rank-and-file employees (non-insiders) who were affected by the exercise in 2006 of backdated stock options or stock appreciation rights. The program was implemented because the IRS wanted companies to have the ability to "satisfy the tax obligations of employees who did not knowingly participate in these schemes" to backdate stock option grants. The deadline for companies to enter the program was February 28, 2007. This program was not considered a great concession from the IRS because companies already had (and still have) the ability to pay these taxes anyway, provided that such payments are considered additional compensation to the employee.

Additionally, most backdated stock options are no longer eligible for modifi-

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cation under the transition rules under Section 409A. In Notice 2005-1 and the proposed regulations issued under Section 409A, the IRS provided a transition period during which companies could bring non-compliant plans into compliance with the new rules. The initial transition period ended on December 31, 2006. In Notice 2006-79, the IRS extended the transition period for compliance with Section 409A to the end of 2007 with one notable exception – backdated stock options and stock appreciation rights of companies whose securities are required to be registered under Section 12 of the Securities Exchange Act of 1934. Therefore, backdated stock options and stock appreciation rights granted prior to the effective date of Section 409A by public companies are ineligible for modification after 2006. Accordingly, with respect to such backdated options and stock appreciation rights, companies and the holders of such stock options and stock appreciation rights are very limited in what they can do and, generally speaking, will subject the holder to immediate taxation, including the additional 20% tax, when such options or rights vest.

The SEC Investigations

The SEC has stepped up its investigations of companies that they believe have backdated stock options. Currently, the SEC is investigating over 140 companies with respect to backdated stock options. The SEC has also filed complaints against several executives for their roles in backdating stock options. On February 14, 2007, the SEC filed and settled civil charges against the former CEO and Chairman of Take-Two Interactive Software, Inc., in which the SEC alleged that the executive enriched himself and others by backdating options over a seven-year period. The complaint also alleged that due to the backdating of the options, the executive violated the applicable provisions of the Sarbanes-Oxley Act by knowingly filing (or was reckless in not knowing) quarterly and annual reports, proxy statements and registration statements that contained materially false and misleading statements. The executive consented to an order that, among other things, permanently barred him from acting as an officer or director and required him to disgorge ill-gotten gains of over $4 million.

Additionally, on August 9, 2006, the SEC filed an action against several former executives of Comverse Technology, Inc. alleging fraud. The SEC claimed that the executives were responsible for backdating stock options over a 10 year period and in creating a slush fund of backdated options by causing options to be granted to fictitious employees which were then used to recruit and retain key employees. The complaint alleges that one of the executives realized actual gains of nearly $138 million from sales of stock underlying the exercise of backdated stock options, of which at least $6.4 million represents the "in-the-money" portion of the options on the date of grant due to the backdating. On January 10, 2007, the SEC announced that one of the former executives in this case entered into a settlement with the SEC which requires him to pay over $3 million in civil penalties, disgorgement and prejudgment interest.

Shareholder Derivative Suits Involving Manipulated Option Grants

Two very recent Delaware Chancery Court decisions could have a wide-reaching effect on companies that have manipulated option grants. The decisions addressed whether lawsuits could be brought against a company's board of directors for either backdating options, or granting "spring-loaded" (or by analogy, "bullet-dodging") stock options. Spring-loaded stock options are options that are granted prior to a company news release that is assumed will have a positive effect on the company's stock price, while bullet-dodging stock options are options that are granted after news has been released by the company which has a negative effect on the company's stock price.

In *Ryan v. Gifford,* (C.A. 2213-N, Feb. 6, 2007), a shareholder derivative suit, the plaintiff alleged that the directors and compensation committee members of Maxim Integrated Products, Inc. breached their fiduciary duties by intentionally backdating options. In *In re Tyson Foods, Inc. Consol. S'holder Litig.,* (C.A. 1106-N, Feb. 6, 2007), another shareholder derivative suit, the plaintiff alleged that the board of directors of Tyson Foods, Inc. violated their fiduciary duties by providing for spring-loaded option grants. The plaintiffs cited several instances where option grants to executives were made several days prior to news releases about a favorable merger transaction and positive earnings reports.

In each case, the Delaware Chancery Court denied each of the defendants various motions to dismiss and allowed each plaintiff's case to proceed for similar reasons. In the *Ryan* case, the court opined that "the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith." In *In re Tyson Foods, Inc.,* the court stated that "[g]ranting spring-loaded options, without explicit authorization from the shareholders, clearly involves an indirect deception." The court went on further to explain that granting spring-loaded options was not a question of insider trading, but rather whether "a director acts in bad faith by authorizing options with a market-value strike price . . . at a time when he or she knows those shares are actually worth more than the exercise price." The court further stated that in such a case, the director could, at such times, be breaching his or her duties of loyalty with the company and not acting in good faith as a fiduciary. In both cases, the plaintiffs still will need to prove that the directors did act with requisite knowledge and intent to constitute bad faith.

Two important notes about these cases: first, the court allowed, in each case, the shareholder to bring the action directly to the court, rather than making a pre-suit demand to the board. The court stated that the board's culpability in granting backdated options raised questions about the board's exercise of business judgment and excused the shareholder from making such a demand to the board. Second, the court held that, in each case, if proven, the directors would be found to have breached their duties of loyalty as well as not acting in good faith with respect to granting these manipulated options (whether backdated, spring-loaded or bullet-dodging options). If so proven, then a director would not be able to use the protections afforded to him or her under the Delaware Business Law and could be subject to liability for pecuniary damages to the corporation.

Conclusion

As the issues surrounding backdated stock options continue to make headlines around the world, investigations by the IRS and SEC and shareholder derivative suits will continue to flourish. In addition, with many companies being required to restate financial statements and annual reports due to these issues, it is important to consider the other ramifications that could arise, such as misstated tax returns and misstated representations in purchase/merger agreements.