

Articles

"Stock Option Scandal"

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From a securities law perspective, a lot happened in 2006, but the stock option scandal is the most noteworthy. Unlike other recent, industry-specific kerfuffles, the stock option problem reached across sectors and touched all industries. In fact, the problem is so pervasive that it spurred more than 100 U.S. Securities and Exchange Commission and U.S. Department of Justice investigations.

A stock option gives the holder the right to purchase a share of stock at a predetermined price - the exercise price - which is typically the closing price of the company's stock on the date that the company grants the option. Thus, on the grant date, the option has no intrinsic value and is deemed to be "at the money."

At the heart of the scandal are efforts by executives to grant options to company employees with exercise prices below the closing price of the company's stock on the actual grant date - resulting in an option with intrinsic value on the date that it is granted, called an "in the money option." This typically is accomplished by forging or backdating corporate documents to make it appear falsely that the company granted the option on a date when the company's stock price was lower than on the true grant date.

Assume, for example, the board of XYZ elects to issue 1,000 options to its CEO on Dec. 15. At the close of the market that day, XYZ's stock was trading at \$10. A company electing to game the system, however, may recognize that the closing price on Dec. 3 was \$6 and decide to alter company records to grant the options as of Dec. 3 - resulting in an immediate benefit of \$4 per share for the CEO.

There are numerous variations on option backdating, but the effect of each is to provide an in-the-money option to company employees through some deceptive means.

The primary consequence of backdating is that it requires a company to record a compensation expense, which, if not taken, results in an understatement of expenses and overstatement of earnings. Until recently, the company did not need to record a compensation expense if a stock option held no intrinsic value, i.e., for an at-the-money option. However, the company should record a compensation expense - the difference between the exercise price and the fair market value on the date of the grant - for an in-the-money option.

From a disclosure perspective, a court or the SEC may deem the company's annual report, proxy statements or beneficial-ownership reports required under §16 of the Securities Exchange Act of 1934 - made by officers and directors regarding their ownership and purchase of sale of the company's securities - misleading because the company did not disclose that it backdated options. Backdating also could subject an officer to SEC or DOJ prosecution for false certification under the Sarbanes-Oxley Act of 2002.

In addition to exposure of fraudulent backdating, the stock option scandal has revealed the inadequacy of many companies' procedures related to the granting of stock options. Every public company should examine past option granting practices to determine if backdating occurred and should carefully review their existing practices to ensure against future problems.