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A Brief Primer on Stock Option Backdating

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1. What is Stock Option Backdating?

a. **Stock Options.** A stock option gives the optionee the right, during a specified term, to purchase stock at a fixed price (the "exercise" or "strike" price). The exercise price is commonly set at the fair market value (the "FMV") of the underlying stock as of the date the option is granted. The optionee has the opportunity to profit if the value of the stock increases during the option term so that the value exceeds the exercise price. An employer corporation can use stock option grants to provide employees an incentive to increase the value of the employer corporation's shares.

b. **Backdating.** Stock option backdating occurs when an employer corporation purports to grant a stock option at a date earlier than the actual grant date. A corporation may do this in an effort to provide the optionee with a reduced exercise price, selecting an effective grant date on which the FMV of the stock is low. A grant of a stock option with an exercise price that is less than the stock's FMV is said to be "in-the-money," since the optionee could immediately exercise the option and realize a profit.

c. **Related Practices Also Under Investigation.** While not technically stock option backdating, two other stock option practices have recently attracted regulatory attention.

i. Grants Preceding Positive News. The first involves the timing of stock option grants to precede material announcements that are likely to cause an increase in stock value. Many commentators have suggested that this practice, sometimes referred to as "spring-loading," is a form of prohibited insider trading.

ii. Backdating of Exercise Date. The second involves backdating a stock option exercise date rather than a stock option grant date. Corporations might use this form of backdating either (i) to select an exercise date with a lower stock value, allowing the optionee to report less taxable income on exercise, or (ii) to select an exercise date with a higher stock value, allowing the optionee to tender shares to pay his exercise price at a time when those shares had a high value.

2. How Is the "Grant Date" of a Stock Option Determined?

a. **Tax Accounting – Section 1.421-1(c)(1) of the Treasury Regulations**. Section 1.421-1(c)(1) of the Treasury Regulations states as follows:

For purposes of this section and Sections 1.421-2 through 1.424-1, the language "the date of the granting of the option" and "the time such option is granted," and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. A corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

b. Financial Accounting – 2005 Interpretation of FASB Statement 123(R). FASB Statement No. 123(R) (revised 2004) currently governs the financial accounting treatment of stock options. Under Statement 123(R), the grant date of a stock option is the date the issuing corporation and the optionee have a "mutual understanding" of the key terms and conditions governing the stock option grant. In the summer of 2005, the FASB issued FSP FAS 123(R)-2, titled "Practical Accommodation to the Application of Grant Date as Defined in FAS 123(R)." That clarifying statement indicates that the required mutual understanding is presumed to exist at the approval date of a stock option if both of the following conditions are met:

i. The stock option is a unilateral grant (that is, the optionee may not negotiate terms and conditions with the employer); and

ii. Key terms and conditions are expected to be communicated within a reasonable period from the date of approval.

3. What Is the Perceived Economic Harm Associated with Backdating an Option Grant Date?

a. Shareholder Dilution. All stock option grants dilute the existing shareholders' participation in future appreciation in stock value. But in-the-money grants dilute shareholder value even more, since the optionee is allowed to purchase shares for less than the FMV of the shares as of the date the option is granted.

b. Unreported Corporate Expense. The grant of a stock option to an employee is a transfer of value from employer to employee. Under current rules, the transfer must be reflected as an expense of the corporation, thereby reducing the corporation's reported profits. The expense will be larger if the option, based on its true grant date, is in-the-money. An employer corporation that backdates a stock option grant will therefore understate its compensation expense and overstate its profit.

4. Corporate Issues.

a. Waste of Corporate Assets. Is stock option backdating a violation of the directors' (or compensation committee's) duty to conserve corporate assets? It seems likely that persons granting the option would simply assert that they were trying to provide maximum incentive to the optionee, who in turn would provide valuable services to the issuing corporation. It is generally not illegal to grant options to employees with an exercise price less than the underlying shares' fair market value. Determinations as to the level of executive compensation are often given wide latitude under the business judgment rule.

b. Grants Exceeding the Authority Conferred by Shareholder Approval. Most employee stock plans are approved by a corporation's shareholders. If the plan as approved imposes limits on the corporation's ability to issue in-the-money options, and stock option backdating results in a violation of those limits, has the corporation acted in a manner that is unauthorized or ultra vires? This seems somewhat unlikely, since most plans allow the directors or compensation committee to modify plan terms (except for the number of shares reserved or the class of employees eligible to receive an award) without obtaining new shareholder approval.

5. Securities Issues.

a. **SEC Disclosure Requirements.** The SEC imposes reporting obligations on public companies to report compensation paid to key executives and also to report details about their stock option grants. Stock option backdating might create a materially misleading statement if the backdating was not properly reported to shareholders in a timely filing. This will be a concern primarily for publicly-traded companies.

b. **Failure To Comply with State-Level Blue Sky Requirements, Including Section 25102(o) of the California Corporations Code.** Section 25102(o) of the California Corporations Code provides a securities exemption for employee stock plans that require exercise prices of not less than 85 percent of FMV of the underlying stock (110 percent of FMV in the case of grants to ten-percent shareholders). A backdated stock option may violate this rule if the exercise price is less than 85 percent of the underlying stock's FMV as of the true grant date.

6. Tax Issues.

a. **Loss of ISO Status.** Stock option backdating can violate tax rules dealing with incentive stock options. If the stock option was intended to be an incentive stock option (an "ISO"), and it was granted with an exercise price less than the FMV of the underlying stock as of the true grant date, it will fail to qualify for tax-favored ISO treatment. The detrimental consequences here would fall almost entirely on the optionee, who would face increased regular income tax liability on exercise of the option. In some respects, loss of ISO status may prove beneficial to the issuing corporation, since the corporation could qualify for a tax deduction on the exercise of the option if the option flunks the ISO tests.

b. **Nonqualified Deferred Compensation Under IRC Section 409A.** Stock option backdating can also trigger adverse tax consequences under the harsh rules applicable to nonqualified deferred compensation under Section 409A of the Internal Revenue Code. These rules can apply to non-ISOs (non-ISOs are often referred to as NSOs or NQOs) granted with an exercise price that is less than date-of-grant value of the covered stock. The tax consequences of failure to comply with Section 409A restrictions are generally a 20-percent penalty tax and an interest charge on the optionee's option income.

c. **IRC Section 162(m) – Limits on Deductibility of Executive Compensation**. Section 162(m) of the Internal Revenue Code can prevent a publicly-traded company from deducting compensation paid to its highest ranking executives to the extent the pay exceeds $1,000,000 per year. There are exceptions to nondeductibility for "performance-based" compensation, including certain stock option income. But a stock option will qualify as performance-based, for this purpose, only if its exercise price is greater than or equal to the value of the underlying stock as of the option grant date. If an option grant is backdated so as to violate this rule, the option may not qualify as performance-based.

d. **IRC Section 280G – Parachute Payments.** Section 280G imposes severe tax sanctions on so-called "parachute payments." Parachute payments are large payments to corporate insiders associated with a change in corporate control. Compensation can be treated as a parachute payment if it equals or exceeds three times the insider's annual base pay from the corporation. A backdated stock option can affect the Section 280G computation in two ways: (i) if the additional stock option income is a component of the parachute payment, it can increase the amount taxable under Section 280G (detrimental to the employee) or (ii) if the additional stock option income is a component of the corporate insider's base pay, then it can increase the base against which the parachute payment is measured (favorable to the employee).

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e. **Withholding and Employment Taxes.** If a stock option backdating audit flips a compensatory stock option from ISO to non-ISO status, the change in status could increase the employer corporation's potential exposure for withholding and employment taxes.

f. **Reasonable Compensation.** A corporation can generally deduct compensation payable to an employee only to the extent the compensation is reasonable. It is possible that additional income attributable to stock option backdating would cause in an increase in an employee's compensation that would exceed this "reasonableness" limit.

7. Financial Accounting Issues.

a. **Understated Stock Option Expense.** For corporations that prepare audited financial statements, including all publicly-traded corporations, stock option backdating can have an impact on the corporation's reported profit or loss. A grant of an in-the-money stock option represents a larger corporate expense than the grant of an at-the-money stock option, and the granting corporation's financial statements may have to be modified to reflect that difference. The difference is likely to be most dramatic for stock options granted prior to 2006.

b. **Stock Options Granted Prior to 2006.** Prior to 2006, generally accepted accounting principles typically permitted "fixed option" accounting where the option's exercise price was no less than fair market value of the underlying stock as of the grant date. This kind of accounting often meant that the issuing corporation did not report any expense item due to the issuance of the option. But if the exercise price was less than fair market value of the underlying stock on the grant date, the option would be thrown into the stricter rules applicable to "variable option" accounting. This could require the issuing corporation to accrue an expense item over the vesting term of the option, thereby reducing corporate earnings. Backdating issues, therefore, could have a large impact if the backdating required a reclassification of options from the benign fixed option category into the harsher variable option category.

c. **Stock Options Granted in 2006 and Thereafter.** Generally accepted accounting principles were modified effective as of 2006 to require granting corporations to take into account a compensation expense whenever they issued compensatory stock options. The new rules require this treatment regardless of whether the option's exercise price is less than, equal to or greater than the underlying stock's value as of the date of grant. So a backdated stock option, where the value is less than underlying stock value on the true grant date, will still result in some understatement of compensation expense – the compensation expense associated with an in-the-money grant will be higher than the expense associated with an at-the-money grant. But the restatement required for backdated stock options issued in 2006 and thereafter is likely to less significant than that required for backdated stock options issued in prior years.