The Consequences of Backdating Executive Stock Options

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One of the biggest recurrent financial headlines in recent years concerns incentive corporate compensation in the form of stock options. In 2005 a study was conducted on the timing of corporate executive stock options awards. The study concluded that it was likely in some cases the timing of stock options grants was manipulated or backdated in order to make the options profitable.[1] Now, more than 130 companies are either being investigated by the SEC and/or have disclosed misstated options, according to the Wall Street Journal.[2] The backdating of options, among other things, causes companies to misstate their earnings, leading to diminished shareholder value. Backdating also potentially violates securities and tax laws.

Stock option awards became a popular tool for emerging technology companies during the dot-com boom of the 90s. Many such companies lacked the capital to provide generous paychecks to attract corporate executive talent. Instead, these companies used stock option awards which would only become profitable to the grantee if the stock price rose. Thus, in theory corporate executives had an incentive to work towards making the company more prosperous and shareholders would benefit from the increase in stock value. However, corporate executives in some cases backdated the grant date of their option awards in order to guarantee profit on their option awards.

Awarded stock options only gain value if the stock price rises from the grant date to the exercise date of the option. Such stock options are classified as in-the-money options. Stock options where the grant date and exercise date are equal (at-the-money) or where stock price drops between the grant date and the exercise date (out-of-the-money), are worthless in value. Some corporate executives would pick a date retroactively for the grant date where the stock price was lower than the exercise date in order to secure a profit. Often when this was done, the grant date was set at the date with the lowest stock price of the grant month or even fiscal quarter. A study on stock options concluded that approximately 5.2 percent of all stock option grants made between the years 1995-2005 of a sample of 19,017 option grants had a grant price at the lowest price of the grant calendar quarter.[3] United Health Group's Chief Executive, William McGuire, received 12 option grants which were consistently "lucky" in being granted on low stock price dates right before a stock run-up. His grants were so lucky, that the odds were 1 in 200 million that he would receive such favorably consistent lucky grants.[4] Given these facts, the odds are extremely favorable that these grants were backdated.

Despite, the obvious moralistic wrongs with backdating stock options, the potential legal violations are not so obvious. The next section will discuss the possible securities and tax law violations of backdating stock options.

Securities Law Violations

Section 10(b) of the Securities Exchange Act of 1934 prohibits the use of any "manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[5] Section 10b-5 of the Act makes it unlawful for any person to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact (or omit same), and to engage in any act, practice or course of business which operates as a fraud or deceit upon any person in the connection with the purchase or sale of any security.[6]

Backdating stock options may fall under violation of these rules because the company's financials may be found to be fraudulent and misleading if it was stated that the exercise price was equal to the grant price when in fact the stock option was backdated for a different grant date. Also, backdating might fall under violation of these rules because backdating can misstate a company's earnings if the options are treated as at-the-money options which bear less expense on a company than backdated in-the-money options.

Violations of these securities laws, makes a company susceptible to shareholder lawsuits. Recently Apollo Group, Inc. and Bed, Bath and Beyond both have been sued by shareholders for fraud in connection with backdating stock options.[7] Several securities class action suits have been filed against Affiliated Computer Services Inc. and Vitesse Semiconductor Corp.[8]

The passage of the Sarbanes-Oxley Act on August 29, 2002, restricted the reporting of stock options within two business days of the grant date.[9] Executives could no longer wait several months to report the grant of a stock option award. This law significantly decreased stock option backdating. Studies show that after the passage of the act, backdating decreased from 23 percent of all unscheduled at-the-money grants to 10 percent.[10]

Criminal Implications

Directors of companies who backdate stock options may also face criminal penalties in addition to civil penalties and fines. The Securities Act of 1933 and the Exchange Act of 1934 both allow for the imposition of criminal penalties for violation of any such Act. Violators of the Securities Act of 1933 face a possible conviction of imprisonment up to five years and/or a fine of up to $10,000.[11] Violators of the Exchange Act of 1934 face a possible conviction of imprisonment of up to 20 years and/or a fine of up to $5,000,000.[12] In order to convict under these statutes, both require a willful intent to violate such Acts. A willful intent requires that the actor had a bad purpose or intent behind his action but not necessarily a specific intent to violate any securities laws.[13]

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The scienter requirement can be difficult to translate to charges related to backdating stock options because directors of corporations can allege that they did not intend to make any fraudulent misrepresentations but rather that backdating was a routine and accepted practice. So far, criminal indictments have only been sought against directors who clearly intended to use backdating for fraudulent purposes. The indictment against Jacob Alexander, former CEO of Comverse Technology Inc, alleges that Jacob Alexander purposely backdated stock options by devising grants to fictitious employees and then depositing the funds in a secret "slush" fund.[14] William Sorin, former general counsel of Comverse and former CFO David Kreinberg, both plead guilty to securities fraud.[15]

Tax Law Violations

Stock options became a more favorable method of pay to corporate executives after 1993, when Section 162(m) of the Internal Revenue Code was enacted.[16] The law requires that the tax deduction for the top five most highly paid executives at a company be capped at $1 million per year per executive. However, at-the-money stock options were excluded from consideration under this law because they were titled "performance based compensation" and thus were exempted from the cap on deduction.[17] Therefore, companies restructured their compensation programs to include more stock options in order to include executive compensation under the tax deduction. After the 1993 law was passed, stock option grants at S&P top 500 companies increased by 45 percent on average.[18] When a company purports to award at-the-money stock options but in fact awards backdated stock options which are in-the-money, the company misstates its tax liability. The company purports that the stock options are part of qualified performance based compensation when in fact the options should be included as part of the $1 million cap on corporate executive compensation.

Section 422 of the Internal Revenue Code allows a company to grant tax free incentive stock options (ISO). In order for an option to be considered an ISO it must be not be granted in-the-money.[19] Therefore, companies may be liable for failing to withhold income taxes due on such stock options if they classify an option an ISO when in fact it does not qualify because it is in-the-money. The IRS may also penalize the company for failure to withhold income taxes at an interest of 8 percent, plus an additional 15 percent penalty, plus another additional

20 percent penalty if the failure to withhold is negligent.[20] In addition, backdated options which are purported by a company to be an ISO, vesting on or after January 1, 2005, are in violation of Section 409A of the Internal Revenue Code. Such options are considered deferred compensation and are subject to a tax at the time of vesting and an additional penalty tax of 20 percent of the compensation, plus interest on underpayment.[21]

Backdating stock options may also violate financial reporting requirements. Prior to December 15, 2005[22], companies had to report based on the Accounting Board Principles (APB) Opinion 25.[23] Under this regulation, companies were required to account for the difference in grant price and exercise price of in-the-money stock options as an expense to the company. Companies that categorized backdated stock options as otherwise, often misstated their expenses by failing to include these in-the-money options. Companies that made this error are now being required to restate earnings and profits to account for backdated options. This creates a potential problem to investors who relied on reported profits of a company to make investment decisions.[24]

Recently, the Securities and Exchange Commission passed new rules regarding executive compensation disclosure. The rules approved on July 26, 2006 require substantial disclosure of executive compensation, making it difficult for companies to backdate stock options without anyone noticing as in the past. Companies will be required to explain in detail their executive compensation policy. A total compensation dollar amount for each executive will be required for disclosure. In addition, a compensation table section will be required which details when options are granted and approved by the compensation committee. If the exercise price differs from the grant price, the company will be required to disclose the method for determining the exercise price.[25] The aim behind this rule is to make obvious any attempt by a company to give options priced below the value on the date they were granted.[26]

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Corporate Governance

Studies suggest that options backdating may be linked to a bigger problem of general bad corporate governance. It was previously thought that backdating was a pattern among technology firms because of the tendency of such firms to use stock options as compensation more than other types of firms. However, now a link between stock option manipulation and governance has been established. Stock option grants that are most likely backdated occurred more frequently at firms where there was a lack of independent directors and where CEOs had longer tenure.[27] This suggests that backdating was most prevalent in firms where executives had greater control and influence, thus suggesting a conscious abuse of power. Also, although stock options theoretically are meant to be used as a substitute for executive pay, a study shows that CEOs receiving options that are most likely backdated receive a total compensation which is higher than compensation of executives at peer firms.[28] Thus, backdated options were most likely granted out of greedy motivations, not an actual need for substitute performance based pay.

Repercussions of Backdating

Backdating stock options undermines the entire purpose behind granting stock options. Stock options are meant to be a form of performance based pay since employees are only rewarded if the stock value of the company rises. However, when options are backdated employees are rewarded no matter what the stock value of the company is and worse are even rewarded when the stock price declines. This severs the relationship between performance and compensation. This is turn can result in the misallocation of company resources because of the lack of incentives for executives to reward based on performance.[29]

As backdating has become a front-page story on newspaper headlines, investors are becoming wary in their confidence in companies that backdate. This is particularly because investors are realizing that companies may have reported inflated profits by not accounting for backdated options. As a result, stock prices in companies being investigated for backdating are falling. UnitedHealth in recent years has become a rapidly growing company with projected revenues of 72 million for 2006. However, UnitedHealth is being investigated for major backdating

problems. As a result, investor confidence has fallen and stock prices reflect this change.[30]

The decline in stock prices in companies embroiled in backdating stock options scandals translates into a loss for the company and its investors. A study calculated the benefits of backdating to its recipients and the potential harm to the company and investors due to stock prices declining upon public announcement. It found that the average benefit of backdating per year per firm was only about $0.6 million dollars while the decline in stock price due to being implicated in backdating was about $500 million. Thus, shareholders are being substantially harmed for the small benefit of a select few executives.[31]

Conclusions

The potential harmful effects on a firm that backdate stock options are no doubt numerous. By violating securities laws, a firm faces penalties from the SEC and faces shareholder lawsuits. A firm that practices backdating may also be subject to back taxes and penalties from the IRS. Public announcements of SEC and IRS investigations in turn diminish investor confidence, further harming the company. All of these negative effects on a firm are at the cost of compensation to a few executives. This points to an overall problem with honest corporate governance.

Although firms may feel the effects of improperly backdating stock options for some time to come because many will have to undergo investigations and restate earnings, new securities laws will most likely greatly curb this practice in the future. The enactment of the Sarbanes-Oxley act greatly reduced the number of backdated options and the new SEC compensation compliance rules enacted in July will make it even more difficult to continue backdating in the future.

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[2] As of December 28, 2006- see the WSJ options scorecard: http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html

[3] Lucian Bebchuck, Yaniv Grinstein & Urs Peyer, Lucky CEOs, 34 (Harvard Law School and the National Bureau of Economic Research, working paper, November 16, 2006), available at http://www.issproxy.com/pdf/LuckyCEOs_Bebchuk-Grinstein-Peyer.pdf.

[4] *Hot Topic: Probing Stock-Options Backdating*, Wall St. J., May 27, 2006, at A5.

[5] 15 U.S.C. §78j (1982).

[6] 17 C.F.R. §240.10b-5 (Lexis 2007).

[7] *2 More Companies Hit With Complaints Alleging Executives Backdated Stock Options*, 5 Mealey's Emerg. Securities Litig. (November 2006) (Lexis).

[8] Amanda Bronstad, *The Next Step in Stock Option Probes: 'Backdate' lawsuits*, The National Law *Journal, June 9, 2006*, www.law.com/jsp/article.jsp?id=1149757520283#.

[9] Martha Boersch and Renee Beltranena Bea. "The Criminal Implications of Backdating Stock Options." The Metropolitan Corporate Counsel, November 2006, www.metrocorpcounsel.com/current.php?artType=view&artMonth=January&artYear=2007&EntryNo=5813.

[10] Erik Lie, Associate Professor of Finance, University of Iowa, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (September 6, 2006).

[11] 15 USCS § 77x (Lexis 2006).

[12] 15 USCS § 78ff (Lexis 2006).

[13] Tarvestad v. United States, 418 F.2d 1043; 1969 U.S. App. LEXIS 9761, at **8.

[14] United States v. Jacob Alexander, Indictment, (E.D.N.Y. September 9, 2006), http://online.wsj.com/public/resources/documents/AlexanderIndictment20060927.pdf.

[15] Judith Burns, *Ex-Counsel At Comverse Settles Lawsuit*, Wall St. J., January 11, 2007, at A11.

[16] 26 U.S.C.S. § 162(m) (Lexis 2006).

[17] M.P. Narayanan, Cindy A. Shipani, and H. Nejat Seyhun, *The Economic Impact of Backdating Executive Stock Options*, 105 Michigan L. Rev. (forthcoming June 2007).

[18] Mark Maremont and Charles Forelle, *Open Spigot: Bosses' Pay: How Stock Options Became Part of the Problem — Once Seen as a Reform, They Grew Into Font of Riches And System to Be Gamed — Reload, Reprice, Backdate*, Wall St. J., December 27, 2006, at A1.

[19] *See supra* note 9.

[20] Theo Francis, Another Consequence of Backdated Stock Options: Stiff Tax Bills, Wall St. J., December 12, 2006, at B1.

[21] *See supra* note 17.

[22] Date when accounting rules of Statements of Financial Accounting Standards 123 came into effect.

[23] *See supra* note 17.

[24] Pearl Meyer, *Option Pricing Abuse and Boards*, 9145 Practicing L. Inst. (2006).

[25] Thomas L. Hanley and Jack R. Garfinkle, *SEC Approves New Compensation Disclosure Rules*, 29 Nat. L. J., November 20, 2006.

[26] By Kara Scannell and Joann S. Lublin, *SEC Issues Rules On Executive Pay, Options Grants –– Backdating Scandal Leads Agency To Force Increased Disclosure; Other Perks Will See Light of Day*, Wall St. J., July 27, 2006, at C1.

[27] *See supra* note 3.

[28] Id.

[29] *See supra* note 17.

[30] Yuval Rosenberg, *A Top Insurer Gets the Options Flu*, 154 Fortune, October 2, 2006, at 168.

[31] *See supra* note 17.