

## BEST PRACTICES IN STOCK OPTION GRANTS

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Stock option backdating has become the fraud du jour. As with anything suffering intense scrutiny, practices that were not intended to give unfair advantage at the time, now can look remarkably like practices that were intentionally fraudulent. Therefore, in some respects, a new regime may be called for.

### When is an Option Granted?

When, exactly, is an option “granted?” Can you sign a stock option agreement with a new hire and have the board approve it later?<sup>2</sup> How much later? Can you have a current grant date, yet use an earlier “vesting measurement date?” Can the board approve an option grant, and yet have the stock option agreement be dated two months later? What happens if the board never approves the stock option, but an agreement is signed? Section 422 of the Internal Revenue Code, while using some derivative of the word “grant” 17 times, never defines what that means.

The “grant” date matters. Stock options have taken the form they presently occupy primarily due to tax provisions. The “incentive” in incentive options is a tax incentive. And options cannot have tax incentive value unless they are “granted pursuant to a plan.”<sup>3</sup> To be tax-incented, options cannot be exercisable for more than 10 years from their date of grant, and must be “granted” when the optionee is an employee of the issuer.<sup>4</sup>

Most stock option plans provide something to the effect that the administrator has complete control over the plan including (i) selecting the consultants and employees to whom options may from time to time be granted; (ii) determining whether and to what extent options are granted; and (iii) determining the number of shares to be covered by each option granted. Most stock option plans also provide something to the effect that all decisions, determinations, and interpretations of the administrator are final and binding.

The Chief Accountant of the Securities and Exchange Commission (“SEC”) said in a September, 2006 letter that “[t]ypically a company’s corporate governance provisions, stock option plans, and applicable laws, specify the actions required in order to effect the grant of a stock option.”<sup>5</sup>

Although departing founders of start-ups have, from time to time, successfully sued to recover their “stock options,” which were carelessly mentioned in a business plan but never properly documented, we will assume here that a stock option is granted on board approval.

### Documenting Board Approval

Board approval would usually occur by action taken at a meeting or by unanimous written consent. But, consents do not actually constitute action until they are unanimous. What if it takes a week to collect the signatures? What if everyone thought that the board was in agreement, but one director “changes their mind” and refuses to sign the consent? Even if a board consents orally, the written consent is meaningless unless unanimous.

There has been some suggestion that a written consent should only be called effective when last signed. However, such a regime might be abused as well. And more than one commentator has suggested that written consents not be used at all.

The historic practice of dating the consent and circulating it to collect signatures might be acceptable, especially if directors have given oral consent and indicated an intention to sign the written consent when circulated. But companies should probably adopt some time period after which a written consent is deemed “stale” and ineffective.

### The Comverse Case and Fraud

The SEC case against the CEO, CFO and General Counsel of Comverse Technology, Inc. is based in theories of fraud in backdating options for ten years to historically low closing prices for the Comverse’s stock.<sup>6</sup> The complaint states that, “[b]y engaging in this scheme, these executives were able to conceal from investors that the Company was not recording material compensation expenses and was materially overstating [the company’s] net income and earnings per share.”<sup>7</sup>

Could Comverse have backdated the options, *announced* it was backdating the options, recorded the higher option expense, and happily done business? Was backdating the problem, or inaccurate accounting the real problem? An argument could be made that it



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was primarily the later. When the company granted an option at a lower price than the current fair market value, it accounted for that grant at the earlier, lower, price and booked less compensation expenses than it would have had it acknowledged that part of the option was in-the-money at the time of grant.

The complaint further states that the defendants created company records that falsely indicated that the company's board committee had acted on the earlier date, but that no corporate action took place on the backdated date. And the complaint alleges that the defendants actually backdated option grants to fictitious employees and then used this slush fund for recruiting. And it seems that the compensation committee actually had no idea that there were no real employees by the names used for these fictitious grants. The complaint states that the defendants made these fictitious option amounts small enough so as to not arouse suspicion.

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The complaint alleges that the master list of optionees was changed following compensation committee approval. In that case, there never was any effective compensation committee approval itself and the option grant was really nothing more than an ultra-vires act. A *Wall Street Journal* article on March 18, 2006 reported that the odds of the CEO's option grants falling on dates when the stock price was so fortuitously low were approximately one in six billion.<sup>8</sup>

Some of the 26 backdated option grants named were actually "company-wide" grants involving all or many company employees; a couple of cases involved over 3,000 separate grantees and eight or nine million shares. Some of the "look backs" involved less than a month in time (in one case only six days), but still used historically low prices.<sup>9</sup>

In one case, a grant date preceded the optionee's start date, which was inconsistent with the company's stock option plan and, by definition, could not have been an incentive option, since those may only be granted to employees.

#### Fiduciary Considerations

Obviously, directors need to keep in mind the best interests of the issuer and its shareholders when granting stock options. While the incentive provided in recruiting new hires is a legitimate

concern, those new hires cannot reasonably expect anything other than being incented to grow the company from the day they join, forward. And providing incentives in the form of shaving off exercise price pennies is hardly worth the time and attention of most boards. Whether the option is exercisable at \$2.00 or \$2.50 should have little bearing on the incentive to help grow the company to where its stock commands a market price of \$10 or \$20.

To the extent that options are granted, and a date having no relevance to any of the potential dates is cherry picked, thus yielding a lower price than would otherwise be obtainable, an argument can be made that value has been transferred from the shareholders to the optionees. This transfer of value could be argued to be a breach of the fiduciary duty that would require keeping the best interests of all the shareholders in mind when acting on a corporate matter. Most of the civil actions filed so far are couched as breach of fiduciary duty claims.<sup>10</sup>

Other forms of near-abuse are still possible, and deserve a good analysis of fiduciary considerations. These include "spring-loading" options; saving up good news, granting options at the then-current fair market value and then announcing the good news, and bullet-dodging; announce bad news, thus depressing the stock price and then granting options at the new, lower, fair market value.

#### Accounting Considerations

Many of the problems arise from dating an option as of a previous date and using that previous date's accounting treatment, i.e., claiming an at-the-money grant when you already know that it is in-the-money. These have resulted in much of the approximately ten billion dollars in lost shareholder value that has been estimated by the Associated Press.<sup>11</sup> It is really the inaccurate financial statements resulting from the failure to account for options as in-the-money that has caused much of the problems.

The SEC has even acknowledged in a letter from the Chief Accountant that, "there may also be situations where an at-the-money grant was actually decided with finality, but there were unimportant delays in the completion of administrative procedures to document the grant that did not involve misrepresentation of the option granting activities."<sup>12</sup>

#### Thoughts from the SEC

The SEC is investigating over 100 matters relating to potential abuses of employee stock options. Linda Chatman Thomsen, SEC Director of the Division of Enforcement, has described the practice of having a board committee that is

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comprised of one director as, “a near perfect opportunity for abuse.”<sup>13</sup>

Thomsen also said that, “I think most of the lessons to be learned are consistent with what we all recognize as basic common sense.”<sup>14</sup> Similarly, John W. White, SEC Director, Division of Corporation Finance, gave a speech entitled, “Principles Matter,” and has said that the newly-required Compensation Discussion and Analysis section in annual reports should be “principles-driven.”

#### Current “Best Practices”

What does all this mean? The current best practices might look something like the following:

1. Do not sign option agreements until they are board approved.
2. Only grant options at a board (or committee) meeting or, if absolutely necessary, on a unanimous written consent when the consents are collected within some short time period (i.e., 24 hours?).
3. Immediately following the grant, tell the optionees that they were granted options and document the options granted within a couple of days of the grant.
4. In an abundance of caution, and to avoid appearances of bullet-dodging or spring-loading, consider scheduling quarterly or other meetings at which, and only at which, options will be granted.
5. Account for options according to exactly how they were granted. If options are in-the-money, account for them as in-the-money.
6. Timely file all Forms 4 (two days following an option grant).
7. Correctly fill out all 8-K and 10-K compensation disclosure sections carefully following the new SEC compensation disclosure rules.
8. Give careful thought to the goals of stock option programs (one requirement of the new compensation disclosure rules and the CD&A), and consider creating a stock option grant policy.
9. Consider granting options only following material news, such as periodic filings.
10. Carefully follow the terms, conditions and provisions of the stock option plan.
11. If option grant authority is placed in a committee, make it a committee of at least two.
12. Take the long-term view. Focus on building a great com-

pany, not lining your pockets.

13. Do not panic; if you circulate a board unanimous written consent, and you do not get the signature pages back immediately, do not freak out.
14. Disclose everything, take all action anticipating that you may see it in the newspapers and always consider the “can-I-explain-this-to-my-kids” rule. ■

#### Endnotes

- <sup>1</sup> The author thanks Nealan Afsari and Margaret Massimi for reading and commenting on drafts of this article, but lays sole claim to all errors.
- <sup>2</sup> We will assume that the plan administrator is the board for purposes of this article. It could just as easily be a committee of the board, typically a compensation committee.
- <sup>3</sup> I.R.C. § 422(b)(1) provides that, to be an incentive option, the option must be, “granted pursuant to a plan which includes the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted.”
- <sup>4</sup> I.R.C. §§ 422(b)(3), 422(a)(2).
- <sup>5</sup> Letter of September 19, 2006 from the office of the Chief Accountant of the Securities Exchange Commission summarizing the staff’s views regarding the accounting for stock options in the historical financial statements of public companies.
- <sup>6</sup> *Securities and Exchange Commission v. Jacob Alexander, David Kreinberg and William F. Sorin* (E.D.N.Y August 89, 2006) Civil Action No. 06-CV-3844.
- <sup>7</sup> *SEC v. Alexander, et al.*, Complaint; Summary, at p. 1.
- <sup>8</sup> Based on an analysis of stock option grants made between roughly 1995 and 2002.
- <sup>9</sup> The stock had appreciated \$6.50 per share in the case of the six-day look back.
- <sup>10</sup> The author believes that there are less than two dozen civil actions to date.
- <sup>11</sup> Ellen Simons, Options, Backdating: Lost Share Price, Additional Compensation Total More Than \$10 Billion Assoc. Press, October 24, 2006.
- <sup>12</sup> *Id.* at n. 5.
- <sup>13</sup> *Id.* at n. 5.
- <sup>14</sup> *Id.* at n. 5.