Pillsbury
Winthrop
Shaw
Pittman LLP

Client Alert

Stock Option Practices
August 15, 2006

The Stock Option Backdating Scandal: Lessons for Privately-Held Companies

The publicity surrounding backdating of stock option grants has focused on publicly traded companies. Pillsbury Winthrop Shaw Pittman and its Stock Option Task Force are actively engaged in the representation of companies and boards of directors in connection with these issues. However, even privately-held companies should learn from the questionable practices that have come to light and adopt procedures that avoid these concerns. In this alert, we identify some of the practices that have created problems, explain why these matter to even privately-held companies and suggest best practices to avoid issues.

What is backdating?

In general, this term is being used as a catch-all to refer to various practices that resulted in designating a "grant date" for a stock option that is other than the date the Board of Directors, committee of the Board, or officer with authority to grant stock options formally approved the stock option grant. As explained below, the grant date is important because the stock option exercise price should typically be set at the fair market value of the stock on the date of grant. Some companies are alleged to have intentionally designated the grant date at an earlier date than the award was actually approved in order to use a lower stock price as of that earlier date. In other cases, the "backdating" may have resulted from a failure to obtain proper approval for the stock option grant by the intended grant date. A third scenario (not literally a backdating of a grant) occurs where the option was approved before the grant date, the grant date was selected later, and the lowest price over the time period was designated as the grant date.

What are the issues that result from any of these backdating practices?

The failure to identify the correct date of grant results in financial accounting, plan compliance, securities law and tax issues. These issues may be relevant whether or not a company is publicly traded.

What are the financial accounting issues?

Up until the 2006 fiscal year, most privately-held companies accounted for stock options under Accounting Principles Bulletin No. 25 (APB 25). Under APB 25 a stock option issued at no less than the fair market value of the stock on the date of grant, at a fixed price for a fixed number of shares and that vested based on continued service over period of time, generally resulted in no compensation charge to earnings. If the option was granted at a time when the fair market value exceeded the exercise price, then a charge to earnings would have been recognized over the vesting period. Under the current accounting rule, Financial Accounting Statement No.123(R) (FAS 123(R)), the fair value of the option (e.g., the Black-Scholes value) is recognized as a charge to earnings over the vesting period. An exercise price that is lower than the fair market value on the date of grant will increase the fair value of the option. Thus, under these rules, an exercise price that is less than fair market value on the date of grant would under APB 25 result in a charge against earnings when none was expected and under FAS 123(R) result an increased charge to earnings.

What are the plan issues?

It has been very common for stock option plan documents to provide that options may be granted at no less than a specified percentage of the fair market value of the stock on the date of grant. If the option grant violates the terms of a shareholder-approved plan, questions regarding the validity of the grant or other ramifications may result. For example, the Company may be subject to an investor's rights agreement which limits the ability of the Company to grant options unless pursuant to a particular document or plan.

What are the tax issues?

Incentive Stock Option Status. Options intended to be incentive stock options may not be granted with exercise prices that are less than the fair market value of the stock on the date of grant or 110% of fair market value if granted to a 10% shareholder. Also, the ability to receive favorable capital gains tax treatment for an incentive stock option depends on meeting certain holding periods which are measured from the date of grant of the incentive stock option. Without regard to whether there is an exercise price issue, failure to properly identify the grant date could result in an inadvertent failure to meet the holding period.

Section 409A. Any nonqualified stock option (i.e., an option that does not qualify as an incentive stock option) that was not vested as of December 31, 2004, and which has an exercise price less than the fair market value of the stock on the date of grant (whether or not such grant was permitted by the plan document) is subject to adverse tax consequences under Section 409A of the Internal Revenue Code as adopted by The American Jobs Creation Act of 2004. Under current guidance issued by the Internal Revenue Service, certain actions are available to avoid adverse taxation under Section 409A of the Code. These actions must be taken by December 31, 2006. **All options that were not vested as of December 31, 2004, need to be reviewed to determine whether the exercise price is less than the fair market value on the true date of grant and whether any action is necessary before the end of 2006 to avoid adverse tax consequences to option holders under Section 409A of the Code.**

What are the securities law issues?

In most jurisdictions, a privately-held company setting the exercise price at less than the fair market value of the stock on the date of grant, whether resulting from a backdating or otherwise, should not result in securities laws concerns. However, a stock option intended to qualify for exemption from qualification under the California securities laws generally may not be granted with an exercise price less than 85% of fair market value, or 100% generally of fair market value in the case of a stock option granted to a 10% shareholder.

Failure to comply with this substantive requirement in California, or a similar requirement in another jurisdiction, could result in loss of exemption.

A company should also be mindful of Federal and state antifraud legislation, as well as the potential for shareholder derivative suits for waste or breach of fiduciary duties, in connection with stock option grant practices that are not consistent with disclosures to shareholders or the best interests of the shareholders.

What best practices exist for granting stock options to avoid problems?

Questions regarding the grant date of stock options can be avoided by making grants at a meeting of the Board of Directors or the committee charged with plan administration. If consents are used, most state laws provide that a consent is not effective until the last director or committee member signs the consent. Thus, each director should be required to date his or her signature in order to avoid uncertainty as to the actual date of grant. State corporate laws vary as to the ability of the Board of Directors to delegate authority to make option grants and/or determine fair market value. If the grants are being made by an officer to whom authority has been delegated in compliance with state corporate law, it would be appropriate to use a form of grant approval that has to be signed and dated by the officer (possibly with a provision for the signature of a witness or a requirement that the grant be approved by email or fax communication to a designated person).

In light of new Section 409A of the Internal Revenue Code, it is also important that, at the time of grant, the company make a determination of the fair market value of the stock **and** document the basis for the determination. As of the date of this alert, IRS guidance provides for safe harbor methods for complying with the fair market value requirement. Depending on the status of the company, an independent or internal valuation may be appropriate. In all cases, however, the company needs to be able to defend the basis for the determination, and documentation prepared contemporaneously with the grant of options will be important to support the company's position.

Our Client Alert, "Beyond Backdating: Stock Option Grant Self-Assessment Guide," August 7, 2006, Vol. 1605, No. 6054, provides an inventory of tax and state securities law issues to consider when reviewing stock option grants, policies and procedures. It is available on our website at *www.pillsburylaw.com*.

Live Link

Beyond Backdating: Stock Option Grant Self Assessment Guide, Vol. 1605, No, 6054, 07-Aug-2006

For further information, please contact:

Tax and Executive Compensation & Benefits

Lawrence L. Hoenig (bio)
Silicon Valley
+1.650.233.4525
lhoenig@pillsburylaw.com

Cindy V. Schlaefer (bio)
Silicon Valley
+1.650.233.4023
cindy.schlaefer@pillsburylaw.com

Susan P. Serota (bio)
New York
+1.212.858.1125
susan.serota@pillsburylaw.com

Howard L. Clemons (bio)
Northern Virginia
+1.703.770.7997
howard.clemons@pillsburylaw.com

Regulatory Issues

Charles J. Landy (bio)
Washington, DC
+1.202.663.8358
charles.landy@pillsburylaw.com

Jeffrey R. Zuckerman (bio)
New York
+1.212.858.1025
jeffrey.zuckerman@pillsburylaw.com

Clifford C. Hyatt (bio)
Los Angeles
+1.213.488.7582
clifford.hyatt@pillsburylaw.com

Corporate Investigations & White Collar Defense

Mark R. Hellerer (bio)
New York
+1.212.858.1787
mark.hellerer@pillsburylaw.com

Jeffrey S. Ross (bio)
San Francisco
+1.415.983.1730
jeff.ross@pillsburylaw.com

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.
© 2006 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.