

WAS YOUR TARGET A TIMER?

MORE AND MORE COMPANIES FACE SCRUTINY FOR THEIR OPTION GRANT PRACTICES. HERE'S HOW TO AVOID BUYING ONE OF THEM

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illustrations by William Brown

AS OF MID-SEPTEMBER, more than 120 companies were undergoing some form of investigation involving their stock option grants, and more are likely to come under scrutiny. Among nearly 150 late filers of quarterly results in the second quarter, roughly 50 companies disclosed delays resulting from stock option grant reviews. These numbers raise an obvious question for active acquirers: How do you make sure that an otherwise promising target doesn't have an options grant problem?

Generally, the practices that have recently been called into question can be grouped into three categories:

- Backdating, or using a date earlier than the date on which the options were properly granted
- Spring-loading, or granting stock options shortly before the release of favorable information
- Failing to follow procedures by misdating or altering the record dates of resolutions, grant notices or option agreements

Significantly, many executives have generated millions of dollars from



these practices, in some cases simply by shifting the date a grant was made to the recipient.

Options-timing practices became problematic for many public companies because of two regulatory developments: enactment of the Sarbanes-Oxley requirement that companies report option grants within two business days of the grant and the implementation of FAS No. 123R, which requires companies to expense the grant date fair value of all stock op-

tions, rather than just those granted below fair value.

Although backdating is not per se illegal under U.S. law, the failure to properly disclose or account for backdated options may have significant implications for a public company, including investigations by the Securities and Exchange Commission, the Department of Justice and the Internal Revenue Service; the restatement of historical financial statements resulting from the failure to record compensation expenses with backdated options; additional tax liabilities, including reporting and withholding obligations; and related shareholder suits. As we're already seeing, stock option problems may also prevent companies from filing reports in a timely manner.

Obviously, acquirers want to avoid problems like these. The way to do so is to thoroughly assess a target's stock option policies in the due diligence process. Four main areas should be examined:

1. Know the company's policy concerning stock option grants. Is there a

written policy? Who has authority to grant options? Was the policy monitored? Were the options properly authorized?

2. Consider the role of the board in approving grants of options. What facts did the board (or a compensation committee of the board) know, and when? What did outside directors know? Were opinions of inside or outside counsel sought in connection with respect to any aspect of the option grants? Find out what information the company's outside accounting firm had access to. Understand what information was disclosed to counsel, and what was communicated to shareholders.

3. In the case of backdated option grants, be sure to determine the correlation between the dates of the backdated grants and the share prices. Legal counsel can advise you of the implications under the law, and whether reserves need to be established.

4. Be aware of the company's disclosure obligations. What are the company's initial policies and procedures? Were changes made to those policies and procedures, and if so, were they material? Does the company have a practice of delaying its setting of option prices until market conditions are more favorable?

These issues must be addressed in situations involving self-dealing or

so-called spring-loading. Spring-loading, however, is not always improper, and this practice usually raises fewer technical issues than backdating. The determination of whether there are legal concerns depends on many facts and circumstances. The SEC's proposed rules on disclosure of ex-



ecutive compensation should address many concerns about future grants of spring-loaded options, since these rules require companies to disclose and explain both their thinking and the practices that underlie compensation decisions.

Along with due diligence concerns, acquirers should be wary of potential

liability under Exchange Act Rules 10b-5 and 14a-9 in connection with misstatements or omissions contained in merger agreements or other documents filed with the SEC. Issuers are required to include a summary description of the merger agreement, including representations and warranties, in the proxy to shareholders.

In transactions in which the target company shareholders receive consideration consisting, in whole or in part, of securities registered under the Securities Act, the merger agreement is also required to be incorporated by reference into the proxy. Under the circumstances, a representation or warranty made by a target company concerning its stock options, if not true, would result in the publication of false or misleading material disclosures relating to contractual provisions. Thus, the violation may be on the part not only of the target company, but also of the acquiring company. **CD**

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