Option Granting Best Practices: Avoiding the Sins of the Past[1]

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The recent options backdating scandal has been instructive on a number of fronts, and the New Year is a good time for companies to discern relevant lessons to avoid repeating the mistakes of the past. In particular, for those companies that continue to use stock options and other equity-based incentives, one obvious area of focus should be the standard procedures and safeguards employed for administering these equity-based incentive plans. These lessons of the past are not just for the bad actors of the world: more than one company has been mired in a "scandal" merely as the result of honest mistakes, well-meaning actions, or mistaken understandings.

Based on our review of the improper procedures that have caused problems for a multitude of publicly traded companies as well as their officers and directors, several "best practices" for administering option plans have emerged that will help prevent future problems. To summarize our findings, these best practices include:

- **Avoid Conflicts:** Ensure that there is no direct conflict of interest when issuing options, and avoid even the appearance of impropriety.
- **Don't Go Solo:** Appoint two or more members to any board committee em-powered to grant options or other equity-based incentives.
- **Keep It Regular:** Grant options on regularly scheduled, pre-determined dates.

Option Backdating Fundamentals

To assess the real risk of option plan administration, it is important to understand the fundamentals of backdating. As has been widely reported, the options backdating scandal revolves around the revelation that some public companies previously failed to disclose that they had "backdated" options. Backdating can be defined as the practice of setting an option's exercise price and grant date as of a date earlier than the point in time when the option was actually granted. By failing to disclose this practice, these companies have opened themselves up to charges of misleading the public markets.

Because the exercise price is typically tied to the compa-ny's underlying stock price on the date of grant, backdating enables a company to select a date prior to the actual date of grant when the stock price was lower. In this way, backdating gives the option holder a lower exercise price and hence a potential financial benefit reaped at the expense of other shareholders.

Consider that the option holder ultimately hopes to re-ceive the difference between the stock price at the time of exercise and the exercise price. With a lower exercise price, this difference stands to be greater and consequently the option holder's profit also stands to be greater. At the same time, the company receives less in proceeds from the option holder because the exercise price is lower than what it would have been had it been set at the higher stock price prevailing on the actual date of grant.

Instead of disclosing the backdating of options, many companies improperly disclosed to the public that the backdate was the actual date of grant, thereby hiding the fact that the exercise price was less than the stock price on the actual date of grant. These companies thus failed to disclose to investors the full financial benefits reaped by their employees. Although backdating is not illegal if properly disclosed, it was this failure to disclose the backdating that has caused numerous legal, accounting, and tax problems for the companies and individuals involved.

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- **Unfailing Disclosure Compliance:** Unfailingly comply with public disclosure requirements, such as Form 4, on time, every time.

- **Process, Process, Process:** Standardize and automate the internal process of granting and tracking option grants.

- **Avoid Actions by Unanimous Written Consent:** Avoid granting options by unanimous written consent because these documents can be more easily backdated and there is a much greater chance that the wrong grant date will mistakenly be used.

- **Don't Fix Past "Clerical Errors":** Do not retrospectively correct the corporate record because even honest efforts to fix past mistakes can be construed as fraud.

IGNORE THE LESSONS OF THE PAST AT YOUR OWN PERIL

In the current environment, company officers and directors are understandably more than a bit nervous about stock option plan administration and the details of option accounting. The root cause of past problems has ranged from well-intentioned missteps to outright fraud. At last count, more than 175 public companies have been implicated in the scandal. More than 30 senior executives and a handful of directors have separated from their companies as a result of problems stemming from stock option grants. As of the end of 2006, roughly 20% of the securities class action cases filed against public companies were related to improper options accounting. Additionally, more than 120 shareholder derivative suits relating to improper options accounting have been filed.

Insurance carriers that provide director and officer liability insurance are also well aware of these issues. Carriers now routinely ask companies questions about their granting practices. There is some good news though. Companies that demonstrate a firm command of stock option administration best practices are likely to be considered better risks by D&O insurance carriers than those companies that cannot. A skilled D&O insurance broker should consequently be able to translate this reduction in perceived risk into better pricing and terms in the insurance contract.

BEST PRACTICES

As a result of these developments, some companies have announced that they are backing away from the use of stock options as compensation. For example, IBM recently announced that it would no longer grant options to members of its board of directors. Nevertheless, many other companies remain committed to providing incentives that enable employees to enjoy rewards tied to long-term stock gains.

Fortunately, the immediate cessation of all equity-based incentive grants is entirely unnecessary. There are straightforward and easy-to-follow procedures that will enable companies to grant options without triggering accounting issues, investigations or law suits. Furthermore, these best practices are not limited solely to stock options. Companies would benefit from implementing the following best practices for any type of equity-based incentive program.

1. AVOID CONFLICTS

In today's climate, it goes without saying that an executive is not supposed to be the one to grant options to him or herself. This result should be avoided even if the self-dealing comes about solely because of the executive's service on the board committee that administers a company's stock option plan. In other words, executives should have no involvement with authorizing the options that they are granted. If the executive in question is on the stock option granting committee, the executive should either recuse himself when it comes to discussing his or her own compensation or a separate committee should be established to handle that executive's compensation. In the best case, only a committee comprised solely of non-employee directors should make equity grants to executives of a company.

Perhaps less obviously, committees that grant options should also work hard to insulate themselves not only from direct conflicts but also from any appearance of impropriety. To ensure independence, companies ought to closely scrutinize the relationships between option grantees and the members of any option-granting committee or all board members if

the full board retains the power to grant options.

In particular, companies must avoid interlocking compensation committees. Broadly speaking, there is an "interlock" whenever one individual has influence or power over the options that can be granted to a second person, and the second person in turn has influence or power over the options that can be granted to the first person. This situation might occur if, say, a CEO serves on the board of another company, and the CEO of the other company serves on the board of the first CEO's company. The fear is that, because of this interlock, the two CEOs will informally agree to a compensation-related quid pro quo with each CEO approving options for the other.

Moreover, companies must consider whether there are social ties between or among executives and the directors and whether these social ties make independence less likely or at least make independence appear to be less likely. In the same vein, companies should recognize that gift giving—even if the gift is in the form of a charitable donation to a board member's favorite charity—may chip away at the appearance of a committee member's independence.

2. DON'T GO SOLO

Any committee empowered to grant options or other equity-based incentives should have at least two or more members; or stated conversely, never empower a committee that is comprised of only a single member to grant stock options or other equity-based incentives.

Under a typical stock option plan, a company's board is empowered to decide upon the timing of grants, the number of shares underlying options granted, and the recipients of those grants. The standard stock option plan and general principles of corporate law in turn empower the board of directors to delegate such option granting authority to a committee consisting of one or more individuals. These individuals can be either members of the board itself or other company personnel, usually senior executives.

In contravention of this recommendation to avoid going solo, more than one board in the past has delegated the power to grant options to a committee of only one person. Naturally, it is substantially easier for a single person to engage in questionable or illegal practices—or just exercise poor judgment—than a committee of two or more. A single person acting alone is unfettered by the need either to convince another to go along with his or her scheme or to hide the questionable practices from fellow committee members. In other words, to commit an improper act, a committee of one need not bypass the inherent internal control imposed by fellow committee members.
However, if we rightly assume that most people are fundamentally honest, the real problem with committees of one may not be actual misdeeds, but instead the appearance of impropriety. Because there are no internal checks, delegating the ability to grant options to one person provides the board with little cover if questions ever arise about a committee of one's actions. At the very least, the board may have to subsequently spend time and money investigating the committee of one's actions, even if those actions ultimately prove to be entirely aboveboard. A committee of one also results in unnecessary risk for the individual who has the authority to make the equity grants. By acting alone, the person is less able to defend him or herself from charges of impropriety should they arise.

This potential for impropriety raises questions that a board would be well advised to eliminate at the outset by simply adding additional members to the committee charged with overseeing a company's equity-based incentive plan. Furthermore, in-depth involvement of a company's internal and external legal counsel in documenting the decisions of the committee adds beneficial layers of internal control and oversight.

3. KEEP IT REGULAR

All options—whether for new hires or for current employees—should be granted on regularly scheduled, pre-determined dates, except under extraordinary circumstances. In such unusual situations, option grants should be postponed at least until the next regularly scheduled date. When options are consistently granted on pre-determined dates that are determined well in advance, option-granting manipulation is much more difficult, and hence the risk of accusations and investigations is greatly reduced.

Many companies have moved to either monthly or quarterly grant dates. Although both time periods are acceptable, monthly grant dates raise a potential complication more easily avoided with a quarterly grant date. Therefore, unless a monthly grant date is necessary for competitive reasons, such as to recruit key employees, a quarterly option grant

date offers a more conservative, and hence slightly preferable, approach.

The problem with monthly grant dates is that a monthly grant date potentially conflicts with a company's trading blackout period. To explain, consider that public companies typically impose blanket restrictions on trading by company personnel in company stock during periods leading up to the announcement of quarterly and annual financial results. This blackout period usually commences anywhere from one month to two weeks before the end of a fiscal quarter and ends three days after the release of financial results for that particular fiscal quarter. Public companies impose such blackout periods in an effort to prevent stock manipulation by employees who may have material, non-public information about the company's quarterly and annual results.

Companies that choose quarterly grant dates can, and should, pick a date that is outside of the trading blackout period. Companies with monthly grant dates, however, will inevitably end up with grant dates that fall during periods when their windows for trading by employees are closed.

The problem with granting options during the blackout period is that this practice can be at odds with the underlying purpose of the trading restrictions. Granting options during the blackout period arguably increases a company's risk of being charged with intentionally granting options while in possession of material non-public information, information that could cause the company's stock price to move.

If done for purposes of stock manipulation, issuing options during the blackout period is known as "spring-loading" or "bullet-dodging". Although the question of whether spring-loading and bullet-dodging are actually illegal is an unsettled one, spring-loading and bullet-dodging are certainly not best practices. Companies are well advised to steer clear of these practices and avoid becoming the test case that resolves the legal uncertainty. Finally, under the new rules issued by the Securities and Exchange Commission for the upcoming proxy season, companies must disclose any practices they have with respect to timing option grants to executives in coordination with the release of material non-public information. For companies that springload, this disclosure could become rather problematic.

Thus, for those companies that continue to use monthly grant dates, a defense against charges of impropriety of this type may be a consistent pattern of systematically granting a similar number of options each month. An even better defense may be to adopt a quarterly grant date and avoid the problem altogether.

Whether monthly or quarterly, the option grant date practice chosen by a company should be reflected in its hiring practices. Gone are the days when it could be deemed prudent to grant options on the date that an individual is hired. New hire letters should now clearly state that the new hire option grant will be made at the time of the next regular option grant date, and that the particulars of the option grant—especially the price—will only be fixed at that time.

For current employees, annual "refresh" grants should also be made to everyone at the same time each year. Similarly, many companies have chosen to issue refresh grants to their directors on the day of or the day after the annual shareholder meeting.

A company should thus unerringly stick to its regularly scheduled, pre-determined grant dates, except in extraordinary circumstances. The question of what constitutes such extraordinary circumstances is one that depends on particular facts and circumstances, but might include such events as a pending merger not yet disclosed to the public. The determination is a judgment call that should fall to the board of directors and legal counsel.

4. UNFAILING DISCLOSURE COMPLIANCE

Make sure your company has a way to systematically and unfailingly comply with Form 4 filing requirements and other similar public disclosure regulations in a timely way.

Form 4 filings call for the public disclosure of transactions by senior executives in a company's stock, including the grant or exercise of an option. With the advent of Sarbanes-Oxley, senior executives now have only two days to make a Form 4 filing in all circumstances whereas they previously had a longer period of time that depended on exactly when the transaction took place.

In the past, many viewed Form 4 filings as nothing more than an annoying administrative requirement. This attitude,

however, turned out to be very costly for some.

Several companies that were not caught-up in the initial wave of the options backdating scandal breathed a premature sigh of relief. These companies were later forced to conduct expensive investigations because it came to light that their executives had failed to make Form 4 filings on time. The concern is that potential plaintiffs can allege that the Form 4's were filed late because the underlying option grants were really backdated.

Of course many of the executives that filed Form 4s late only did so because of administrative error. This is cold comfort, however, for companies that have had to answer questions from the SEC and conduct expensive investigations to verify that these oversights were merely mistakes and not the result of something more nefarious.

5. PROCESS, PROCESS, PROCESS

Related to compliance with SEC filing requirements, companies should also standardize and automate as much as possible the internal process of granting and tracking option grants. Companies should have a clear protocol and timeline for issuing option grant paperwork after the grants have been made. Companies should also use software that tracks the option grants efficiently rather than relying on someone's outdated excel spreadsheet. The software that your company uses should be highly auditable so that any changes made to option grants are easily identified and difficult to mask.

6. AVOID ACTIONS BY UNANIMOUS WRITTEN CONSENT

Boards should ideally grant all options during regularly scheduled meetings. Accordingly, where possible, boards should avoid granting options through actions by unanimous written consent because the current perception is that such documents can be more easily backdated and manipulated. Moreover, when a consent is signed in counterparts, the generation of multiple signature pages increases the risk that there will be an error in the paperwork, if for no other reason than there are simply more sheets of paper to track. Finally, it is difficult to determine the grant date of options approved by consent.

In the past, corporate attorneys correctly advised their clients that board actions could be taken by written consent in lieu of a meeting as long as the consents were unanimous. However, attention was not always paid to when the consents were actually physically delivered to the corporate secretary. Undated signature pages were common. Indeed, given the pace of business during the time at issue in most of the stock-option scandals, namely the internet boom, it is widely acknowledged that corporate record keeping was often not a priority.
Now, in retrospect, undated signature pages or pages dated "as of" a particular date have given more than one forensic accountant—and consequently more than one investigator—heartburn. At best, it is often unclear whether options were duly authorized prior to being granted, and at worst, it is often all too clear that some options were improperly granted without proper authorization by the board.

Nevertheless, actions by unanimous written consent remain an important way for a board of directors or a subcommittee of directors to get work done, but the thinking now is that actions by unanimous written consent are best avoided, if possible. If they are used, careful attention must therefore be paid to corporate record keeping.

In many cases, the date of the action should be the date the last signature page is actually received by the corporate secretary. The fact that this date might be different from the date that the last page was signed—and the fact that under corporate law it is the last signing date that counts for dating purposes—simply highlights the reason that actions by written consent are now considered a less-than-optimal way for a board to make or document its decisions.

This concern is more than simply theoretical. Many of the companies that have had to restate their financial statements because of improper options accounting were companies that had issues with actions by written consents. These companies accounted for the options as of the date that the written consents were sent out for signature rather than as of the date that the final signature was received by the corporate secretary.

7. DON'T FIX "CLERICAL ERRORS"

Companies should make good corporate recordkeeping a

high priority and get it right in the first instance. Neither a company's officers nor any other personnel should go back and try to correct the record retrospectively. Even honest and well-meaning efforts to fix past mistakes in the corporate record can be construed as fraud, especially if these efforts come at precisely the wrong moment, such as shortly before the commencement of an investigation.

Inevitably, a corporation's minute book and accounting records will not be perfect. More than anything else the options accounting scandal has revealed that good record keeping, or corporate hygiene, is much more difficult than many previously understood. When company personnel look back through the minute book, there is a natural tendency to want to correct "clerical errors", such as supplying missing signature pages, amending slightly imperfect attachments, or filling in blanks. In today's world, however, this type of activity can be considered the equivalent of forgery, and for that reason should be avoided lest the individual put him or herself in legal jeopardy.

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The suggested best practices above are just that—suggestions, rather than mandates. There is no one right way to grant options and other equity incentives that must be followed by companies. Therefore, each company has some leeway in tailoring its practices to fit its own situation.

Nevertheless, companies must face up to the reality that option granting protocol is now front and center in the minds of regulators and plaintiffs' attorneys. There is no longer much leeway even for honest mistakes. Moreover, in the upcoming proxy season, companies will have to contend with strict new disclosure requirements regarding executive compensation. More than one company has consequently realized that it may be preferable to revise its compensation practices to fall closer in line with the generally accepted best practices suggested above. The alternative seems much less attractive: suffering through the process of disclosing and justifying practices that, while legal, are perhaps not widely perceived as prudent.

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