

# Stock Option Backdating: What Every Director Should Now Know

Martine Guimond & Julie-Martine Loranger

Gowling Lafleur Henderson LLP

## The number of U.S. cases grows and media attention heightens:

- **UnitedHealth**—Financial restatement of between \$400 and \$600 million
- **Comverse**—Top executives found guilty of criminal charges, while paying roughly \$3 million to settle civil accusations of fraud—top lawyer sentenced to a year and one day for his role in the backdating scheme
- **Maxim**—Delaware judge opens the floodgates for shareholder derivative suits in backdating cases

American courts have brought the practice of stock option backdating to the forefront. Described by the Wall Street Journal as “the perfect payday,”<sup>1</sup> some company executives and directors are now beginning to suffer the consequences of a practice that saw several of them draw undue profits after issuing stock options on dates hand-selected to coincide with favourable exercise prices.

## The American Perspective

The number of cases involving options backdating continues to rise in the United States. There have already been nearly 150 shareholder derivative lawsuits filed, as well as over 100 public inquiries launched by both the SEC (Securities and Exchange Commission) and DOJ (Department of Justice). Nearly 40 directors and officers have resigned as a result of these investigations. Just how high these numbers will climb is not yet certain; according to a study conducted by Professor Lie of the University of Iowa, an estimated 30%, or 2,300, American corporations have engaged in the backdating of stock options.<sup>2</sup>

Recent court decisions have given way to a variety of actions against both company executives and directors. Of late, Delaware's Court of Chancery has agreed to hear a shareholder derivative suit that is aimed at both the directors and the recipients of backdated stock options; the former for a breach of their fiduciary duty, and the latter for unjust enrichment.<sup>3</sup> The case of former Comverse CFO, David Kreinberg, highlights the reality that repercussions may extend beyond civil liability. Having been the first to plead guilty to charges of fraud and conspiracy in relation to backdating, Mr. Kreinberg was also forced to pay \$2.4 million in order to settle civil fraud charges. The situation is similar for Comverse's former general counsel as well as former CEO, Jacob Alexander.

With Canadian corporate culture generally considered akin to that of the United States, the question of whether or not options backdating will reach scandalous proportions North of the border inevitably presents itself. In anticipation of this possibility, there is certain information that all company directors should now be aware of.

## Backdating Defined

At its root, backdating allows for the use of hindsight when determining the grant date for stock options and therefore the price. By drafting or modifying the grant document to reflect a past date associated with a favourable exercise price, one may create the illusion that the decision to grant options was, in fact, made on the indicated date. While, according to the grant document, it appears that options are offered “at the money,” meaning at a price equal to the share price at the time of the grant, the options are, in reality, offered “in the money.” As opposed to an “at the money” option, an “in the money” option holds an intrinsic value; there is already a built-in profit at the time of the grant.

Options backdating contravenes the very nature and purpose of stock option grants.

Originally conceived as a tremendous tool allowing companies to attract talent and reward employees without affecting cash flow, stock options also serve to align the interests of company executives with those of shareholders. The granting of an “in the money” option clearly negates such an alignment.

## Backdating Techniques

### Modifying the Supporting Document

In its most traditional form, backdating is accomplished by the intentional modification of the minutes of the meeting in which an option grant is authorized. Such situations make it possible to modify not only the date of a grant but also the number of options in question and the identities of the grantees. As highlighted by Delaware courts, it is the intent with which these actions are taken that causes them to be in bad faith, thus opening the doors to director liability.<sup>4</sup> This element of intent is also present when other backdating techniques are employed. Certain practices are more likely to raise red flags than others; grants by unanimous written consent and large grants with long lists of grantees are among such practices. Open-ended clauses reading “effective as of,” as well as long, ambiguous lists attached to more complex grant documents, are particularly likely to raise suspicions of misconduct.

### Spring-loading

Beyond practices involving the modification of grant documents, the value of options may also be inflated by timing a grant in relation to the release of information that is likely to affect stock price. For example, “spring-loading” takes place when a grant is authorized prior to the publication of positive information that is likely to cause a rise in stock price. In this case, the result is not only a more favourable exercise price but the likely contravention of Canadian securities legislation as well.



Martine Guimond



Julie-Martine Loranger

## The Canadian Perspective – CSA Staff Notice 51-320

In response to potential concerns over the situation in the U.S., the Canadian Securities Administrators (CSA) released a staff notice,<sup>5</sup> which provides directors with certain guidelines intended to reduce the risk of non-compliance with securities legislation. These guidelines include, among other points, (i) the establishment of a compensation committee; and (ii) the adopting of policies regarding corporate disclosure, insiders and “black-out” periods around earning announcements. The notice concludes with a warning that enforcement action may be taken if the CSA is made aware of any non-compliance with securities legislation.

While the CSA indicates that options backdating is not as rampant in Canada as it is in the U.S., the preliminary results of a study reported in the Chicago Tribune appear to suggest that the practice is nevertheless present in this country.<sup>6</sup> Although only a preliminary report has been compiled to date, the study notes that, following the examination of 66 of Canada’s largest corporations, exchange practices in line with those of backdating were found. While conclusive evidence has yet to be reported, the study highlights the fact that the opportunity was present.

## Recommendations When Faced With Inquiries, Derivative Suits or Class Actions Inquiries

Following the significant amount of press surrounding backdating cases, some companies are starting to conduct internal inquiries into their own option granting practices. Be it internal or not, the primary goal of an inquiry is to determine whether, in fact, backdating has occurred.

Depending on both the factual situation and the budget, the early stages of an inquiry may involve the employment of forensic accountants, as well as the production of a statistical analysis outlining the more suspect grants. In certain cases, statistics may constitute overwhelming evidence; the WSJ determined that the odds of systematically authorizing grants on ideal dates are around 1 in 300 billion.<sup>7</sup> At the very root of the process, it is crucial to identify all individuals implicated in the granting of options and to gather all relevant documents.

A rather wide range of documents could be potentially significant. To begin, a company’s stock option plan, as well as any other written policies and procedures may provide a preliminary understanding of grant practices. Meeting minutes are often the most significant evidence if the grant was authorized in an actual meeting. Furthermore, Minute books may also contain any grants by unanimous written consent. Often the most damning evidence of backdating, as witnessed in the Comverse case, comes from internal communications such as emails, memos and meeting notices, which may help establish the reality behind a given situation.

## Derivative Suits

With shareholder derivative suits clearly established as the most frequently used judicial recourse for backdating cases in the U.S., they may be brought against both directors for a breach of their fiduciary duty, as well as against any grantee of backdated stock options for unjust enrichment. Claims are also possible when a director or officer of a corporation fails to implement any form of control over the granting of stock options or, chooses to neglect the methods of control already established.

## Class Actions

Resulting from the fact that stock prices have remained relatively stable in the majority of backdating cases, there has not been an overwhelming number of class action suits filed in the U.S. This does not, however, negate the possibility of future class action lawsuits in relation to the timing of options.

## Outlook

While it remains to be seen whether or not stock option backdating will ever erupt into a scandal North of the border, it has become clear that Canadian securities authorities have prepared themselves for the possibility. As a result, it is only prudent that company directors do the same; self-awareness of one’s option granting practices is key at this point.

On a different front, options backdating has caused many American insurers to re-examine their Director and Officer policies. In many cases, these policies contain exclusions related to the conduct of the director and officer. Generally, a policy will not insure against intentionally fraudulent conduct, an issue that highlights the importance of differentiating intentional backdating from errors in accounting.

The TSX suggests that all corporations proceed with a review of their option granting practices in order to ensure that backdating has not occurred. Should such a review unearth a possible backdating situation, it is crucial to consult counsel.

Gowlings can provide assistance and guidance to review your Directors and Officers policies and your option granting practices, as well as any other compensation plan.

**For more articles, please visit Above Board @ Gowlings, available on gowlings.com.**

*Article written by Martine Guimond and Julie-Martine Loranger with assistance from Alexander Bayus, Student-at-Law.*

<sup>1</sup> Wall Street Journal (18 March 2006).

<sup>2</sup> Lie, E., 2005, On the timing of CEO stock option awards, Management Science 51, 802-812.

<sup>3</sup> Ryan v. Gifford, WL 416162, (Del.Ch. 2007).

<sup>4</sup> Ashby Jones and Mark Maremont, “Maxim Ruling Opens Door For Backdating Cases” Wall Street Journal (8 February, 2007), online: AdvisenFPN <<http://fpn.advisen.com/articles/article607358471507633269.html>>

<sup>5</sup> CSA Staff Notice 51-320

<sup>6</sup> Stuart Weinberg and Mark Heinzl, “Backdated options in Canada?” [Chicago] Tribune (3 December 2006), online: <<http://www.chicagotribune.com/business/chi-0612030307dec03.0,1246024.story?coll=chi-business-hed->>.

<sup>7</sup> Wall Street Journal, supra note 1.