

STOCK OPTION BACKDATING

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Overview

- Key Terms
- What is a Backdated Option?
- History
- Potential Consequences
- SEC Proxy Disclosure Rules
- What Should Companies Do?

Key Terms

- Grant date
 - Used to establish option exercise price
 - BOD, committee or officer typically authorizes option grants
- Exercise price
 - Most option plans require that options be granted with exercise price equal to at least the fair market value of the company's stock on the option grant date
 - Discounted options subject to adverse tax and accounting consequences
- “At the money”
 - Option whose exercise price is equal to at least the FMV of the company's stock on the option grant date
- “In the money” or “discounted”
 - Option whose exercise price is less than the FMV of the company's stock on the option grant date

What Is A Backdated Option?

- Generally, an option granted with exercise price lower than actual FMV on date of grant (i.e., in the money grant)
- Lower exercise price is generally achieved by using documented grant date that pre-dates authorized grant date

History

- Backdating scandal preceded by SEC investigations of “spring loading” and “bullet dodging” option grants
- March 18, 2006 WSJ article powder keg
- Repercussions of the scandal:
 - investigation of numerous companies with suspicious grant patterns
 - rash of internal investigations
 - SEC inquiries
 - criminal probes by US Attorney
 - executive terminations

Sampling of Implicated Companies

- Affiliated Computer Services
- Altera Corp
- Analog Devices, Inc.
- Apple, Inc.
- CNET Networks, Inc.
- Comverse Technology Inc.
- F5 Networks, Inc.
- Juniper Networks, Inc.
- KLA-Tencor Corp.
- McAfee
- Openwave Systems, Inc.
- Siebel Systems
- Numerous others

Overview of Potential Consequences

- Accounting Issues
- Tax Issues
- Securities and Corporate Law Issues

Accounting Issues

- FAS 123(R) and APB 25 – both require compensation expense for in the money option grants
- APB 25: expense calculated at measurement date
- Failure to recognize expense could result in restatement of company's financial reports
- September 19, 2006 SEC letter

Tax Issues - ISOs

- ISOs generally must be granted at the money
- Discounted options ineligible for ISO status
- Employee: potential liability for failure to pay FICA and income taxes on spread at exercise
- Employer: potential liability for failure to report income and withhold taxes on spread

Tax Issues – Section 409A

- Options granted before 2005 and fully vested as of 12/31/04 are grandfathered and exempt from 409A
- All other options:
 - at the money – exempt from 409A
 - in the money – subject to 409A
- Consequences of option noncompliance with 409A:
 - taxation of “deferrals” upon vesting, and
 - 20% penalty tax plus interest
- 409A transition period for repricing option to exercise price
 - deadline: 12/31/06 for options granted to executive officers, 12/31/07 for other options
 - decreases economic value of option to employee
 - company-wide repricing may constitute “tender offer”

Tax Issues – Section 162(m)

- Limitation on employer deduction for senior executive remuneration to \$1,000,000 annually
- Exemption for “performance-based compensation”
- Options granted to senior executives qualify for this exemption only if granted at the money
- Potential disallowance of employer tax deduction for *all income* resulting from exercise of in the money options
- Possible consequences: back taxes on lost deduction, plus penalties and interest

Securities and Corporate Law Issues

- SEC disclosure
- Sarbanes-Oxley issues
- Section 16 issues
- Share registration issues
- Other potential securities law violations
- Shareholder lawsuits

RECAP – Potential Liability/Consequences

- Accounting expense and possible restatement of financial statements
- Loss of corporate tax deduction plus penalties
- Tax penalties for executives
- Stock exchange delisting
- Shareholder lawsuits
- Prospect of civil and criminal liability (prison)
- Adverse effect on share price, ratings agencies' outlook
- D&O insurance

New SEC Proxy Disclosure Rules

- Tabular disclosures:
 - Summary Compensation Table – annual FAS 123(R) cost of each option
 - Grant of Plan-Based Awards Table –
 - FAS 123(R) grant date of the option
 - fair value of each option on grant date (computed under FAS 123(R))
 - for in the money option, closing market price of underlying stock on the grant date
 - if exercise price is not the stock's closing price on grant date, disclosure of methodology for determining exercise price
 - the date the BOD or compensation committee took action to grant the option, if that date differs from the FAS 123(R) grant date
- Enhanced narrative disclosure in CD&A
 - Timing of option grants
 - Determination of exercise price

Action Items

- Consider internal review of option grant practices
 - Grant dates (fixed or variable)
 - Timing of option grants
 - Confirm proper “measurement date” used for accounting purposes
 - Relevant provisions of charters, bylaws and option plan
 - Conduct interviews of responsible parties
 - Compare grant dates to historical stock prices

Action Items (continued)

- Evaluate whether corrective actions are needed based on internal review
- Consider revamping option grant process and establishing internal controls
- Check D&O policy regarding option grants