

## STOCK OPTIONS BACKDATING

*By now most readers of this newsletter will be familiar with the furor that has arisen from allegations that companies awarded stock options with a grant date assigned retroactively to coincide with a low-point in the company's stock price.*

*This conveniently low price became the exercise price (strike price) at which the recipient, upon vesting of the award, could buy the stock from the company.*

*With the exercise price being low, the chance of the options being "in the money" (where the market price exceeds the exercise price) is much improved. Such backdating of the grant date to a convenient low point, unless properly recorded and disclosed, could have adverse accounting and taxation implications, possibly resulting in civil or even criminal penalties.*

*(Note: A distinction should be made between alleged intentional backdating with the specific purpose of guaranteeing enrichment of the recipient - the subject of this newsletter - and backdating resulting primarily from administrative inadvertence, done with the intent of clarifying and correcting.)*

### SEPARATE INTERESTS

A widely-held notion is that stock options are a form of compensation that aligns the option-holders' interests with those of outside shareholders. An owner of options, however, becomes focused not just on the stock price but also on the stock price relative to the options' strike price and vesting date. If millions of dollars are at stake subject to the conditions of the grant, it is not hard to see how potential multi-millionaires might do all they can to extract the greatest possible value from their award.

Individual profits from intentional backdating appear to come at the expense of the company. If an option is backdated to achieve a strike

price of \$30 when the correct strike price should be \$50, the company ultimately receives \$20 less per share when the option is exercised: an undisclosed transfer of wealth from the company to selected employees.

Yet it could be argued that without such financial stimulus, highly-valued executives might leave. This could prove to be a greater detriment to the company than any shortfall suffered when the options are exercised. This dilemma is an indication of the current confusion surrounding the whole issue.

### ALTERNATIVES

Intentional backdating, if it took place, was likely done to maximize the benefit of the

award to the recipient. Yet there are legitimate ways that options awards can be arranged to help achieve a similar result.

One is by issuing the options with an exercise price lower than the stock price on the day they were granted - known as discounting. Another way to adjust an award is to reprice the strike price to a level that is more likely to produce a profit for the recipient. Discounting and repricing, however, become public knowledge: undeclared backdating has the benefit of concealment.

### **DISCLOSURE AND COMPLIANCE**

**E**xecutive compensation arrangements that are made public in an appropriate manner, adhere to securities laws and are fully tax-compliant are not a concern for regulators, tax authorities or law enforcers. Such arrangements become just another business decision that shareholders can evaluate accordingly.

But secretive actions of questionable legality are a different matter. In addition to public moral indignation, the company can face dam-

aging investigations and potential prosecutions or civil actions from the SEC, the IRS, the U.S. Justice Department and maybe the states' attorney-general offices.

### **IMPLICATIONS FOR D&O CARRIERS**

**U**ntil the uncertainty over the circumstances and ramifications of alleged backdating is better resolved, it is the disclosure element that perhaps most concerns D&O insurers.

Property insurers can request that a building be inspected to confirm it is built as described; a casualty underwriter can see and touch a product to ascertain the liability risk. D&O underwriters do not have that advantage.

In addition to the rigorous financial analysis that most serious carriers conduct based on publicly-filed documents, a D&O underwriter relies on the trustworthiness of a company's senior executives. If allegations of surreptitious backdating driven by an imperative to mislead prove to be founded, underwriters' trust could be eroded. ❖

## ***RICH MEALLE JOINS THE UNDERWRITING TEAM***

**C**hicago Underwriting Group, Inc. is pleased to announce that Rich Mealle has joined our D&O underwriting team.

Rich has been underwriting various lines of professional liability insurance since 1991 with an emphasis on public company D&O and Initial Public Offering (IPO) exposures.

Prior to joining Chicago Underwriting Group, Rich was with Genesis Professional Liability Managers serving as a Midwest Underwriting Manager for public company D&O; this provides Rich with considerable experience in many of the market segments serviced and targeted by Chicago Underwriting Group.

Rich is a graduate of Baldwin-Wallace College with a B.A. in Finance and Economics and Case Western Reserve University with an MBA.

Please contact Rich at [rmealle@cug.com](mailto:rmealle@cug.com) or by phone: 312.750.8971.

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**Thank You!**

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