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Guide to hot (back)dating scene

Crackdown is coming and you should understand the consequences

The Securities and Exchange Commission recently announced it would pursue securities fraud actions against many of the public companies that participated in the long-standing and widespread practice of “backdating” or “timing” stock-option grants.



POINT OF VIEW

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In past months, companies that have drawn the SEC’s notice for possible civil fraud proceedings have become measured in the hundreds, and the SEC seems to be gaining momentum. The SEC is telegraphing probable exposure not only for officers, but also for other executives and directors.

Amplifying the alarm bell, myriad companies have appeared on the criminal radar, with the Department of Justice sometimes entering the arena alongside the SEC for parallel civil and criminal actions. A recent joint SEC and DOJ release touts this area as an opportunity to flex the cooperative relationship between agencies. Accordingly, the issue now threatens not just the coffers, but executives’ liberty. Regulators are pursuing smaller companies as well as larger ones.

What is options backdating?

When a company “backdates” options, it typically shifts an option-grant date to a time period when the company’s stock price was lower, without recording compensation expenses. This increases the option holder’s potential gain when the option is ultimately exercised.

The chief regulatory problem with this practice is that it usually is not properly disclosed or accounted for in corporate books, records or financials. There are several reasons why a company would engage in the prac-

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...tice, but an example in one recent SEC complaint alleges a company altered employees’ start dates (and, thus, their option-grant dates) to sweeten compensation packages for highly sought-after new recruits.

Consequences of investigations and prosecutions (or even a company’s discovery of backdating before the government enters the picture) include:

- Disruptive delays in 10-Q and 10-K reporting while internal investigations are completed, auditors satisfied and accounting records remedied.

- Potential delisting from markets such as NASDAQ, with the reputational and trading consequences that accompany delisting.

- Civil securities class actions filed by predatory lawyers purporting to represent private investors, which will proliferate on the heels of announcements of backdating problems.

- SEC fraud proceedings resulting in director and officer bars, penalties, embarrassing litigation, disrepute and other damages.

- Astronomical legal and auditing bills.

Be proactive, not reactive

Companies should examine compliance issues from many regulatory fronts. Now, rather than later, management, boards and designated committees need to thoroughly investigate to confirm improper backdating has not occurred on their watch, and they should implement safeguards to

ensure backdating does not occur going forward. In many of the actions brought or threatened, the board and even high-level executives were unaware other executives were participating in or condoning backdating.

Steps you can take

Raise the issue at your next board or executive meeting. If there is any likelihood that backdating occurred, designate a group — ideally an audit or “special” committee — to develop an investigative plan. If backdating has not occurred, use this wake-up call to craft a strong compliance plan.

In your investigation, diligently verify officers’ stories. There have been cases where general counsel and CFOs actively have altered records to conceal backdating plans.

If backdating has occurred, ascertain who devised and approved the plan. Circumstances may show a breach of fiduciary duty, in which case any gain should be returned to the corporation.

Although the SEC may look more favorably upon companies that independently address backdating issues before the commission becomes involved, this remains uncertain. Still, the preferable course is to investigate and address problems before they are detected by external eyes, and secure counsel as a guide through any investigative and disclosure concerns.

This is an emerging area that, given the exposure it imposes on companies and executives, would benefit from more finely articulated regulation and commentary. Now is an ideal time to enter the discussion with legislators and counsel to ensure the relevant laws are defined early.

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