

THE LATEST EXECUTIVE COMPENSATION SCANDAL: BACKDATED OPTIONS

Another black mark for executive compensation. This time the scandal relates to backdated option grants to senior executives. To date, at least 19 companies have received subpoenas from the U.S. Attorney's office and/or letters of "informal inquiry" from the Securities and Exchange Commission regarding the timing of options granted to executives. Several companies have announced financial restatements. Others have had senior executives and/or directors resign. Appendix I is a partial list of the companies that are currently under investigation.

The scandal stems from a pattern of option grants that were made just before a sharp rise in share price, or at or near the bottom of a steep price dip. For example, Affiliated Computer Services, Inc. is purported to have awarded options to its then-president during six different years, in each case on one of the four lowest trading days during the respective years. According to *The Wall Street Journal*, the statistical probability of that occurring randomly is one in 300 billion.

Given these odds, questions have arisen as to whether the reported grant date was prior to the date the compensation committee or board approved the option grant, or whether an "as of" date had been used to the same effect (e.g., on June 1st, a compensation committee approves a grant of options effective as of May 1st in order to take advantage of the lower May 1st value). In more extreme cases, the question is whether board or committee minutes have been altered to reflect an earlier approval date. It appears investigations are focusing on these practices, although there are indications that market-timing practices are also being examined.

Backdating issues can also arise inadvertently. If the applicable corporate, tax or accounting rules are not satisfied by the meeting or other stated grant date, the operative grant date for corporate, tax or accounting purposes will be deferred. If a compensation committee or board must act in order to grant an option, which is typical under most option plans, state corporate law will govern the procedure for obtaining this approval. The effective date of a grant cannot occur prior to the time such approval is properly obtained. For tax and accounting purposes, the effective date of a grant does not occur until the date all material conditions to the grant are fixed and determinable.

If an option exercise price is set as of any date earlier than the effective date of grant for corporate, tax or accounting purposes, the option is at risk of being treated as backdated. Some common examples include the following:

- If a new hire is promised a grant in connection with employment, but the compensation committee does not approve the grant until after employment commences, the grant date is the date of committee approval and not the date of hire. Conversely, if the compensation committee approves the grant on the date the offer is accepted, but employment does not start until later, and if the plan requires that grants be made only to employees, the grant date will be the date when employment commences, not the date the offer is accepted.

- If a compensation committee approves an aggregate grant to employees but leaves the per employee allocation to management, the grant date is the date when the allocation is finally determined and communicated to employees, and not the date that the committee approved the award.
- If a unanimous written consent is used by a compensation committee or board to approve the grant, under the corporate law of most states, the consent is effective only on the date when the last director signs the consent, and not on any earlier date that may appear in the text of the consent or on the date when the first director signed.

If backdating is found to be intentional, liability for fraud may exist. Whether or not intentional, backdating calls into question the appropriateness of a company's internal controls and governance and audit practices. In addition, backdating can result in significant corporate, accounting, tax and disclosure issues, including whether: (1) the grant is defective, (2) applicable NYSE or Nasdaq shareholder approval requirements have been violated, (3) liability exists for inaccurate or untimely disclosure (e.g., Section 16 filings, proxy statements, and 10-K filings), (4) the grant fails to qualify as "performance-based compensation" under Internal Revenue Code Section 162(m), resulting in loss of compensation deductions when the options are exercised, and (5) executives will incur tax penalties due to treatment of such options as nonqualified deferred compensation.¹

Discounted options, while not illegal, may raise some of the same issues unless the applicable plan documents permit the grant of awards with an exercise price that is less than fair market value at the date of grant. The discount also has to be considered in calculating the related accounting expense for the award, and discount options must be properly disclosed.

Many of the above issues can be avoided by following sound corporate governance and grant practices. To avoid future problems or the appearance of impropriety, companies should consider the following steps:

- Avoid grants "as of" any date in the past (although this will not prevent using a prior date as a basis for vesting).
- Fix all material terms of an award by the date of compensation committee or board approval, and avoid giving management subsequent discretion over award allocation.
- Either expressly set the date of the compensation committee or board meeting as the date of grant, with all material terms of grant included in, or as an exhibit to, the meeting minutes, or set the grant date as of a future date, with the exercise price determined as of such future date.

¹ For discussion on the treatment of options as nonqualified deferred compensation, see our client memorandum, "Treasury Proposes New Deferred Compensation Regulations: Brave New World for Executives," dated November 7, 2005, which can be found at www.willkie.com/firm/pubs.aspx.

- If using a unanimous consent to approve grants, make sure all signatures are received by the intended grant date.
- With the exception of new hires, establish a regular fixed date upon which grants will be made effective (e.g., the first day of the window period following an earnings release).
- For new hires, have the committee approve a grant made prior to hire to be effective as of the date of hire, with an exercise price determined as of the date of hire. If the terms of the option plan limit grant recipients to employees, the grant date may not be prior to the employment commencement date.

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If you have questions, or would like assistance in identifying or reviewing issues relating to option grants or other timing practices, please contact Stephen T. Lindo (slindo@willkie.com, 212-728-8242), Frank A. Daniele (fdaniele@willkie.com, 212-728-8216), Steven J. Gartner (sgartner@willkie.com, 212-728-8222), David E. Rubinsky (drubinsky@willkie.com, 212-728-8635), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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APPENDIX I
COMPANIES INVOLVED IN BACKDATING ALLEGATIONS

<i>Name of Company (Ticker Symbol)</i>	<i>Announced Investigation by Federal Prosecutors or SEC Examination</i>	<i>Announced Need for Financial Restatement</i>	<i>Executive Officer/Director Terminations</i>	<i>Date of Applicable 8-K Filings</i>
Affiliated Computer Services (ACS)	Yes	Yes	--	3/6/06 and 5/18/06
Analog Devices (ADI)	Yes	--	--	5/24/06
Brooks Automation (BRKS)	Yes	Yes	Yes	5/15/06 and 5/23/06
Caremark RX (CMX)	Yes	--	--	5/18/06
CNET Networks (CNET)	Yes	--	--	5/22/06
Converse Technology (CMVT)	Yes	Yes	Yes	3/14/06, 3/17/06 and 5/4/06
F5 Networks (FFIV)	Yes	--	--	5/23/06
Jabil Circuit (JBL)	--	--	--	5/3/06
Juniper Networks (JNPR)	(a)	--	--	--
KLA Tencor (KLAC)	Yes	--	--	5/24/06 and 5/30/06
Mercury Interactive (MERQ)	Yes	--	Yes	7/2/05 and 11/2/05
Nyfix (NYFX)	Yes	--	--	5/19/06
Power Integrations (POWI)	Yes	Yes	Yes	5/9/06 and 5/24/06
RSA Security (RSAS)	Yes	--	--	5/19/06
SafeNet (SFNT)	(a)	--	--	--
Semtech (SMTC)	Yes	--	--	5/23/06
Sycamore Networks (SCMR)	Yes	Yes	--	5/23/06 and 5/30/06
United Health Group (UNH)	Yes	--	--	5/18/06
Vitesse Semiconductor (VTSS)	Yes	--	Yes	4/27/06 and 5/18/06