The Economic Impact of Backdating of Executive Stock Options[#]

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ABSTRACT

The paper discusses the economic impact of legal, corporate governance, tax, disclosure, and incentive issues arising from revelation of dating games with regard to executive option grant dates. It provides an estimate of the value loss incurred by shareholders of firms implicated in backdating and compares it to the potential gain that executives might have obtained through backdating. Using a sample of firms that have already been implicated in backdating, we find that the revelation of backdating results in an average loss to shareholders of about 8%. This translates to about $500 million dollars per firm. By contrast, we estimate that the average potential gain from backdating to all executives in these firms is under $600,000 per firm annually. We suggest some remedies for not only backdating, but also for other dubious practices such as springloading.

THE ECONOMIC IMPACT OF BACKDATING OF EXECUTIVE STOCK OPTIONS

I. Introduction

The burgeoning compensation packages of top executives of U.S. companies have attracted considerable attention in the past few years.[1] Most of the public attention has centered on the compensation levels[2] while academics have focused on the incentive effects of compensation.[3] Shareholder activists have argued for years that compensation levels are high because top executives have captured the compensation process and that it no more an "arms-

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[1] *See* Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39 (2004) (discussing how media attention has been focused on executive compensation.). *See also Commissioner Atkins Speaks at SEC Open Meeting*, U.S. FED. NEWS, July 26, 2006 (demonstrating how executive compensation has received so much media attention that the commissioner had to respond to public concerns). For examples of news stories covering executive compensation in the United States, see John Gray, *How Much is Too Much?*, CANADIAN BUSINESS, July 17, 2006/Aug. 13, 2006, at 55; Kathy Kristof, *Bosses' Pensions Sure to Shock*, SUN-SENTINEL (FORT LAUDERDALE, FL), Aug. 7, 2006, at 20; Terence O'Hara, *Many Executies' Paychecks Swelled, No Matter How They Did,* WASH. POST, July 10, 2006, at D07.

[2] *See* Gray, *supra* note 1, at 55 (a newspaper story from Canada expressing the opinion that executive compensation in the United States is excessively high); Kristof, *supra* note 1, at 20 (a newspaper story discussing the contribution of pensions to the compensation levels of executives); O'Hara, *supra* note 1, at D07 (a newspaper story providing specific examples of U.S. executives who are receiving high levels of compensation); *Total Compensation Up 7.2% According to 2006 Survey of Manager & Executive Compensation in Hospitals and Health Systems,* PR NEWSWIRE US, Aug. 3, 2006, http://www.prnewswire.com (last visited Aug. 16, 2006) (a newswire story focused solely on the compensation data for executives in the health care industry).

[3] *See, e.g.,* Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807 (2005) (a specific analysis of Fannie Mae's executive compensation arrangements that reveals how the system weakened manager's incentives to enhance shareholder value); Qiang Cheng & Terry D. Warfield, *Equity Incentives and Earnings Management*, 80 THE ACCT. REV. 441 (2005) (a study based on the hypothesis that managers with high equity incentives are more likely to engage in earning management to increase the value of their shares to be sold); Eliezer M. Fich & Anil Shivdasani, *The Impact of Stock-Option Compensation for Outside Directors on Firm Value,* 78 J. BUS. L. 2229 (2005) (a study focusing on the effect of stock-option plans on the alignment of incentives of outside directors along with those of shareholders).

length" transaction between the board and the top executives.[4] Although academics have been slower to even consider this point of view, there has been a spate of research in recent years that provides evidence inconsistent with the arms-length model.[5]

In this paper, we discuss the implications of one form of executive capture of the compensation process, namely, the practice of backdating executive stock options. Evidence consistent with the practice of backdating was first suggested in 2005 by Professor Lie[6] and by Professors Narayanan and Seyhun.[7] Although the media subsequently picked up the results of this research and started reporting on the practice, it became a full-fledged scandal when the *Wall Street Journal* published a report on its front page suggesting that executives of six companies might have backdated their options.[8] Since then, there have been new revelations of backdating on a regular basis. As of this writing, over sixty companies have been embroiled in backdating, with Securities Exchange Commission (SEC), the Justice Department, the Internal

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[4] *See* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991); CORPORATE GOVERNANCE 221, 221-225 (ROBERT MONKS & NELL MINOW EDS., 3d. ed. 2001).

[5] Bebchuk has been in the forefront of academics that question the arms-length model and suggest that the compensation process has been captured by the executives being compensated (Power hypothesis). For a detailed critique of the arms-length model and a synthesis of the Power hypothesis, see LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004); *see also* Marianne Bertrand & Sendhil Mullainathan, *Agents with and without principals*, 90 AM. ECON. REV. 203 (2000) and Marianne Bertrand & Sendhil Mullainathan, *Are CEOs rewarded for luck? The ones without principals are*, 116 Q. J. ECON. 901 (2001) for evidence in support of the Power hypothesis. For a critique of this hypothesis, see Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options*, 69 U. CHICAGO. L. REV. 847 (2002).

[6] Erik Lie, *On the timing of CEO stock option awards*, 51 MGMT. SCI. 801, 802 (2005).

[7] M. P. Narayanan & Nejat Seyhun, *Do Managers Influence Their Pay? Evidence from stock price reversals around executive option grants*, 2005 (working paper, University of Michigan, Ann Arbor, available at http://sitemaker.umich.edu/optionsdating/files/050117execoptions.pdf).

[8] Judith Burns, *Dow Jones Newswire*, Jan. 27, 2006; Charles Forelle & James Bandler, *The perfect payday,* Wall St. J., Mar. 18, 2006, at A1; *see also* Mark Hulbert, *Test of good corporate citizenship*, MARKET WATCH, Feb. 18, 2005.

Revenue Service (IRS), and several state attorneys general starting their own investigations.[9] It has also triggered questions about the role of auditors in checking this practice.

Backdating is only one form of dating game that executives can play. Backdating involves the executive (with or without the knowledge of the board) designating as the grant date a date before the date the board made the decision to grant options.[10] This is done to obtain options at a lower exercise price since the exercise price is usually set equal to the stock price prevailing on the designated grant date.[11] Obviously, it is worthwhile to backdate only if the stock price has been rising in the days before the board decision date. Although backdating is the practice that has received the most attention, other dating games are also possible. For example, if the stock price has been falling before the board's decision date, executives can wait to see what the stock price does in the near future before designating a grant date

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[9] The *Wall Street Journal* maintains a list of companies on its website that are under investigation by the SEC and/or the Justice Department. *See* http://online.wsj.com/public/us. The first civil and criminal charges involving backdating were brought by the U.S. Attorney for Northern California against former CEO, CFO, and Human Resource Director of Brocade Communications in late July, 2006. Several state attorneys general, notably of the states of Minnesota and Ohio, have started their own investigations. The *New York Times* reported in late July, 2006 that the IRS is reviewing companies implicated in backdating. *See* Eric Dash, *I.R.S. Reviewing Companies in Option Inquiries,* N.Y. TIMES (July 28, 2006), at C-12.

[10] Although it is the norm to set the board decision date as the grant date, we are aware of no SEC regulation that requires it. Section 1.421-1 of Internal Revenue Code, however, requires specification of the grant date. It states that "'the date of the granting of the option' and 'the time such option is granted,' and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. A corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable." I.R.C. § 1.421-1.

[11] Options with the exercise price equal to the prevailing stock price are called at-the-money options. If the exercise price is lower (greater) than the stock price, they are called in-the-money (out-of-the-money) options.

(backdating is clearly pointless). If the stock price continues to fall, they can designate a future date as the grant date. We term this practice forward dating.[12]

We argue in this paper that misdating of option grants has legal, economic, tax, and governance implications all of which are detrimental to shareholders. Specifically, we discuss four consequences of misdating that can adversely impact shareholder value: 1) Legal issues: There are legal consequences arising from backdating or forward-dating without complete disclosure. In addition, the ethical issues raised might have economic consequences as they undermine the investors' confidence in the top executives; 2) Tax issues: The tax treatment of in-the-money options is different than the tax treatment of at-the-money options with implications for both the company and its executives; 3) Corporate disclosure issues: Disclosure of misdating practices can lead to restatement of earnings as the camouflaged pay is recognized as compensation expense. The reduced earnings can result in a downward reassessment of shareholder value; and 4) Incentive issues: Misdating amounts to stealth compensation. If this is done because executives have captured the compensation process, then the managers are being inefficiently compensated, resulting in incorrect incentives.

We discuss the economic impact of each of the above issues. We then measure the economic impact of dating games on a list of firms that have already been implicated or are under investigation for these practices. The list of firms is taken from a web site maintained by the *Wall Street Journal*.[13] We find that firms on this list lost on average a market value of $510 million per firm during a window of 21 days around the first announcement that implicated a firm in backdating, either by the firm's own admission, or because the SEC or the Justice

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[12] *See* M.P. Narayanan & Nejat Seyhun, *The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation?* 2006 (working paper, University of Michigan, Ann Arbor, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=896164) (evidence consistent with forward dating).

[13] *See* http://online.wsj.com/public/us.

Department has commenced an investigation.[14] We compare this figure to the average gain executives of a firm might have gotten during 2000-2004 if they had backdated aggressively, i.e., backdated on every grant date that backdating would have been profitable. We find that executives would have benefited utmost by $600,000 per firm per year by backdating during this period.[15] It appears that the potential benefit to executives from clandestine backdating is miniscule compared to the potential damage to shareholder at the revelation of this activity.

We suggest some remedies to eliminate clandestine backdating and other types of stock price manipulation to influence executive compensation. It has been documented[16] that the Sarbanes-Oxley Act of 2002 (SOX)[17] has not been successful in fully eliminating clandestine backdating or other forms of manipulation such as springloading. Recently the SEC has voted to approve changes to reporting requirements that will eliminate the dating games.[18] We discuss remedies to eliminate springloading as well.

The paper is organized as follows. Section II provides an overview of the dating games, namely backdating and forward-dating. Section III discusses the four consequences of these dating games and their impact on shareholder value. Section IV measures the impact on shareholder value of a list of firms already implicated in dating games. Section V suggests some remedies for limiting the manipulation of executive compensation. Section VI concludes.

II. An Overview of Backdating and Forward Dating

In this section we provide a brief description of two types of dating games, namely backdating and forward dating, and the academic evidence consistent with their prevalence

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[14] *See infra* Section IV D.
[15] *See infra* Section IV D.
[16] *See* M.P. Narayanan & Nejat Seyhun, *Effect of Sarbanes-Oxley Act on the Influencing of Executive Compensation* (2006 working paper, University of Michigan, Ann Arbor, available at http://sitemaker.umich.edu/optionsdating/files/060320replag.pdf).
[17] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and other chapters (2002)).
[18] 17 C.F.R. §§ 239, 249 (2006).

before and after enactment of SOX. Before we describe these games, it is important to note that backdating or forward dating by itself is not illegal, as long as it is duly-authorized by the board, fully disclosed, and reporting and tax rules are followed.

Dating games are best explained using simple examples. Suppose an executive is awarded options on April 15 by the board of directors when the firm's stock price is $40. As is the practice with almost all awards, these options are awarded at-the-money, implying that the exercise price is set equal to the stock price on the grant date, i.e., $40.[19] If the stock price at the time of exercise exceeds the exercise price of $40, the payoff to this executive will be the difference between the stock price prevailing at the time of exercise and the exercise price of $40.

However, suppose the firm's stock price has been rising before the board decision date. The executive sees an opportunity to increase his or her compensation and declares that he or she received at-the-money options on March 15, when the stock price was below $40, say $30, and files a Form 4 report with the SEC that March 15 is the grant date.[20] This is backdating. This declaration automatically sets the exercise price equal to the stock price on March 15, or $30. What the board intended was that the executive receive options on April 15 with an exercise price of $40. What the executive declared was that he/she received at-the-money options with an exercise price of $30 on March 15. The payoff to this executive now equals the stock price at the time of exercise less the exercise price of $30 if the stock price ends up above

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[19] As Hall and Murphy note, about 95% of the options are granted at-the-money and the remaining are granted out-of-the money. Brian J. Hall & Kevin J. Murphy, *Optimal exercise prices for executive stock options*, 90 AM. ECON. REV. 209 (2002). There are two possible reasons for the absence of in-the-money options. First, FASB rules require that the difference between the stock price and the exercise price of in-the-money options be charged against earnings. Second, in-the-money options are not considered "performance-based compensation" under Section 162(m) of the Internal Revenue Code and therefore are not deductible if an executive's total nonperformance-based compensation exceeds $1 million a year. 26 U.S.C.S. § 162(m) (West 2006). We describe these issues in detail in Sections III B and C, *infra.*

[20] In this example, we implicitly assume that the executive is solely responsible for the mis-dating. The basic idea remains the same even if the board is complicit in this practice.

$30 at the time of exercise. By obtaining options at a lower exercise price than the board intended, the executive received more compensation than intended by tampering with corporate documents. Also, because the board decision was really made on April 15, this executive received options that are $10 in the money immediately.

Now consider a different scenario. As before, the board grants at-the-money options on April 15 when the stock price was $40. Now, however, suppose the stock price has been falling prior to the board decision date. Backdating is clearly fruitless. The executive can now play a different dating game: forward-dating. The executive can wait to see what the stock price does. If it continues to decline, the executive can wait to designate a *future* date as the grant date. Suppose the stock falls to $35 by April 25. The executive declares that he or she received at-the-money options on April 25, at the exercise price of $35.

The essential difference between backdating and forward-dating is that the manager-designated grant date is before the board decision date in the case of the former while it is after in the case of the latter. The extent of backdating or forward-dating is a trade-off between the potential for additional compensation and the risk of detection. Backdaters can seek a date farther in past from the board date to obtain a lower exercise price at the increased risk of detection. Similarly, forward-daters can wait until the stock price continues to fall before reversing direction to maximize their payoff.

How were these dating games originally detected? It would be simple if we knew the board decision date and the designated grant date. Although data about the manager-designated grant date is available from Form 4 filings with the SEC, board decision dates are not readily available to researchers.[21] Professors Narayanan and Seyhun[22] were the first to propose a test

[21] The disclosure of changes in the equity holdings of beneficial owners (defined as director, officer, beneficial owner of more than ten percent of any class of equity securities) is governed by Section 16(a) of the Securities and Exchange Act of 1934 (Act). 17 C.F.R. § 240.16a (2006). On August 27, 2002, in line with Section 403 of SOX, the SEC amended the disclosure rules for beneficiary ownership reports to be filed under Section 16(a). The filing requirements

relating reporting lags to stock price patterns around the grant date to overcome this problem.[23] Because the date the SEC received Form 4 is available, we can measure the time lag between the manager-designated grant date and the report date. If executives are backdating, a longer reporting lag implies that, on average, they were backdating aggressively, seeking a lower exercise price. This in turn implies that the extent of stock price rise following the manager-designated grant date will be positively correlated with the reporting lag. This is precisely what Narayanan and Seyhun found.[24] Using a dataset of over 600,000 grants during the period of 1992-2002 (almost all of them pre-SOX), they found that post-grant returns increased with reporting lags.[25] In the follow-up study using post-SOX data of over 638,000 grants, Narayanan and Seyhun found a similar positive correlation.[26]

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became effective on August 29, 2002. SOX has instituted two major changes regarding the disclosure of executive option grants. First, it requires that most grants be reported within two business days following the execution date of the transaction. Second, it requires that practically all executive option grants by reported on Form 4. These changes have effectively forced reporting of almost all executive option grants on a single form within two business days following the grant date. Effective June 30, 2003, Form 4 must be filed electronically within the two-day deadline. Prior to SOX, grants meeting certain requirements could be reported on Form 5 which was required to be filed only within 45 days after the end of the company's fiscal year, while other grants had be reported on Form 4 which was required to be filed within the first 10 days of the month following the month of the grant.

[22] Narayanan & Seyhun, *supra* note 7.

[23] Lie's conclusion that some executives might be backdating is entirely based on comparing the pattern of raw and market-adjusted stock returns around the grant dates. Lie, *supra* note 6. Heron and Lie use the more direct method proposed in Narayanan and Seyhun, *supra* note 7, that uses the positive relationship between reporting lags and post-grant stock returns. R. Heron & Erik Lie, *Does backdating explain stock price pattern around executive stock option grants?* J. FIN. ECON. (forthcoming).

[24] Narayanan & Seyhun, *supra* note 7.

[25] *Id*.

[26] Narayanan & Seyhun, *supra* note 12. The fact that stock prices rose on average after the grant date has been well-known for about a decade. *See* David Yermack, *Good timing: CEO stock option awards and company news announcements,* 52 J. FIN. 449 (1997). However, this pattern of stock prices is consistent with manipulations other than the dating games described here. For example, managers might release good news just after a grant or award themselves grants just before releasing good news. We call these manipulations "timing." They are also known as "springloading." See *id.* and David Aboody & Ron Kasznik, *CEO stock option*

Forward dating is more difficult to detect. The reporting lag technique cannot identify the prevalence of forward-dating as cleanly as it can detect backdating for the following reason: when forward-dating, there is no built-in lag since the executive is picking a date in the future and can always report promptly after picking the date. Narayanan and Seyhun use a slightly different technique to provide evidence consistent with forward-dating.[27] Consider an executive engaged in forward-dating who also wishes to report the grant promptly so as not be in violation of reporting regulations. After SOX, the executive needs to report within two business days of the grant. This executive is forward-dating only because the stock price has been falling. If he or she is an aggressive forward-dater, the executive will continue to observe the stock price until it reaches a trough and starts reversing. If the reversal continues for two days, the executive designates the date prior to the day the stock price started reversing as the grant date and reports the grant immediately, filing Form 4 electronically the same day to meet SOX reporting requirements. The testable implication that arises from this scenario is that two-day reporting lags should be more likely than zero or one-day reporting lags when the stock price is falling prior to the designated grant date. A second prediction for the same sample of firms is that stock price should be more likely to rise after the manager-designated grant date. Narayanan and Seyhun find this to be the case, which is consistent with forward-dating.[28]

A related question that arises is the effect of SOX on dating games. The SOX requirement that option grants must be reported within two business days severely limits the extent of backdating by executives desirous of meeting the requirement. However, Narayanan and Seyhun show that more than 20% of the grants after SOX are reported late and that about

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awards and the timing of corporate voluntary disclosures, 29 J. ACCT. & ECON. 73 (2000) for evidence of timing. It is the relation between post-grant stock price rises and reporting lags that distinguishes dating games such as backdating and forward-dating from timing or springloading. See Narayanan & Seyhun, *supra* note 7 for more evidence that distinguishes the dating games from timing.

[27] Narayanan & Seyhun, *supra* note 12.

[28] *Id*.

10% are reported later than one month (or 22 business days).[29] This result provides prima facie evidence that backdating may be still going on after SOX. The evidence provided by Narayanan and Seyhun confirm this conjecture.[30] The paper shows that the 30-day post-grant return was 3.4% before SOX but fell to 1.6% after SOX. SOX has clearly reduced the practice as expected but has not fully eliminated it.[31]

What types of companies and executives are likely to have benefited the most from backdating? Narayanan and Seyhun found that large grants (more than 100,000 options) that were reported more than a month late after SOX had significantly greater returns after the grant date compared to the rest of the sample. Thirty-day stock returns after grants between 100,000 and 500,000 options were about 15% while the figure was about 25% for grants over 500,000 options.[32] Such late-reported large awards were made disproportionately by smaller firms: about 58% of the firms in this category had market capitalization of less than $100 million and about 78% of them had market capitalization of less than $500 million. Another interesting statistic was the significantly lower number of scheduled grants (that is, grants that are scheduled in the same month as previous year's grants). Although about 51% of the grants were scheduled grants in the whole sample Narayanan and Seyhun found that in the late-reporting large-grant sample only 28% were scheduled grants.[33] When grants are scheduled during certain days of the year (the day of the board meeting to ratify the annual report, for example), and these days are public knowledge, the probability of backdating is likely to be lower.

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[29] Narayanan & Seyhun, *supra* note 16.
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.*

III. Economic Impact of Backdating

As indicated earlier, there are four channels through which backdating can affect shareholder value: 1) Legal issues; 2) Tax issues; 3) Financial reporting or disclosure issues; 4) Incentive issues. In this section, we briefly describe how backdating affects shareholder value through each of these channels.

A. Legal Issues

The inclusion of stock options in executive compensation packages is generally meant to align management's interests with the interests of the company's shareholders.[34] This is accomplished by making the executive's compensation dependent on stock performance.[35] As discussed above in Section II, when option grants are backdated or forward dated, investors are unaware that the options granted are in-the-money. Thus, shareholders may be misled into believing that management's interests are firmly aligned with theirs through the compensation package, when in fact executives can receive additional compensation without stock prices rising. Moreover, stock options granted at-the-money may not require the company to incur expenses in the same way that in-the-money options do.[36] As discussed in Part C below, when a company grants discounted stock options it must record a compensation expense.[37]

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[34] *See* Randall S. Kroszner, et al., *Economic Organization and Competition Policy*, 19 YALE J. ON REG. 541, 548 (2002); Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans,* 35 WAKE FOREST L. REV. 31, 37 (2000).

[35] *See Thomas*, supra note 34 at 38.

[36] Financial Accounting Standards Board Statement of Financial Accounting Standards ("SFAS") No. 123 R (revised 2004), *Share-Based Payment,* Dec. 2004. For reporting periods prior to June 15, 2005 the governing accounting standards and related opinion were, Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and Financial Accounting Standards Board SFAS No. 123, *Accounting for Stock-Based Compensation*, October, 1995. *See infra* Section III C, for further discussion of this issue.

[37] *See infra* Section III C for further discussion of this issue.

Backdating and forward dating are thus misleading shareholders not only with respect to the amount of compensation being granted to executives, but also with respect to the financial statements. As discussed more fully below,[38] without full disclosure and accounting of the practice, it is misleading to certify the financial statements as GAAP compliant.[39]

This deception is no doubt contrary to the purposes of the securities laws[40] and the more recent Sarbanes-Oxley Act,[41] but the courts have not yet had the opportunity to rule on whether the practice of backdating is a violation of the securities laws. That opportunity is looming on the horizon, however, with recent litigation filed by both the SEC and private litigants pertaining to the issue.[42] Furthermore, it appears that convincing arguments can be made that the practice of backdating and forward dating of options violates both federal securities law and state law. The recent actions filed by the SEC against the executives of Brocade[43] and Comverse Technology, Inc.[44] indicate the Commission's belief that the backdating practices have resulted in violations of the securities laws.[45]

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[38] *See infra* Section III C.
[39] *See infra* Section III C.
[40] The Securities Act of 1933 was "[a]n act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, 48 Stat. 74 (1933).
[41] Sarbanes Oxley "will improve disclosure, impose tougher penalties, and better protect investors in cases of fraud." Representative John H. Sununu, Remarks to the 107th Congress, Second Session (July 25, 2002), *in* Conference Report on H.R. 3863, Sarbanes-Oxley Act of 2002.
[42] As of July 27, 2006, it has been reported that 84 derivative actions and 10 class actions have been filed by private litigants in connection with backdating of options. Cary O'Reilly, *Option Backdating Spurs Few Lawsuits*, THE SEATTLE TIMES, July 27, 2006, at C2. In addition, the SEC has filed two civil lawsuits and the U.S. Attorneys for the N.D. Cal. and E.D. N.Y. have filed corresponding criminal charges in those cases.
[43] Complaint, SEC v. Reyes, et al., No. 06-4435 (N.D. Cal. 2006), Complaint, United States v. Reyes and Jensen, No. 3-06-70450 (N.D. Cal. 2006).
[44] Complaint, SEC v. Alexander, et al., No. 06-CV-3844 (E.D. N.Y. 2006), Press Release, Department of Justice, Former Executives of Comverse Technology, Inc. Charged with

In this Section, we argue that backdating and forward dating practices, to the extent intended to provide undisclosed compensation, violate Section 10(b) of the Securities Exchange Act of 1934[46] and Rule 10b-5 promulgated thereunder[47] as well as state corporate laws regarding corporate governance. Although we recognize that several other provisions of the federal securities laws are also implicated,[48] an exhaustive review of the federal securities laws that might be violated is beyond the scope of this Article. Instead, we seek to provide an

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Backdating Millions of Stock Options and Creating a Secret Stock Options Slush Fund (Aug. 9, 2006), available at http://www.usdoj.gov/usao/nye/pr/2006/2006Aug09.htm.

[45] Complaint, SEC v. Reyes, et al., No. 06-4435 (N.D. Cal. 2006); Complaint, SEC v. Alexander, et al., No. 06-CV-3844 (E.D. N.Y. 2006). In addition, a final judgment was entered recently in the case brought by the SEC against the former Senior Vice President and General Counsel, Leonard Goldner, of Symbol Technologies, Inc. Litigation Release, Securities Exchange Commission, Former General Counsel of Symbol Technologies, Inc. Consents to Permanent Injunctive Relief, Officer-and-Director Bar and Administrative Order Under Rule 102(E) (March 2, 2006), available at http://www.sec.gov/litigation/litrelease/lr19585.htm. The SEC complaint against Symbol Technologies, Goldner and ten other former executives alleged that the defendants entered into a fraudulent scheme to inflate financial performance. Among other things, Goldner was alleged to have manipulated stock option exercise dates. Litigation Release, Securities Exchange Commission, SEC Charges Symbol Tech., Inc., and 11 Former Symbol Executives with Securities Fraud (June 3, 2004), available at http://www.sec.gov/litigation/litreleases/lr18734.htm. Goldner pled guilty in 2004 to criminal charges brought by the U.S. Attorney's office, and on February 7, 2006, the U.S. District Court entered a final judgment pursuant to a consent decree with the SEC prohibiting him from acting as an officer or director of a public company. *See* Litigation Release, Securities Exchange Commission, Former General Counsel of Symbol Tech., Inc., Consents to Permanent Injunctive Relief, Officer-and-Director Bar and Administrative Order Under Rule 102(E) (March 2, 2006), available at www.sec.gov./litigation/litreleases/lr19585.htm.

[46] 15 U.S.C.S. 78j (1982).

[47] 17 C.F.R. § 240.10b-5 (2006).

[48] We note, for example that the complaint against the executives of Comverse Technology, Inc. includes allegations of violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a), Sections 10(b), 13(b)(5), 14(a) and 16(a) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78j(b), 78m(b)(5), 78n(a) and 78p(a), and Exchange Act Rules 10b-5, 13b2-1, 13b2-2, 14a-9 and 16a-3, 17 C.F.R. §§ 240.10b-5, 240.13b2-1, 240.13b2-2, 140.14a-9 and 240.16a-3. Two defendants were also alleged to have violated Exchange Act Rule 13a-14, 17 C.F.R. § 240.13a-14. In addition, the SEC presented several aiding and abetting claims. Complaint, SEC. v. Alexander, et al., No. 06-CV-3844, E.D. N.Y. (2006).

overview of the issues related to Section 10(b) and Rule 10b-5 claims and state corporate law regarding fiduciary duties as illustrative of the legal issues presented by backdating and forward dating practices. These issues are discussed below.

1. Federal securities laws

Section 10(b) of the Securities Exchange Act of 1934[49] makes it unlawful for any person to "use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[50] Rule 10b-5, promulgated pursuant to Section 10(b), makes it unlawful for any person:

(1) to employ any device, scheme, or artifice to defraud;
(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[51]

To establish a violation of Section 10(b) and Rule 10b-5, the SEC must prove the following elements:

(1) a material misrepresentation;
(2) in connection with the purchase or sale of a security;
(3) scienter; and
(4) use of the jurisdictional means.[52]

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[49] 15 U.S.C. 78j (1982).
[50] *Id.*
[51] 17 C.F.R. 240.10b-5 (West 2006).
[52] SEC v. Jones & Co., 312 F. Supp. 2d 1375, 1379 (D. Colo. 2004). The SEC is not required to show reliance or loss causation, as is required of a private plaintiff to bring an action under Rule 10b-5. Those elements are elements of a private cause of action for damages. SEC v. Rana Research, Inc., 8 F.3d 1358, 1364 (9th Cir. 1993).

A misrepresentation or omission is material if there is a substantial likelihood a reasonable investor would consider it important in making an investment decision.[53] The United States Supreme Court in *Basic, Inc. v. Levinson*,[54] adopting the language from its earlier decision *TSC Industries, Inc., v. Northway*[55] described the materiality standard as requiring "a substantial likelihood that the disclosure . . . would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[56] Furthermore, whether a misstatement or an omitted fact is material "is generally considered a mixed question of law and fact, and therefore uniquely within the province of the fact finder."[57]

To determine materiality courts consider factors such as whether the disclosure affected a change in stock price,[58] and the percentage of earnings or losses that were misstated. In 1999, the SEC released a Staff Accounting Bulletin that rejected reliance on quantitative "benchmarks" to determine materiality, stating that "misstatements are not immaterial simply because they fall beneath a numerical threshold." [59] According to SAB 99, materiality must be considered in light of "all relevant considerations," including qualitative factors such as whether the misstatement or omission was deliberate or intentional.[60]

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[53] Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988).
[54] 485 U.S. 224.
[55] 426 U.S. 438, 443 (1976).
[56] *Basic*, 485 U.S. at 231-32.
[57] SEC v. Todd, 2006 US Dist. LEXIS 41182, *13 (S.D.Cal. 2006).
[58] In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410 (3d. Cir. 1997).
[59] SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (1999).
[60] *Id.*

The Second Circuit Court of Appeals adopted the SEC staff's approach outlined in SAB 99 in *Ganino v. Citizens Utilities Co*.[61] The plaintiffs in *Ganino* alleged that the defendant corporation improperly recognized financial support fees as income without disclosure, thereby fraudulently inflating the stock price.[62] The Second Circuit ruled that the district court erred in using a quantitative benchmark to measure materiality.[63] Other federal Circuit Courts of Appeals have adopted similar context-based approaches to measuring materiality.[64] In addition, according to the court in the Southern District of New York, "the misstated or omitted fact must have been one that would have assumed actual significance in the reasonable shareholder's decision-making process, [but] there is no requirement that the fact would have been outcome determinative."[65]

Backdating and forward dating of options, thus, appear by their nature to fall within the parameters of the current standards for material misrepresentation. There seems to be a substantial likelihood that a reasonable investor would consider the information regarding the dating of the options important when making an investment decision. As discussed above,

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[61] 228 F.3d 154, 163-64 (2d Cir. 2000) ("[B]ecause SEC staff accounting bulletins 'constitute a body of experience and informed judgment,' and SAB No. 99 is thoroughly reasoned and consistent with existing law . . . we find it persuasive guidance for evaluating the materiality of an alleged misrepresentation.") (citations omitted).

[62] *Id.* at 159-60.

[63] *Id.* at 163-64.

[64] *See, e.g.,* No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 934 (9th Cir. 2003) (rejecting defendant's argument for adoption of a bright-line "market reaction" rule to determine materiality, choosing instead to conduct a "fact-specific inquiry"); SEC v. Ginsburg, 362 F.3d 1292, 1302 (11th Cir. 2004) (holding that "[t]he determination of materiality requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of these inferences to him...."); Searls v. Glasser, 64 F.3d 1061, 1066 (7th Cir. 1998) (finding the determination of materiality to be a "highly fact-dependent analysis").

[65] RMED Int'l, Inc. v. Sloan's Supermarkets, Inc., 185 F.Supp. 2d 389, 399 (S.D. N.Y. 2002).

executive compensation issues are currently at the forefront of shareholder concerns.[66] In a student run empirical study on shareholder proposals in the period between 2000 and 2004, the authors noted that executive compensation proposals were the most common type of shareholder proposals submitted.[67] Moreover, when backdating and forward dating occur, the financial statements are not accurate, and tax laws may be violated.[68] If the practice later comes to light, the company may be required to restate its financial statements and may be subject to various penalties.[69]

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[66] "With more than 20,000 comments, and counting, it is now official that no issue in the 72 years of the Commission's history has generated such interest." Christopher Cox, Chairman US Securities and Exchange Commission, Introductory Remarks at SEC Open Meeting (July 26, 2006), available at http://www.sec.gov/news/speech/2006/spch072606cc.htm (discussing the new executive compensation rules proposed in January 2006, and adopted in July 2006). Richard Grasso, the former chairman and chief executive of the New York Stock Exchange, was forced to resign in 2003 in the wake of shareholder criticism after the details of his compensation package – which included over $139 million in deferred compensation - was released. Gretchen Morgenson & Landon Thomas Jr., *Corporate Conduct: The Overview; Chairman Quits Stock Exchange in Furor over Pay,* N.Y. TIMES, Sept. 18, 2003, at A1. In mid-July, Barnes & Noble, the largest U.S. book retailer, announced that it has been sued by shareholders over option grants. *See* Ted Allen, *Tip of the Iceberg on Options?*, GOVERNANCE WEEKLY, July 21, 2006, http://www.issproxy.com/governance/publications/governanceweekly.jsp; *See also Developments In the Law – Corporations and Society,* 117 HARV. L. REV. 2205, 2205 (2004) ("Few issues in corporate law capture the attention of the academy and the general public quite like executive compensation."); James E. Heard. *Executive Compensation: Perspective of the Institutional Investor,* 63 U. CIN. L. REV. 749 (1995) (The author is the President of Institutional Shareholder Services, Inc.); Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation,* 67 U. CIN. L. REV. 1021 (1999) (discussing the increase in shareholder activism related to executive compensation).

[67] The authors used data from The Corporate Library. "TCL gathers data on over two thousand major American corporations listed in four common indexes. It tracks proposals that have been submitted to those companies...." Jason M. Loring & C. Keith Taylor, *Empirical Study: Shareholder Activism: Directorial Responses to Investors' Attempts to Change The Corporate Governance Landscape*, 41 WAKE FOREST L. REV. 321 (2006).

[68] See Section III B, *infra*, for a discussion of the tax consequences of backdating.

[69] In November of 2005, Analog Devices agreed to a $3 million civil penalty in relation to an SEC investigation. Angelo G. Savino & Russell A. Witten, *Timing of Option Grants and Directors' and Officers' Liability,* 326: 19 N.Y. L.J. 4 (July 28, 2006).

In one of the recent cases filed by the SEC alleging charges of backdating in violation of securities laws, the company, Brocade Communication Systems, was required to restate at least four years of financial statements. The financial impact involved: "(1) net loss of the 2004 fiscal year increased from $1.3 million to $32 million (i.e., net loss was understated by 95.9%); (2) net loss for fiscal year 2003 increased from $136 million to $146 million; (3) net income for fiscal year 2002 increased from $60 million to $126 million; and (4) income for fiscal years 1999 through 2001 declined a total of $303 million."[70] Additionally, Brocade restated a Form 10-K dated November 2004 to include $0.9 million related to options' grants between August 2003 and November 2004.[71] Even by very crude quantitative materiality benchmarks, these amounts in misstated earnings would likely be material.[72]

The recent case filed against former executives of Comverse Technology, Inc. appears even more egregious.[73] In this case, the SEC alleges that "former executives collectively realized millions of dollars of ill-gotten compensation through the exercise of illegally backdated option grants and the subsequent sale of Comverse common stock."[74] The executives purportedly went so far as to create a so-called "slush fund" of backdated options in the names of fictitious employees, hidden from the company's auditors. Once the option grants were approved by the board committee, it is alleged that the backdated options were then used

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[70] Complaint, SEC v. Reyes, et al., No. 06-4435, ¶ 37 (N.D.Cal. 2006).
[71] *Id.* at ¶ 38.
[72] Brocade's restatement of financial statements shaved 20 cents off previously reported earnings per share figures. David Kravets, *Brocade Execs Charged with Backdating Stock Options Go to Court*, SiliconValley.com, August 9, 2006, at http://www.siliconvalley.com/mld/siliconvalley/business/columnists/mark_schwanhausser/15231692.htm.
[73] Complaint, SEC. v. Alexander, et al., No. 06-CV-3844, E.D. N.Y. (2006).

for recruiting and retention of key employees.[75] Moreover, the *Wall Street Journal* reported the former Chief Executive has fled the country in the wake of the SEC charges.[76]

A counterargument to the materiality claim may be made in cases where the backdating or forward dating produced diminimus income for the executives, and thus had a minor effect on the financial statements. However, even in such cases, the shareholders may very well consider the information important when making an investment decision. It seems logical to conclude that shareholders may lose faith in management who choose to compensate themselves in such a hidden manner and their investment decisions may be thereby affected.[77]

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[74] Litigation Release No. 19796, Securities Exchange Commission, SEC Charges Former Comverse Technology, Inc. CEO, CFO, and General Counsel in Stock Option Backdating Scheme (Aug. 9, 2006) available at www.sec.gov/litigation/litreleases/2006/lr19796.htm.

[75] *Id*.

[76] Charles Forelle, *Stock Options Criminal Charge: Slush Fund and Fake Employees*, WALL ST. J., August 10, 2006, at A1.

[77] *See infra* Section III D. For example, managerial integrity was at issue in *In re* Franchard Corp., 1964 WL 67454 (S.E.C. Release no 4710). In that case, the SEC considered whether to issue a stop order suspending the validity of three registration statements of the Franchard Corporation (formerly the Glickman corporation) for failure to disclose, among other things, the unauthorized withdrawals of company funds by Louis J. Glickman, Franchard Corporation's controlling shareholder, president, and chairman. *Id.* at *2. Although a stop order was not issued, the Commission found that Franchard Corporation's disclosures were materially deficient. *Id.* at *13. Particularly, the Commission rejected the contention that the withdrawals, aggregating to over $ 2 million, were immaterial because they "never exceeded 1.5 percent of the gross book value of [the Franchard Corporation's] assets." *Id.* at *6. Rather, that argument ignored "the significance to prospective investors of information concerning Glickman's managerial ability and personal integrity." *Id.* These factors were particularly important to investors because the Franchard Corporation had no operating history and investors were primarily attracted to the company by Glickman's reputation. *Id.* Despite those qualifications, the Commission suggested that the integrity of management "is always a material factor," and Glickman's undisclosed withdrawals were "germane to an evaluation of the integrity of his management. *Id.* at *7. The same reasoning could presumably apply equally to a manager who accepts compensation which is inflated through undisclosed backdating.

Furthermore, the empirical evidence presented below in Section IV supports the conclusion that even an immaterial effect on earnings may have a much greater effect on shareholder wealth.[78]

We recognize that it may be possible in some circumstances for a company to inadvertently engage in backdating practices due to ministerial errors in recording stock grant approval dates.[79] If this is true, and if the financial consequences of the error are indeed minimal, the particular backdating event might be found to be immaterial. Without intent to deceive, the materiality issue may well turn on the dollar amount of the misstatement. Yet, it is also possible that the sloppiness of the record-keeping practices leading to the error would be taken into account as a qualitative factor considered when determining materiality. In any event, controls should be put in place in the future to prevent these errors from occurring. Regardless of intent, the financial statements are still misleading.

The second element of a 10b-5 claim requires that the fraud be in connection with the purchase or sale of securities. To meet this requirement, "it is enough that the scheme to defraud and the sale of the securities coincide."[80] The courts have interpreted this element very broadly, holding that "[t]he misrepresentation need not be made with respect to a particular sales transaction but should be applied generally. For instance, statements in press releases, annual and quarterly reports, proxy statements and SEC filings have been found to satisfy the 'in connection with' element because investors rely on such documents."[81] Backdating options

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[78] *See infra* Section IV.

[79] The SEC is also mindful of the distinction between backdating as a result of illegal activities and those that result from ministerial, logistical delays and are taking care not to lump together "the innocuous with the nefarious." Paul S. Atkins, Commissioner U.S. Securities Exchange Commission, Remarks at the SEC Open Meeting (July 26, 2006).

[80] SEC v. Mandaci, 2004 U.S. Dist. LEXIS 19143, *28 (S.D. N.Y. 2002).

[81] SEC v. Jones & Co., 312 F. Supp. 2d 1375, 1380 (D. Colo. 2004) (citing SEC v. Rana Research, Inc. 8 F.3d 1358, 1362 (9th Cir. 1993)).

leads to misrepresentations in financial statements, SEC filings and potentially proxy statements, all documents upon which investors rely when making investment decisions. Thus, this element should be easily satisfied.

The third element of the 10b-5 claim is scienter. Scienter refers to the state of mind of the defendant. To meet this requirement, the SEC must prove that the defendant had "a mental state embracing intent to deceive, manipulate, or defraud."[82] This element of a 10b-5 claim is often litigated. The Circuit Courts of Appeals have adopted varying standards for meeting the requirement of scienter.[83] The Ninth Circuit Court of Appeals is quite stringent requiring proof of intent or "deliberate recklessness" to establish a 10b-5 claim.[84] The Ninth Circuit extended the Supreme Court's definition of scienter – a "mental state embracing intent to deceive, manipulate or defraud"[85] declaring that "[s]cienter may also be established by a showing of

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[82] Aaron v. SEC, 446 U.S. 680, 686 (1980).

[83] Press v. Chem. Inv. Serv. Corp., 166 F.3d 529, 538 (2d Cir. 1999) (holding that a plaintiff "must either allege (a) facts to show that 'defendant has not the motive and opportunity to commit fraud' or (b) allege facts that 'constitute strong circumstantial evidence of conscious misbehavior or recklessness.'"); In re Comshare, Inc., Sec. Litig., 183 F.3d 542, 549 (6th Cir 1999) (holding that to plead scienter, plaintiffs must allege facts "giving rise to a strong inference of recklessness" and cannot rest solely on allegations of "motive and opportunity"); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1283 (11th Cir. 1999) (holding that plaintiffs must show that defendants acted with "severe recklessness"); Greebel v. FTP Software, Inc., 194 F.3d 185, 188 (1st Cir. 1999) (holding that the scienter standard included "a narrowly defined concept of recklessness which does not include ordinary negligence, but is closer to being a lesser form of intent.").

[84] SEC v. Rubera, 350 F.3d 1084, 1094 (9th Cir. 2005) ("Scienter may be established by recklessness, defined as: 'a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" (quoting Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990))).

[85] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

recklessness."[86] "Reckless conduct is conduct that consists of a highly unreasonable act, or omission, that is an 'extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[87] To the extent many of the backdating investigations are occurring in the Silicon Valley, the Ninth Circuit standard becomes particularly relevant.

Although resolution of this issue will turn on the facts of each individual case, it is logical to conclude that at least large-scale backdating and forward dating practices are usually carried out with a sufficient state of mind. Backdating of options grants appears to be done for only one purpose − to grant in-the-money options while making it appear as though the options were granted at-the-money. At the very least, there is intent to deceive as to the grant date of the option.

Again, we note the possibility of ministerial mistakes resulting in backdating. If such is truly the case, it would be difficult for the SEC to meet the scienter requirement of a 10b-5 claim. One practice that may be prone to mistake involves compensation committee approval of options grants by unanimous written consent. According to Delaware corporate law, unanimous written consents are effective on the date of the last signature.[88] It is possible that due to a variety of circumstances, the last signature may be obtained at a date later than recorded as the effective date of the consent. If the options are dated as of the date incorrectly

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[86] SEC v. Todd, 2006 U.S. Dist. LEXIS 41182, at *19 (S.D. Cal. May 23, 2006) (citing SEC v. Dain Rauscher, Inc., 254 F.3d 852, 856 (9th Cir. 2001)).

[87] *Dain Rauscher*, 254 F.3d at 856 (quoting Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990)).

recorded as the effective date of the consent, backdating has occurred. In such circumstances, there may be no intent to deceive, and the behavior, although negligent and misleading, might not be reckless.

On the other hand, it is also possible that practice of unanimous written consents for committee approval of options grants could be subject to abuse and used intentionally to perpetrate fraud. This practice underlies the allegation of the SEC in the case against the executives of Comverse Technology, Inc.[89] It seems a best practice, in light of the propensity for error or the possibility of fraud, would be for compensation committees to avoid use of unanimous written consents for future approvals of option grants. At a minimum, a telephonic or other meeting, with a fixed date, would be in order.

The last element of a 10b-5 claim requires that the fraud was perpetrated "by the use of any means or instrumentality of interstate commerce, or of the mails."[90] This element is easily satisfied. Section 402 of Regulation S-K requires disclosure of executive compensation agreements.[91] "Filing with the SEC . . . satisfies the jurisdictional means requirement."[92]

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[88] 8 Del. C. § 141(f) "any action required or permitted to be taken at any meeting of the board of directors...may be taken without a meeting if all members of the board..., consent thereto in writing."

[89] Complaint, SEC v. Alexander, et al., No. 06-CV-3844 at ¶ 41–42.

[90] 17 C.F.R. § 240.10b-5 (2006).

[91] 17 C.F.R. § 229.402 (1992).

[92] SEC v. Todd, 2006 U.S. Dist. LEXIS 41182, *9 (S.D. Cal. May 23, 2006). In addition to Rule 10b-5 violations, there are a number of other securities laws that are likely implicated by dating games. For example the elements of a claim in violation of Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (West 2006), are "essentially the same" as a Section 10(b) claim. SEC v. Jones & Co., 312 F. Supp. 2d 1375, 1379 (D. Colo. 2004). Similarly, Section 13(b)(5) of the Exchange Act, 15 U.S.C. §78m(b)(5), may also be implicated by backdating and forward dating activities. Section 13(b)(5) is violated by "knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record or account described in Section 13(b)(2)." *Id.* In the Brocade and Comverse Technology cases currently pending, the defendants are alleged to have falsified

It is also possible that the board of directors might be implicated in the dating games along with the officers who implemented the scheme.[93] Under the federal securities laws, the definition of reckless used by the Ninth Circuit in *SEC v. Dain Rauscher*[94] may implicate board members if they knew or should have known about the misleading dating of option grants. In the Brocade case, charges have been filed against the former Vice President of Human Resources because she allegedly falsified documents in furtherance of the scheme, and also against the former CFO because he allegedly knew of the scheme and did nothing to end it.[95] In fact, according to *Howard v. Everex Systems, Inc*., the recklessness standard may be established by demonstrating that "red flags" existed "casting doubt on the truthfulness or accuracy of representations."[96] The *Howard* court held that there was sufficient evidence for a jury to find that a director had the requisite level of scienter when he signed financial statements that misrepresented the financial condition in the face of negative information about

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documents and records of option grants, and by extension financial records. Complaint, SEC v. Reyes, et al., No. 06-4435, ¶ 33–36 (July 20, 2006), Complaint, SEC v. Alexander, No., et al., No. 06-CV-3844, E.D. N.Y. (2006). The defendants in the Brocade case are also alleged to have provided false information to the board of directors and to outside auditors in order to allow the scheme to remain undetected. *Id.* There are also a number of reporting provisions that may be violated by submitting financial statements that are false due to backdated options, including Exchange Act 13b2-2, Rule 13a-14, Rule 12b-20, Rule 13a-1, Rule 13a-13, Rule 13b2-1. 17 C.F.R. § 240.13b2-2 (2006); 17 C.F.R. § 240.13a-14 (2006); 17 C.F.R. §12b-20 (2006); 17 C.F.R. § 240.13a-1 (2006); 17 C.F.R. § 240.13a-13 (2006); 17 C.F.R. § 240.13b2-1 (2006). Again, this list is meant to be illustrative rather than exhaustive.

[93] "[A] director who has the requisite level of scienter and signs a fraudulent [form filed with the SEC] can be liable as a primary violator of § 10(b) for making a false statement." Howard v. Everex Systems, Inc., 228 F.3d 1057, 1061 (9th Cir. 2000) (citing AUSA Life Ins. Co. v. Dwyer, 928 F.Supp. 1239 (S.D. N.Y. 1996)).

[94] 254 F.3d 852, 856 (9th Cir. 2001) ("Recklessness is 'a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it'") (quoting Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990)).

[95] Complaint, SEC v. Reyes, et al., No. 06-4435 (N.D. Cal. 2006).

the actual financial condition.[97] It therefore seems that a board that approved backdating of grants, without making appropriate financial disclosures, would also likely be liable for federal securities law violations.

The more difficult case will be where the board approved the options grants but did not know that the executives were backdating or forward dating the grants. Here the question, under federal securities laws, will be whether there was scienter. Without actual intent to defraud, the courts will need to determine whether the behavior was deliberately reckless. They will likely consider whether "red flags" existed, such that they should have been aware of the practice.[98]

We note that the alleged fraud in the Brocade case seems to have been instigated by the only member of the compensation committee.[99] A best practice may be to avoid utilizing the corporate law provision that permits one member committees, at least for executive compensation.[100] Additional committee members may help provide a check on self-serving behaviors of one committee member**.** Additionally, the revised NYSE corporate governance rules require that the compensation committee be made up entirely of independent directors to minimize conflict of interest issues.[101]

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[96] 228 F.3d at 1064.
[97] *Id.*
[98] In the complaints filed to date against the executives of Brocade, the SEC has not charged the board members with any violations. This is likely because Reyes, the former CEO was acting as the only member of the compensation committee and allegedly provided false information to the board. However, it would seem that a board that approves options with backdated grant dates may be liable if they should have known that the grant dates were incorrect, and did not make the required financial disclosures.
[99] Complaint, SEC v. Reyes, et al., No. 06-4435, ¶ 20 (N.D. Cal. 2006).
[100] 8 Del. C. § 141(c)(2) ("each committee to consist of one or more of the directors of the corporation.").
[101] NYSE, Inc., Listed Company Manual, § 303(A)5(a) (2004).

2. State corporate law implications

In addition to violations of federal securities laws, the dating games played by corporate executives run contrary to their fiduciary duties to the corporation and to the shareholders. In general, corporate officers and directors owe the corporation and the shareholders the fiduciary duties of care[102] and loyalty,[103] and intertwined with care and loyalty is the obligation to act in good faith.[104] The duty of care requires officers and directors to act as the reasonable person would act under similar circumstances.[105] Loyalty obligations require that corporate officers and directors act in the best interest of the corporation, not for self-interests.[106] To the extent executives engage in related-party transactions, they are obligated to disclose such transactions

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[102] This duty goes back at least to the 1880s when articulated by the court in Hun v. Cary, 82 N.Y. 65 (1880). *See also, e.g.,* Brehm v. Eisner, 2006 Del. LEXIS 307 (Del. June 8, 2006); Cede & Co. v. Technicolor, 634 A.2d 345 (Del. 1993); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981); Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 17-25 (1989).

[103] *See, e.g., Technicolor*, 634 A.2d at 361; Paramount Commc'ns v. Time, 571 A.2d 1140 (Del. 1989); Mills Acquisition v. MacMillan, 559 A.2d 1261, 1280 (Del. 1988); Weinberger v. UOP Inc., 457 A.2d 701, 710 (Del. 1983); Guth v. Loft, 5 A.2d 503 (1939); *In re* Emerging Commc'ns, Inc., No. 16415, 2004 WL 1305745 (Del. Ch. May 3, 2004, revised June 4, 2004); Dana M. Muir & Cindy A. Schipani, *The Challenge of Company Stock Transactions for the Directors' Duty of Loyalty,*" 43 HARV. J. ON LEGIS. 437 (2006); Dana M. Muir & Cindy A. Schipani, *The Use of Efficient Market Hypothesis: Beyond SOX,* 105 MICH. L. REV. ___ (forthcoming).

[104] *See, e.g., In re* Emerging Commc'ns, Inc., No. 16415, 2004 WL 1305745 (Del. Ch. May 3, 2004, revised June 4, 2004) (discussing good faith and interplay with the duty of loyalty); *In Re* The Walt Disney Co. Derivative Litigation, 2005 Del. Ch. LEXIS 113, *176 ("The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty . . . but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders.").

[105] *See, e.g.,* Briggs v. Spaulding, 141 U.S. 132, 152 (1891); Cede & Co. v. Technicolor, 634 A.2d 345, 364 (Del. 1993), Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), Graham v. Allis-Chalmers Mfg. Co, 188 A.2d 125, 130 (Del. 1963); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (2005).

[106] *See, e.g.,* sources cited *supra*, note 102.

and seek approval by an independent committee of the board.[107] When independent approval has not been granted, the courts will review contested transactions against a standard of entire fairness.[108] That is, the court will only approve the transaction if it was entirely fair as to both outcome and process.[109] The entire fairness is one of the strictest standards of scrutiny employed by the Delaware courts.

Again, although the issues of fiduciary duty breach in any particular case will turn on specific facts and circumstances, it seems unlikely that dating games will withstand the scrutiny of a fiduciary duty analysis. The clearest case appears to be against the executives who engaged in the backdating or forward dating practices. To the extent they manipulated option dates to provide themselves with additional undisclosed compensation, they seem to be in violation of their fiduciary duties. It is difficult to imagine how the executives could argue that they were acting either with due care or in good faith. The manipulation, it would seem, would most often have constituted an intentional misrepresentation of their compensation to the stockholders, and a concomitant misrepresentation of the financial health of the company. Intentional deception is not within the parameters of due care or good faith.

In addition, these practices also implicate the duty of loyalty. The manipulation of stock granting dates seem analogous to the classic case of an executive personally benefiting from a transaction at corporate expense. Back in 1939, the Delaware Supreme Court, in the

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[107] *See, e.g.,* Stegemeier v. Magness, 728 A.2d 557, 562 (Del. 1999); Schock v. Nash, 732 A.2d 217, 225 n.21 (Del. 1999); Oberly v. Kirby, 592 A.2d 445, 466-67 (Del. 1991); Muir & Schipani, *The Use of Efficient Market Hypothesis: Beyond SOX, supra* note 116.

[108] *See, e.g., Oberly*, 592 A.2d at 466-67; *Stegemeier*, 728 A.2d at 562; *In re* Emerging *Commc'ns,* 2004 WL 1305745; President & Fellows of Harv. Coll. v. Glancy, 2003 Del. Ch. LEXIS 25, *69 (Mar. 21, 2003).

[109] *See, e.g.,* Emerald Partners v. Berlin, 787 A.2d 85, 97 (Del. 2001); Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1981); *In re Emerging Commc'ns*, 2004 WL 1305745.

leading case of *Guth v. Loft*,[110] made it clear that fiduciaries may not personally profit at the expense at the company. This duty was reiterated forcefully recently by the Delaware Chancery Court in *In Re The Walt Disney Co. Derivative Litigation*.[111] In *Disney*, the court also stated that "one cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey."[112]

Moreover, due to the direct conflicts of interest inherent in the backdating and forward dating cases, it would seem that in order to pass muster under loyalty standards, they would need to found to be "entirely fair" to the corporation. Stealth compensation is not fair to the corporation, and seems to be the type of self-dealing that the duty of loyalty was meant to prohibit. In the famous case of *Meinhard v. Salmon*, Judge Cardozo articulated the often quoted standard of behavior required of fiduciaries.[113] He stated that "[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[114] The behavior of the executives complicit to the backdating practices seems nowhere near meeting this standard.

As with the claims of securities fraud, the clearest claims for breach of fiduciary duty are against the executives engaged in the backdating schemes. A more difficult question concerns the potential liability of the board of directors. To the extent the board members were aware of the deception and did nothing to disclose the practice, it would seem they would have violated their fiduciary duties of care, loyalty and good faith as well. Although Delaware corporations are permitted by statute to limit or eliminate monetary liability of directors

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[110] 5 A.2d 503 (Del. 1939).
[111] 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005).
[112] *Id.* at*169, n. 447.
[113] 164 N.E. 545, 546 (1928).

through a provision in their articles of incorporation,[115] this exculpation provision applies only to acts committed without intentional misconduct, and acts that do not otherwise violate the duty of loyalty or the obligation of good faith.[116] Thus, to the extent that backdating practices involve intentional misconduct, violations of the duty of loyalty or lack good faith on the part of the board members, the exculpation provision of state law corporation statutes would be inapplicable to protect them from liability for fiduciary duty breach.

We note, however, that decisions regarding executive compensation plans are business decisions which in general would be protected by the business judgment rule. The business judgment rule is a presumption that business decisions are made in good faith and in the best interest of the corporation.[117] To the extent the board wishes to increase executive compensation through backdating or forward dating options, it would seem this practice would be within its province, provided that the compensation plan is properly reported. Courts generally do not second guess business decisions unless there is evidence of bad faith, or conflicts of interests. Without disclosure however, as discussed in Part A above, backdating and forward dating practices deceive shareholders and result in misleading financial information in apparent violation of federal securities laws. The business judgment rule would not apply to acts of deception.

The more difficult case concerns claims that may be brought against directors who, although not aware that backdating was occurring, did not set up systems to prevent it from

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[114] *Id*. at 546.
[115] 8 DEL. C. § 102(b)(7) (2005).
[116] 8 DEL. C. § 102(b)(7).
[117] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Unitrin, Inc. v. American Gen. Corp. (In re Unitrin, Inc.), 651 A.2d 1361 (Del. 1995); Gagliardi v. Trifoods Int'l, Inc.,

occurring. The issue of fiduciary duty breach for questions of oversight is an unresolved question in Delaware law. The clearest pronouncement on the issue came from the Court of Chancery, in dicta, in *In re Caremark International, Inc. Derivative Litigation* ("*Caremark*").[118] In *Caremark*, the court stated that: "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists . . . ."[119] The court further stated in order to show that the directors breached their duty of care, it would need to be shown that:

> either (1) that the directors knew or (2) should have known that the violations of law were occurring and, in either event, (3) the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of . . . .[120]

Thus, under a *Caremark* analysis, the question for the noncomplicit directors would be whether they had attempted, in good faith, to set up an appropriate reporting system, and whether they should have known that violations of the law were occurring.[121]

As noted above, boards should be looking closely for red flags that might tip them off to backdating or forward dating games. Given the wide-spread nature of the current scandal, it is advisable that controls be instituted to show a good faith effort to prevent these scandals from occurring. Two possible controls include avoiding approval of options grants by unanimous

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683 A.2d 1049 (Del. Ch. 1996). *See also* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989).

[118] *In re* Caremark International, Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).

[119] *Id.* at 970.

[120] *Id.* at 971.

[121] In the recent *Disney* case, the court appeared dismayed with the role the board members played in approving the employment contract of the company president, but did not find their behavior so egregious as to result in liability. *In re* The Walt Disney Co. Derivative Litigation, 2005 Del. Ch. LEXIS 113, *190 (Aug. 9, 2005). However, in *Disney,* there was evidence presented that the board was informed of the issues, even though there was no supporting

written consent and avoiding one-person compensation committees.

In addition, it would be advisable for boards of directors to avoid conflicts of interest. Courts more highly scrutinize transactions that involve conflicts of interest.[122] It would seem that if there are conflicted interests between board members and executives who have been granted backdated options, courts are likely to look at the board with skepticism.[123]

B. Tax issues

In order to understand the tax effects of backdating, we first provide a brief overview of relevant tax rules regarding stock option compensation. The primary section of the Internal Revenue Code (IRC) that governs taxation of executive stock options is Section 422.[124] For tax purposes, there are two types of executive stock option plans: statutory incentive stock option plans (ISO) and non-statutory stock option plans (NSO).[125] The following table summarizes the differences between the two types of plans in terms of taxation of option compensation. In addition to the tax rules listed in the table, Section 162(m) of the IRC limits executive compensation deduction for public companies to $1 million per year per executive for compensation paid to the top five most highly-compensated executive officers for proxy reporting purposes.[126] Option compensation that satisfies certain criteria may be considered "performance-based compensation" and as such, would be excluded from the $1 million limit.

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documentation. *Id.* at *34-35. The backdating cases are different to the extent that the boards may have been completely unaware of the practice.

[122] *See* notes 113-14 *supra*, and accompanying text.

[123] The *Wall Street Journal* recently reported conflicts of interest coming to light in the internal probe of stock options at United Health. *See* James Bandler & Charles Forelle, *Interested Parties, In Internal Probes of Stock Options, Conflicts Abound*, Wall St. J., Aug. 11, 2006, A1.

[124] I.R.C. § 422.

[125] Sometimes referred to as qualified and non-qualified plans, respectively.

[126] I.R.C. §162(m). In 1992, the SEC instituted a requirement that a firm's proxy statement contain details of compensation for the Chief Executive Officer and the next four highest-paid executives.

Under Section162(m), the amount of stock option gains will not be included within the $1 million deduction cap as long as the options are granted under a plan that has a per-person per-period limit on the number of options that can be granted each year, the options are not in-the-money when granted, an independent compensation committee grants them, and there is shareholder approval of the plan.

For a stock option to qualify as an ISO (and thus receive special tax treatment under Code Section 421(a)), it must meet the requirements of Section 422 of the Code when granted and at all times beginning from the grant until its exercise. The requirements include:

- The option may be granted only to an employee who must exercise the option while an employee or no later than three months after termination of employment.
- The option must be granted under a written plan document specifying the total number of shares that may be issued and the employees who are eligible to receive the options and the plan must be approved by the stockholders within 12 months before or after plan adoption.

Event	Tax consequences to company/executive	
	ISO	NSO
Option grant	No tax effects	No tax effects
Option vesting	No tax effects	No tax effects if the options are not in-the-money when granted.*
Option exercise	No tax effects	Executive pays ordinary income tax on the difference between the stock price at the time of exercise and the exercise price; the stock price at this time becomes the basis for the executive. Company can deduct the same amount as expense for tax purposes.
Sale of stock from exercise	The difference between the sale price and exercise price is treated as capital gains and taxed accordingly.** No tax effect for the company.	The difference between the sale price and the basis price is treated as capital gains and taxed accordingly. No tax effect for the company.

Comparison of ISO and NSO plans regarding taxation

*In-the-money option grants that vest after January 1, 2005 are treated as deferred compensation and are subject to §409(A).

**If the long-term holding period requirements are satisfied, the capital gain is taxed at the capital gain tax rate. If not, ordinary income tax rates apply.

- The option must be granted within 10 years of the earlier of adoption or shareholder approval, and the option must be exercisable only within 10 years of grant.[127]

[127] The employee must not, at the time of the grant, own stock representing more than 10% of the voting power of all stock outstanding (including stock constructively owned through attribution pursuant to Code section 424(d)), unless the option exercise price is at least 110% of the fair market value and the option is not exercisable more than five years from the time of the grant.

- The option exercise price must equal or exceed the fair market value of the underlying stock at the time of grant, i.e., the option cannot be in-the-money.
- The aggregate fair market value (determined as of the grant date) of stock bought by exercising ISOs that are exercisable for the first time cannot exceed $100,000 in a calendar year. To the extent it does, Code section 422(d) provides that such options are treated as nonstatutory options.[128]

Thus ISO qualify for exemption under Section 162(m).[129] NSO might also qualify if they meet the above requirements. Most executive stock options are NSO since the gains received from these options by executives can be deducted as compensation expense by the granting firms, unlike ISO. Another reason for the popularity of NSO is that they are not subject to the $100,000 limit mentioned above.

Now we turn to the effect of backdating on taxation. Since backdating is always resorted to obtain an exercise price lower than the stock price on the grant date, backdated options will be in-the-money, or discounted. This has three effects that affect taxation.

1. For options originally classified as ISO: With backdating, they no longer meet the non-discounting requirement. They should be classified as NSO, with the result that the executives who had exercised the options owe taxes at the ordinary income tax rate at the time of exercise, as opposed to no taxes if the option was classified as ISO.
2. For options originally classified as NSO and were claimed as exempt to the $1 million limit imposed by Section 162(m):[130] With backdating, they do not qualify for the exemption. The company owes taxes for amounts by which the stock gains from the exercise of these options exceed the $1 million limit.

[128] I.R.C. § 422.
[129] I.R.C. § 162(m).
[130] I.R.C. § 162(m).

3. For options vesting on or after January 1, 2005: Since backdating results in these options being in-the-money, they violate Section 409A and are considered deferred compensation.[131] The executives are now subject to tax at the time of vesting (instead of at exercise) and, in addition, subject to a penalty tax of 20% of the compensation which is required to be included in gross income, plus interest on underpayment. The corporation may deduct the income reported by the executive as compensation expense.

C. Financial reporting and disclosure issues

There have been major changes since the 1990s in the way companies are required to account for option compensation for financial reporting purposes. Therefore, it is useful to briefly review the history of option accounting for financial reporting. Until the mid-1990s, option accounting for financial reporting purposes (as opposed to tax-reporting purposes) was done under the guidelines established by Accounting Principles Board (APB) Opinion 25.[132] Under APB 25, options that were granted at-the-money or out-of-the-money had no impact at all on any of the financial statements.[133] If options were granted in-the-money, the difference between the grant date stock price and the exercise price (called the intrinsic value of the option) had to be treated as an expense and deducted from income. Specifically, the intrinsic value (aggregated over all option grants) is amortized as compensation expense evenly over the vesting period.[134] This treatment lowers the reported income while creating two offsetting entries in the balance sheet: a deferred tax asset equal to the lowered tax due to the compensation expense and an offsetting increase in the shareholder equity.[135]

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[131] I.R.C. § 409A.
[132] Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, Oct. 1972.
[133] *Id.*
[134] Compensation expense is not adjusted for subsequent changes in the market price of the underlying stock. *Id.*
[135] Because no actual tax is paid at the time of the grant, a deferred tax asset is created.

In 1993, Financial Accounting Standards Board (FASB) proposed expensing employee stock options at their fair market value at the time of the grant.[136] The proposal was so controversial that it received more than 1700 comment letters, most of which were opposed to mandatory expensing.[137] The U.S. Senate proposed legislation in 1994 that would have blocked the FASB from forcing expensing, and ultimately passed a nonbinding resolution that condemned the FASB proposal, and threatened to revoke the FASB's independence status. In response, FASB rescinded the mandatory expensing requirement, instead only requiring that the fair market value for the options be disclosed in the footnotes.[138] In 1995, FASB issued the final standard, Statements of Financial Accounting Standards 123, or SFAS 123,[139] which encouraged companies to treat the fair market value as an expense at the time of the grant, but allowed companies to report under APB 25 rules so long as footnotes contained a pro forma presentation of earnings as if SFAS 123 had been adopted. Initially, all companies continued to follow the APB 25 guidelines. In July 2002, several major companies announced that they plan to expense the fair market value of option grants as suggested by SFAS 123.

In 2003, FASB reversed its stance and unanimously voted to recommend expensing the fair market value of the options at the time of the grant. Although the draft proposal again caused widespread furor (close to 5000 comment letters on the draft, and a resolution by the House of Representatives to limit expensing to options granted to the top five executives), FASB went ahead with the proposal this time and released SFAS 123R in December 2004.[140]

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[136] See David Aboody, *Market valuation of employee stock options*, 22 J. ACCT. & ECON. 357, 358 (1996).

[137] *See* Patricia Dechow, A. Hutton, & Richard Sloan, *Economic consequences of accounting for stock-based compensation*, J. ACCT. RES. 1 (1996).

[138] *See* Wayne Baliga, *FASB revises position on stock options*, 179 J. OF ACCT. 18, 18 (1995).

[139] Financial Accounting Standards Board SFAS No. 123, Accounting for Stock-Based Compensation, Oct., 1995. *See* Paulette A. Ratliff, *Reporting Employee Stock Option Expenses: Is the Debate Over?*, 75 THE CPA J. 38, 39 (2005).

[140] Stock Option Accounting Reform Act, HR 3574, was passed in the House of Representatives by a voice vote in April 2004.

After a delay by the SEC, the accounting rules of SFAS 123R became effective from the fiscal year starting December 15, 2005.[141]

The APB 25 guidelines[142] are the relevant guidelines for our discussion because our sample period ends in 2004 when very few companies were expensing options as per the SFAS 123 recommendations. Under these guidelines, the financial statements must be modified in the following manner when backdating is discovered. The income statement must now reflect the fact that the backdated options were granted in-the-money requiring that the intrinsic value of the options be treated as compensation expense. This modification will lower the reported income and increase the stockholders' equity. If a company involved in backdating was expensing its options as suggested by SFAS 123[143] (or as required by SFAS 123R),[144] there is not likely to be any effect on the financial statements because the company would have reported the value of the option using the backdated exercise price.

What economic impact will this restatement have (over and above the revelation that there was backdating) if option values are already disclosed in the footnotes as per SFAS 123? If the analysts had evaluated the values of stock option grants (especially to the top executives) prior to the revelation of backdating assuming no backdating, they will now realize that the company has in reality issued options of greater value to the executives. This realization will result in a lowering of the stock price.[145]

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[141] Financial Accounting Standards Board SFAS No. 123R, *Share-Based Payment,* Dec., 2004.
[142] Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, Oct., 1972.
[143] Financial Accounting Standards Board SFAS No. 123, *Accounting for Stock-Based Compensation*, Oct., 1995.
[144] Financial Accounting Standards Board SFAS No. 123 R, *Share-Based Payment*, Dec., 2004.
[145] Aboody, Barth, and Kasznik show that the reporting of option grants in the footnotes as required by SFAS 123 had a negative impact on the stock price, suggesting that the recognition of the extent of options commitments does have an impact on stock price. David Aboody, Mary E. Barth, & Ron Kasznik, *SFAS No. 123 Stock-Based Compensation Expense and Equity Market Values*, 79 ACCT. REV. 251 (2000).

D. Incentive issues

Economic theory recognizes that agents have the tendency to shirk and rewards that are tied to performance are required to provide them the incentive not to do so.[146] However, recently it has been argued that top executives have captured the compensation process and have weakened the sensitivity of pay to performance.[147] This decoupling of pay from performance has been achieved through several means such as cash and bonus compensation weakly correlated to performance, deferred compensation benefits, subsidized loans, and other perks. Backdating is yet another way executives can reduce the sensitivity of pay to performance.[148] By backdating, executives are ensured of some gains from their options even if the stock price does not increase at all; still worse, they can benefit even if the stock price falls. Although we argue that there is a more direct effect of backdating that overstates the value of the firm through inflated earnings, it can be argued that the value loss due to improper incentives can be substantially higher. This is because, with poor incentives, executives may misallocate the firm's resources, which in turn can cause considerable loss in value. The revelation of backdating practices also reveals to investors the weak sensitivity of pay to performance and thus reduces their valuation of the firm due to concerns about misallocation of resources.

In addition to incentive effects, the revelation of backdating may also lower investors' perception of the ability of the firm's top executives. Able managers have less need to resort to

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[146] *See* Michael Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). *See also* B. Holmstrom, *Moral hazard and observability*,10 BELL J. ECON. 74 (1979).

[147] BEBCHUK & FRIED, *supra note* 5.

[148] Holman Jenkins defends backdating as perfectly legitimate. He claims that it is merely an attempt to pay executives an optimal wage. Boards could have easily achieved this task by simply increasing the number of options paid. Lowering the exercise price either directly or through backdating alters the incentive effects. Holman Jenkins, *The "backdating" witch hunt,* Wall St. J., June 22, 2006, at A13; Holman Jenkins, *Backdating Revisited*, Wall St. J., July 13, 2006, at A17.

dubious practices such as backdating to enhance their compensation and decouple it to performance. The loss of confidence in executives' ability by the revelation of backdating practices will also result in a reduction in stock price.

IV. Evidence on the Economic Impact of Dating Games

Our goal in this section is to estimate and compare the potential benefit to executives from backdating to the loss incurred by investors by the disclosure that the firms may have been involved in backdating. In order to do this, we use a sample of firms identified in the media as being implicated in dating games. Although most of the publicity has been on backdating, it is not clear whether these firms engaged in backdating or forward-dating, or both. For simplicity, we will refer to these firms as being implicated in backdating. The sample is obtained from a continuously updated list maintained by the *Wall Street Journal* on its website.[149] As of June 28, 2006, it contained 48 firms which have been implicated in at least one of the following three ways. 1) The firm itself has acknowledged backdating; 2) The SEC has started a formal or informal investigation of the company; and 3) The Justice Department has started an investigation of the company.[150] Table 1 lists the companies in our sample.

We do not have complete information about the various option grants that are under investigation and the dates they were awarded. Therefore, we cannot precisely estimate the extent of stealth compensation obtained by executives through backdating. Because our intent is to relate the executives' collective gain from backdating to investors' loss from the revelation of backdating, we need only estimate the order of magnitude of these gains. We, therefore, obtain the order of magnitude of these gains by estimating an upper bound of the stealth compensation for the period of 2000-2004 under the assumption that all grants during this

[149] http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.
[150] *Id.*

period were backdated whenever backdating was profitable to the executive. We choose this period as it is almost equally divided between pre-SOX and post-SOX regimes. We then compare the executives' gains to the value loss incurred by investors when it was learned that these firms have been implicated in backdating.

A. Characteristics of implicated firms and their grants

Table 2 provides a summary of the options granted by our sample of firms between January 1, 2000 and December 31, 2004. The option grants data are obtained from a compilation by the SEC of the filings to meet Section 16(a) requirements of the Securities and Exchange Act of 1934 and purchased from Thompson Financial. The data contains all option grants by publicly traded firms reported on Form 4. In line with Section 403 of SOX,[151] the SEC amended the disclosure rules for beneficiary ownership reports to be filed under Section 16(a) to be reported electronically within two business days of getting notification of the grant.[152] We also applied two cleansing filters provided by Thompson to eliminate questionable data.[153] The final sample contains 39,864 option grants from 43 of the 48 firms in our sample.

Table 2 reports separately characteristics of pre-SOX and post-SOX option grants. From Table 2 it can be seen that total option grants by these firms peaked in 2002, the year SOX became effective. About 76 million options were granted that year by these firms and the number has dropped in subsequent years. The average grant size has also steadily declined over the years. The average reporting lag of the grants before SOX was 139 days. Not surprisingly, the two-day reporting requirement has considerably reduced the reporting lag after SOX.

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[151] 15 U.S.C. 7201 § 403.
[152] 15 U.S.C. 78p § 16(a).
[153] We eliminated all data with cleanse indicator codes of S and A. These data are identified because they did not meet Thompson's collection requirements, or numerous data elements were missing or invalid, or reasonable assumptions about the data could not be made.

Tables 3a and 3b breakdown the awards by firm size and executive type, before and after SOX respectively. In Panel A of these tables, firms are classified into four groups based on their market capitalization at the beginning of the grant year (less than $100 million, $100 million to $500 million, $500 million to $3 billion, and greater than $3 billion).[154] It can be seen from both tables that most of the implicated firms are in the two larger categories, while earlier research indicated that most of the firms involved in backdating are smaller ones.[155] The average market capitalization of the implicated companies, measured at the beginning of the grant year, is slightly over $5 billion.[156] Although it is probably not surprising that the larger firms are likely to be investigated first, the statistics provided by Table 3 also indicates that most of the firms likely to be involved in this practice are yet to be implicated.

Panel B of Table 3 divides the sample on the basis of the insiders' seniority, classifying those with the titles (on the grant date) of Chief Executive Officers (CEO), Chairmen of the Board (CB), Chief Financial Officers (CFO), Presidents (P), Officer-Directors (OD, H), as "top executives" and separating this group from all others in the sample. About 20% of the option grants in our sample are to top executives. It can be seen that top executives are on average given much bigger grants than other executives. The average number of shares received by top executives per grant is about four times that received by other executives.

B. Stock price behavior of implicated firms around option grant dates

Figures 1 and 2 show the stock performance around the grant date for our sample of firms. Data on stock market returns are obtained from the Center for Research in Security Prices (CRSP). Both figures show the cumulative mean raw returns from 90 trading days prior to the reported grant date (date 0) to 90 days after the grant date. Each option grant is treated as

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[154] The total number of firms in Table 3 is greater than our sample size of 48 because some firms are included in more than one category as their market capitalizations change over time.
[155] Narayanan & Seyhun, *supra* note 5; Narayanan& Seyhun, *supra* note 12.
[156] As a benchmark, there are about 750 firms traded in U.S. stock exchanges with market capitalization greater than $5 billion on July 26, 2006.

an observation in Figure 1 (i.e., if a firm awards more than one grant on a given day, the return of that firm will be counted more than once), while in Figure 2, each firm-grant date is treated as an observation (i.e., regardless of the number of grants a firm awards in a given day, the return of that firm is counted only once for that day). If there is no manipulation, we should see no patterns on the grant date (on some grant days stock prices will go up and on some grant days they will go down, with no pattern on average). However, as we can see from the figures, there is a very sharp *V*- shaped pattern around the grant date, with the trough of the *V* being on the grant date. This means that, on average, the executives of these firms are receiving grants on dates on which the stock price is the lowest, compared to prices on the surrounding days. It is interesting to note that the pattern persists even after SOX. Although the *V*-pattern, especially before the grant day is somewhat muted after SOX, the rise for 30 days after the grant date is not that different from pre-SOX numbers. This result is consistent with the conclusion of Narayanan and Seyhun that SOX has not eliminated the practice.[157]

A comparison between Figures 1 and 2 shows that the magnitudes of the pre- and post-grant returns are greater when the grant is the observation unit (Figure 1). For example, the 20-day post-grant return in Figure 1 is about 13.5% for pre-SOX grants and about 12% for post-SOX grants; the same numbers in Figure 2 are 11% and 5.5%, respectively. These numbers suggest that there is more backdating when more awards are made on a given day.

C. Estimates of stealth compensation from backdating

As stated earlier, we do not have information regarding the grants being investigated, whether they are being investigated for backdating or forward-dating, and the number of days by which the grants were allegedly mis-dated. Therefore, we will estimate the stealth compensation for the period 2000-2004 under the assumption that all grants during this period were backdated whenever backdating was profitable to executives. We estimate the stealth

[157] Narayanan & Seyhun, *supra* note 16.

compensation for different assumed days of backdating. This gives us an upper bound of the stealth compensation from backdating.

In order to calculate the stealth compensation from backdating, we need to first calculate the value of the options executives in the firms in our sample have received during 2000-2004. We use the Black-Scholes formula to compute option values.[158] The formula needs six inputs: Grant date stock price, exercise price of option, time to maturity of option, volatility of stock returns, the risk-free rate, and dividend yield. We know from the executives' Form 4 filing the exercise price, the maturity of the option, and the grant date. We obtain the grant date stock price from CRSP. The volatility is estimated as the volatility of stock returns during the 90-day period before the grant date. A risk-free rate of 5% is used.[159] We assume that the dividend yield is zero for all the stocks in our sample.[160] Using these inputs in the Black-Scholes formula, we compute the value of each option and multiply it by the number of options in each grant to obtain the value of each option grant.[161]

The results of the option valuation are presented in Table 4. It can be seen from the table that there are stark differences in the value of options and option grants before and after SOX. Although the total value of options granted prior to SOX was $3,561 million it was only $1,385 million after SOX, even though the two periods are approximately of the same length. Moreover, although the average value of a single grant was $226,194 prior to SOX, it dropped to $58,082 after SOX, almost to 25% of the pre-SOX value. However, the value of options

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[158] SFAS 123R accepts the use of Black-Scholes model to value executive stock options. Financial Accounting Standards Board SFAS No. 123R, *Share-Based Payment,* Dec., 2004.

[159] The ten-year Treasury bond yield has fluctuated between 4% and 6% during 2000-2004.

[160] Of the 48 firms in the sample, only six firms had paid cash dividends during this period. In none of these five cases did the dividend yield exceed 0.5%. Hence, the error by ignoring dividends is negligible. In any case, since we are seeking an upper bound, ignoring cash dividends of these six firms has no material impact on our results.

[161] Because some entries for exercise price and maturity are missing in the Form 4 filings, we are able to value only 15,743 grants on 389 grant days before SOX (compared to 15,920 grants on 413 grant days in the whole sample), and 23,853 grants on 325 grant dates after SOX (compared to 23,944 grants on 333 grant days in the whole sample).

granted by a firm on a single grant date only dropped to about 50%, from $9.15 million to $4.26 million. These figures combined with the reduction in average options per grant reported in Table 2 indicate that there are fewer options being granted, but more executives are receiving grants.[162]

We compute an upper bound to the average benefit from potential backdating during our sample period as follows. We start by assuming that all option grants are backdated if backdating will increase the value of the options, i.e., will result in a lower exercise price. This will happen only if the stock price has been rising up to the grant date. It is reasonable to assume that backdating will result in the exercise price being lowered by the same proportion as the drop in the stock price. An example will clarify our calculation.

Suppose an at-the-money option grant in our sample has been backdated by 20 business days. Let the stock price on the manager-reported grant date be $10, which is also the reported exercise price. If it had not been backdated, the exercise price would have been the stock price that prevailed 20 days after the reported grant date, which was, say, $12. This means the stock return during the backdating period of 20 days was 20%. It also means that the exercise price without backdating would have been 20% greater than $10, i.e., $12, to keep the options at-the-money. Therefore, we can obtain the exercise price of the option in the absence of backdating by increasing the reported exercise price by the stock return during the period of backdating.

Because we do not know by how many days the options were backdated, we calculate the upper bound for different assumed backdating periods: 5, 10, 20, 30, 40, 50, and 90 business days. We assume there was no backdating on a grant date if the stock return for an assumed backdating period following the grant date was negative because backdating is pointless if the stock price was falling after the reported grant date. The fraction of reported

[162] Some of the drop in the value of a grant is explained by the reduction in the average value of an individual option (the average option value has dropped from $17.11 to $11.53). The drop in the average value of an individual option can be partly attributed to the drop in volatility (from 88% pre-SOX to 61% post-SOX).

grant dates that would have been beneficial to executives if they were backdated ones ranged from 60% to 68% pre-SOX, depending on the assumed backdating period. The range is virtually identical post-SOX (60% to 70%).[163]

As can be seen from Table 4, the upper bound of the average stealth compensation to all executives of a firm on each grant date from potential backdating ranged from $112,000 if backdated for 5 days to $326,148 if backdated for 90 days in the pre-SOX sample. The upper bound of the potential benefit ranged from $80,188 to $224,316 in the post-SOX sample about a third less compared than the preSOX range. This benefit is on average 1.25% to 3.66% of the value of the options the executives received during the pre-SOX period and 1.82% to 6.11% for the post-SOX period. In aggregate, the upper bound of the potential benefit from backdating ranged from $28 million to $80 million during the pre-SOX period from January 1, 2000, and $17 million to $51 million during the post-SOX period up to December 31, 2004. Taking the most optimistic estimate, the total aggregate potential benefit of $131 million between 2000 and 2004 translates to less than $3 million per firm for the 43 firms for which option valuation could be done. This averages to $0.6 million per year per firm during this period.

D. Impact of revelation of backdating on shareholder value

Figure 3 shows the impact of the revelation of backdating on shareholder value. This figure plots the cumulative market-adjusted average return for ten days before and ten days after the announcement of backdating (day 0). We define the announcement date as the *first* day that at least one of the following events is reported in the media: 1) a direct or indirect acknowledgement by the company that it has backdated options;[164] 2) an announcement that

[163] The benefit from backdating increases monotonically with the assumed backdating period.

[164] An indirect acknowledgement includes such announcements as senior executives being fired or put on administrative leave and the need to restate financial statements or take a charge. For the purposes of this figure, we do not consider as an event any announcements by companies that they are just investigating their option granting practices. Since the scandal broke, many

SEC is formally or informally investigating the firm for backdating; or 3) an announcement that the Justice Department is investigating the firm for backdating. The market-adjusted daily abnormal return (AR) for each firm *i* is computed for each day during the eleven-day period of [−10, +10], where day 0 is the grant date, as follows:[165]

$$AR_{i,t} = (r_{i,t} - r_{m,t}),$$

where $r_{i.t}$ is the return to stock *i* for day *t*, and $r_{m,t}$ is the with-dividend return to Standard and Poor's 500 Index for day *t*. The individual stock AR for each event day are then averaged across all the stocks in our sample to obtain an average abnormal return for each event day. These average returns are then cumulated to obtain the Cumulative Abnormal Return or, CAR for each event day during the 21-day window. Stock price and Index data were obtained from Yahoo!Finance web site.[166]

Figure 3 shows that over a 21-day period surrounding the announcement date, the average cumulative abnormal return of the stock of the firms implicated in backdating was about −8%.[167] This implies that, adjusted for market movements, the average drop in market capitalizations of these firms was 8% up on announcement of investigation by SEC or the Justice Department or acknowledgment of backdating by the company itself. The median drop over the 21-day period was about 7%. Thirty-five of the 45 firms in the sample record a negative cumulative abnormal return. Some firms had dramatic cumulative market-adjusted drops: Vitesse Semiconductor dropped 57% and Jabil Circuit dropped 31%.

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companies have announced that they will investigate their own option granting practices which does not necessarily imply that there was anything wrong with their practices.

[165] We measure returns 10 days before the announcement date to account for any new releases that we did not find and to capture the effect on stock prices of news leakages. We measure returns 10 days after the announcement date to capture the full effect of the announcement on stock prices.

[166] http://finance.yahoo.com.

[167] Of the 48 firms in our sample, two were acquired by the time they were implicated in backdating and a third company received an acquisition offer around the time it was implicated. The final sample used for Figure 3 therefore contains 45 firms.

Interestingly, Figure 3 also shows that most of the stock price drop occurs before the first public disclosure of the backdating accusations. About 5 percentage points of the total 8% drop occurs during the nine days prior to the first public disclosure. This finding suggests that some insiders or hedge funds may be receiving word of the likely filing of backdating complaints and either selling or shorting the stock in advance. Intense selling activity is likely to drive the price down as shown in Figure 3.

We also computed the value loss in the market capitalization of these firms. The market capitalization of the firms was measured 11 days before the announcement date, just before the beginning of the measurement period in Figure 3. By multiplying the market capitalization of each firm by its cumulative abnormal return over the 21-day measurement period, we obtain an estimate of the value loss of each firm upon the announcement that it is implicated in backdating. The average market capitalization at the beginning of the measurement period was about $8 billion and the average value loss was about $510 million. Each of the top nine firms sustained a loss of $900 million or more.

How does the value loss from being implicated in backdating compare to the potential benefits from backdating? As we saw in Table 4, the upper bound of the aggregate potential benefit for all firms in our sample from backdating during the 2000-2004 period was $131 million. This figure was obtained by assuming that all grants that benefit from backdating are backdated, and that they are backdated for 90 days.[168] This translates to less than $3 million during this period per firm in our sample, or $0.6 million per year per firm. When compared to the $510 million average loss from being implicated in backdating, the upper bound of the potential benefit of $3 million is negligible (about 0.6% of the value loss). It appears that the stockholders are paying a substantial price for managerial indiscretions of rather small benefit to the executives of these firms. If outrage costs are what make executives seek camouflaged

[168] The figures may be somewhat higher we picked the best backdating period for each firm-grant date.

compensation arrangements, with or without the approval of the board, it appears to be a poor trade-off.[169] For a benefit of about $600,000 a year to the executives, shareholders are being put at risk to the tune of $500 million.[170]

V. Remedies

In this section we propose some remedies for not only dating games such as backdating and forward-dating, but also for practices such as timing or springloading. For the purposes of this discussion, we define as springloading the practice of scheduling an option grant just before a positive news release or just before a negative news release, and the practice of scheduling a positive news release just after a scheduled grant date or a negative news release just before a scheduled grant date.

One of the intentions of SOX was to bring more transparency into executive compensation. The rule requiring that executive options be reported within two days of the grant was clearly intended to achieve this.[171] If this rule were strictly adhered to, backdating would not be very profitable to the executives. Although this rule reduced backdating practices, it did not fully eliminate it. As reported in earlier research by Narayanan and Seyhun,[172] about 20% of the grants were not reported in time, which allows for potentially profitable backdating.

We note that the duly-authorized practice of backdating or forward-dating by itself is not illegal. However, it is important that the compensation process is an arms-length transaction between boards or compensation committees and the executives being paid.

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[169] *See* BEBCHUK & FRIED, *supra* note 5.

[170] One cannot but help compare this scenario with Martha Stewart's conviction for obstructing an investigation by the U.S. Attorney for an alleged gain of less than $50,000 from insider trading. This figure was miniscule compared to her reported wealth and also resulted in a value loss about 40% to the stockholders of Martha Stewart OmniLiving during June 2002 when news surfaced of her questionable sale of ImClone stock.

[171] 15 U.S.C. 78p § 16(a).

[172] Narayanan & Seyhun, *supra* note 7.

Regulation needs to prevent the compensation process from being captured by the executives to execute an end run around insider trading laws through springloading practices.

Traditionally, regulators have assumed that executive compensation is an arms-length transaction. As a result of this view, any shares received through executive compensation have been viewed differently than shares executive purchased in the open market and they are exempted from certain insider trading rules. For instance, executives are exempt from the short-swing profits rule (Section 16(b) of the Securities and Exchange Act of 1934)[173] as a result of shares obtained from option exercises (as long as options were awarded more than six months ago). However, the backdating scandal is likely to change this view. Shares acquired through option exercises should lose their exemption status with respect to Section 16(b). This exemption enhances insiders' ability to engage in profitable trading by using their special information. To the extent managers influence important parameters of the compensation packages, vesting decision and therefore, timing of the option exercises can be influenced by the managers. Consequently, it makes sense to treat compensation-related shares similar to open-market-purchased shares. Second, some commentators have argued that springloading itself can be viewed as a form of insider trading.[174] After all, in both situations, insiders obtain undervalued shares as a result of their privileged information, either through an option award by the company (springloading) or open-market purchase of common shares (insider trading). The SEC should also promulgate new rules regarding springloading that brings the practice clearly and explicitly under the definition of illegal insider trading. These potential changes are expected to be quite effective in curtailing the practice of springloading.

The easiest way to limit clandestine backdating and forward-dating is to require companies to report two critical dates: the date the board or compensation committee finalized the option award details, and the grant date as decided by them. If these dates are the same,

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[173] C.F.R. § 240.16(b) (2006).
[174] *See, e.g.*, Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835 (2004).

then any backdating or forward-dating is not being authorized by the board. If the two dates are different, then the board intended it to be so, and as long as all disclosure, accounting, and tax requirements are met, it is legitimate; investors can decide for themselves whether such compensation is optimal or not. Any backdating or forward-dating from the board-approved grant date again constitutes deception.

The SEC voted on July 26, 2006 to approve a major overhaul of executive compensation disclosure rules.[175] The original proposal floated by the SEC in January 2006 for comments did not contain any provisions aimed at curbing nefarious dating games. It only required that the grant date be disclosed. However, the July version included a provision that both the grant date and the decision date (the date the board or compensation committee finalized details of the compensation) be disclosed. In addition, the new rules require that the grant date fair value, and the closing market price on the grant date if it is greater than the exercise price of the award, also be disclosed. Furthermore, if the exercise price of an option grant is not the grant date closing market price per share, the rules would require a description of the methodology for determining the exercise price. It appears that the furor created during the early months of 2006 resulted in amendments to the rules to curb clandestine dating games.

Although the above-mentioned rules will almost certainly eliminate clandestine backdating or forward-dating, they do nothing to limit springloading. Two additional remedies are needed to curb or eliminate springloading. First, annual option awards should not be effective on a single date. Single annual awards increase the incentive to shift release of company-related information to maximize the value of option grants. Instead, annual option awards could be divided into twelve equal monthly installments and awarded on a monthly basis, at the same time executives receive their basic pay. Spreading the awards throughout the year will eliminate executives' incentives to play springloading games. To give an example, if

[175] 17 C.F.R. §§ 239, 249 (2006).

executives announce some bad news before the February award, this will benefit the February options by lowering their exercise price, but hurt the previous January options by pushing them out of the money. Similarly, shifting the release of good news to a date after the February award will benefit February options by pushing these options into the money but hurt the value of March options by increasing their exercise price.

A second remedy for the springloading practice is to explicitly include granting of compensation options as well as the acquisition of shares through exercises of compensation options as falling under the general insider trading provisions of Section 10(b). Just as insiders can be subject to civil and criminal proceedings arising from timely purchase or sale of common shares,[176] this remedy exposes insiders to civil or criminal liabilities if their option awards also follow timely stock price patterns. Given the degree of influence insiders have exerted over their compensation packages, this approach seems reasonable. Ultimately, managers need to convince their shareholders that they have earned their well-deserved compensation packages fairly and by creating wealth for them, and not through manipulative means.

VI. Conclusion

Recent research has established that many executives exert not only legal influence over their compensation, but also in many cases illegal influence as well. Executives exerting legal influence over their own compensation by manipulating the board calls into question the fairness of the compensation process, optimal size of compensation, and whether executives get paid for performance.

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[176] Insider trading violations are prosecuted under Section 10(b), 15 U.S.C.S. 78j and Rule 10b-5, 17 C.F.R. § 240.10b-5 discussed *supra*, Section III A. *See also, e.g.*, U.S. v. O'Hagan, 521 U.S. 642 (1997); Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 22 (1980).

In this paper we focus on mostly illegal means of influencing compensation. Illegal influence over their compensation has taken the form of clandestine backdating and forward dating option grants with or without the knowledge of the board. Springloading falls into a gray area between legal and illegal practices. Many executives have engaged in these practices to further increase the size of their option awards. Illegal influence over compensation decisions raises further issues related to civil and criminal liabilities, tax payments, corporate disclosure, and managerial incentives.

We also estimate the size of the illegally obtained executive compensation with the damage shareholders have suffered when these practices are disclosed. On average, we estimate that the upper bound of managerial benefit derived from these illegal practices averages about three million dollar per firm over a five-year period. In contrast, when these practices become public, the damages borne by the shareholders averages about $500 million per firm. Hence, our evidence suggests that managerial theft is not a zero-sum game, but involves huge dead-weight losses for the shareholders.

Finally, we suggest various remedies to eliminate these practices. Greater transparency with regard to the intent of the board through greater disclosure is likely to control many forms of misdating. In addition, spreading the option awards throughout the year and defining springloading to be illegal insider trading is likely to curb most forms of illegal influence over compensation.

Table 1

List of companies reportedly implicated in dating games

No.	Company	No.	Company
1	Affiliated Computer Services	25	Maxim Integrated Products
2	Altera	26	McAfee
3	American Tower	27	Mead Instruments
4	Analog Devices	28	Medarex
5	Apollo Group	29	Mercury Interactive
6	Applied Micro Circuits	30	Michaels Stores
7	Asyst Technologies	31	Monster Worldwide
8	Broadcom	32	Nyfix
9	Brooks Automation	33	Openwave Systems
10	Caremark Rx	34	Power Integrations
11	CNET Networks	35	Progress Software
12	Comverse Technology	36	Quest Software
13	Cybernoics	37	Renal Care
14	Delta Petroleum	38	RSA Security
15	Engineered Support Systems	39	Safenet
16	Equinix	40	Sanmina-SCI
17	F5 Networks	41	Semtech
18	Home Depot	42	Separcor
19	Intuit	43	Sycamore Networks
20	Jabil Circuit	44	Trident Microsystems
21	Juniper Networks	45	United Health
22	KLA-Tencor	46	Verisign
23	Linear Technology	47	Vitesse Semiconductor
24	Macrovision	48	Xilinx

The firms in this table were those listed on Wall Street Journal's web site as of June 28, 2006 as being implicated in options dating.

Table 2

Summary statistics of firms implicated in dating games

Period	Number of grants	Average shares per grant	Total shares granted	Number of firms	Average shares per firm	Average reporting lag (business days)
Pre-SOX						
2000	1,757	16,547	29,072,793	39	745,456	212.9
2001	8,256	7,760	64,068,535	38	1,686,014	146.7
1/1/2002-8/28/2002	5,907	9,450	55,819,808	32	1,744,369	106.5
Total	15,920	9,357	148,961,136			139.1
Post-SOX						
8/29/2002-12/31/2002	3,191	6,370	20,325,771	26	781,760	7.3
2003	9,930	4,478	44,461,672	40	1,111,542	5.6
2004	10,823	3,966	42,928,636	41	1,047,040	4.2
Total	23,944	4,499	107,716,079			5.2

The table provides the summary statistics of option grants reported by insiders on Form 4 to meet disclosure requirements of Section 16(a) of the Securities and Exchanges Act and awarded from January 1, 2000 through December 2004 by firms listed in Table 1. Total shares granted are the shares that the insiders will receive upon exercise of the options. Number of firms indicates the firms that awarded options. Reporting lag is the number of business days between the grant date and the date on which the SEC received the filing.

Table 3a

Award structure and reporting behavior by firm size and seniority of executive – Pre-SOX

Panel A: By firm size							
Market capitalization	Number of grants	Average underlying shares per grant	Number of firms	Average underlying shares per firm	Total shares granted	Average maturity (years)	Average reporting lag (business days)
< $100 million	64	12,656	2	405,000	810,000	10.0	118.1
Between $100 and $500 million	1,345	4,784	9	714,873	6,433,858	9.8	179.3
Between $500 and $3000 million	4,825	7,624	18	2,043,578	36,784,409	9.7	114.4
> $3000 million	9,686	10,833	26	4,035,880	104,932,868	9.7	145.9
Whole sample	15,920	9,357			148,961,136	9.7	139.1
Panel B: By seniority of executive							
Top executives	3,203	23,103	39	1,897,431	73,999,826	9.7	108.9
Other officers	12,717	5,895	40	1,874,033	74,961,310	9.7	146.7
Whole sample	15,920	9,357			148,961,136	9.7	139.1

Table 3b

Award structure and reporting behavior by firm size and seniority of executive – Post-Sox

Panel A: By firm size							
Market capitalization	Number of grants	Average underlying shares per grant	Number of firms	Average underlying shares per firm	Total shares granted	Average maturity (years)	Average reporting lag (business days)
< $100 million	739	3,448	3	849,333	2,548,000	9.9	2.6
Between $100 and $500 million	8,288	2,706	14	1,601,976	22,427,664	9.8	6.7
Between $500 and $3000 million	7,390	5,639	20	2,083,769	41,675,386	9.5	6.1
> $3000 million	7,527	5,456	16	2,566,564	41,065,029	9.5	2.9
Whole sample	23,944	4,499			107,716,079	9.6	5.2
Panel B: By seniority of executive							
Top executives	4,507	10,502	41	1,154,493	47,334,223	9.6	5.5
Other officers	19,437	3,107	42	1,437,663	60,381,856	9.6	5.1
Whole sample	23,944	4,499			107,716,079	9.6	5.2

Table 3 (Continued)

The sample includes grants reported by insiders of firms listed in Table 1 on Form 4 to meet Section 16(a) requirements of the Securities and Exchange Act of 1934. The sample contains 47 of the 48 firms in Table 1 with daily returns available in the Center for Research in Security Prices (CRSP) database. Table 3a provides the data for the pre-SOX sample of 15,920 grants, awarded from January 1, 2000 through August 28, 2002 while Table 3b provides the data for the post-SOX sample of 23,944 grants, awarded from August 29, 2002 through December 31, 2004. Panel A of each table reports the award sizes, average maturity, and average reporting lag for different firm size groups as measured by the market capitalization of the granting firm at the end of the year prior to the grant year. Total shares granted are the shares that the insiders will receive upon exercise of the options. Number of firms indicates the firms that awarded options. Reporting lag is the number of business days between the grant date and the date on which the SEC received the filing. Panel B of each table provides the same data for top executives and others. Top executives include those with the titles (on the grant date) of Chief Executive Officers, Chairmen of the Board, Chief Financial Officers, Presidents, and Officer-Directors.

Table 4

Potential stealth compensation from backdating

	Pre-SOX	Post-SOX
Total value of options granted (millions)	$3,561	$1,385
Average value of an option	$17.11	$11.53
Number of grants	15,743	23,853
Average value of a grant	$226,194	$58,082
Number of grant days	389	325
Average value of options granted by a firm per grant date (millions)	$9.15	$4.26
Fraction of grant dates on which backdating would have been profitable	60%-68%	60%-70%
Total benefit from potential backdating (millions)	$28-$80	$17-$51
Average benefit from potential backdating on each grant date	$112,000-$326,148	$80,188-$224,316
Average benefit from potential backdating as a fraction of grant value	1.25%-3.66%	1.82%-6.11%

The sample includes grants reported by insiders of firms listed in Table 1 on Form 4 to meet Section 16(a) requirements of the Securities and Exchange Act of 1934. The sample is limited to grants by firms with daily returns available in the Center for Research in Security Prices (CRSP) database and awarded from January 1, 2000 through December 31, 2004 and grants for which exercise price and maturity data are available. Options values are calculated using Black-Scholes formula. The potential benefit from backdating is calculated by assuming that backdating is resorted to whenever profitable. The range of values given in the last four rows results from different assumed backdating periods: 5, 10, 20, 30, 40, 50, and 90 business days.

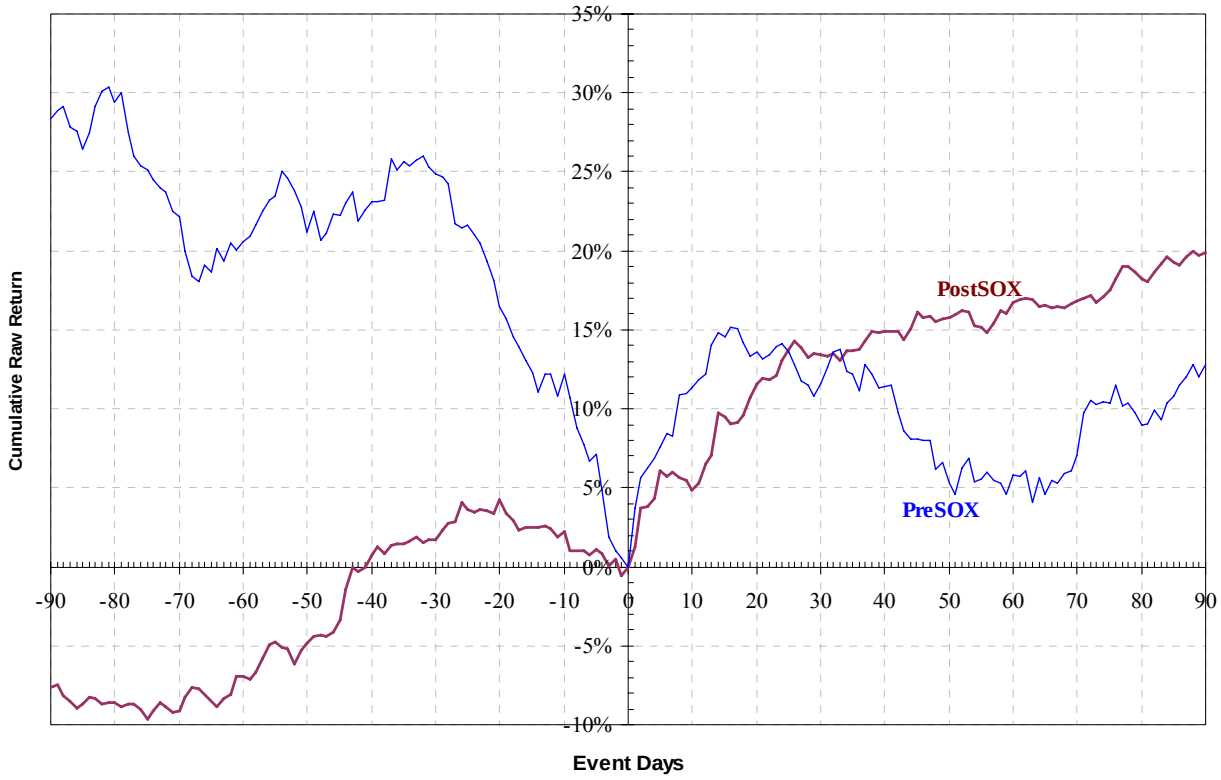

Figure 1

Stock returns around grant date of stock options (observation unit: grant)

The figure plots cumulative raw abnormal stock returns around the option grant date (day 0) of 48 firms listed on the Wall Street Journal web site on June 28, 2006 as having been implicated in dating games. The sample includes grants reported by insiders on Form 4 to meet Section 16(a) requirements of the Securities and Exchange Act of 1934. The sample is limited to grants by firms with daily returns available in the Center for Research in Security Prices (CRSP) database and contains 39,864 grants awarded during the period of from January 1, 2000 through December 31, 2004, with 15,920 grants pre-SOX and 23,944 grants post-SOX. The observation unit is the individual grant. Event days are trading days. Cumulative market-adjusted abnormal return is computed as the difference between raw return and the return to an equally-weighted index of NYSE, AMEX and NASDAQ stocks.

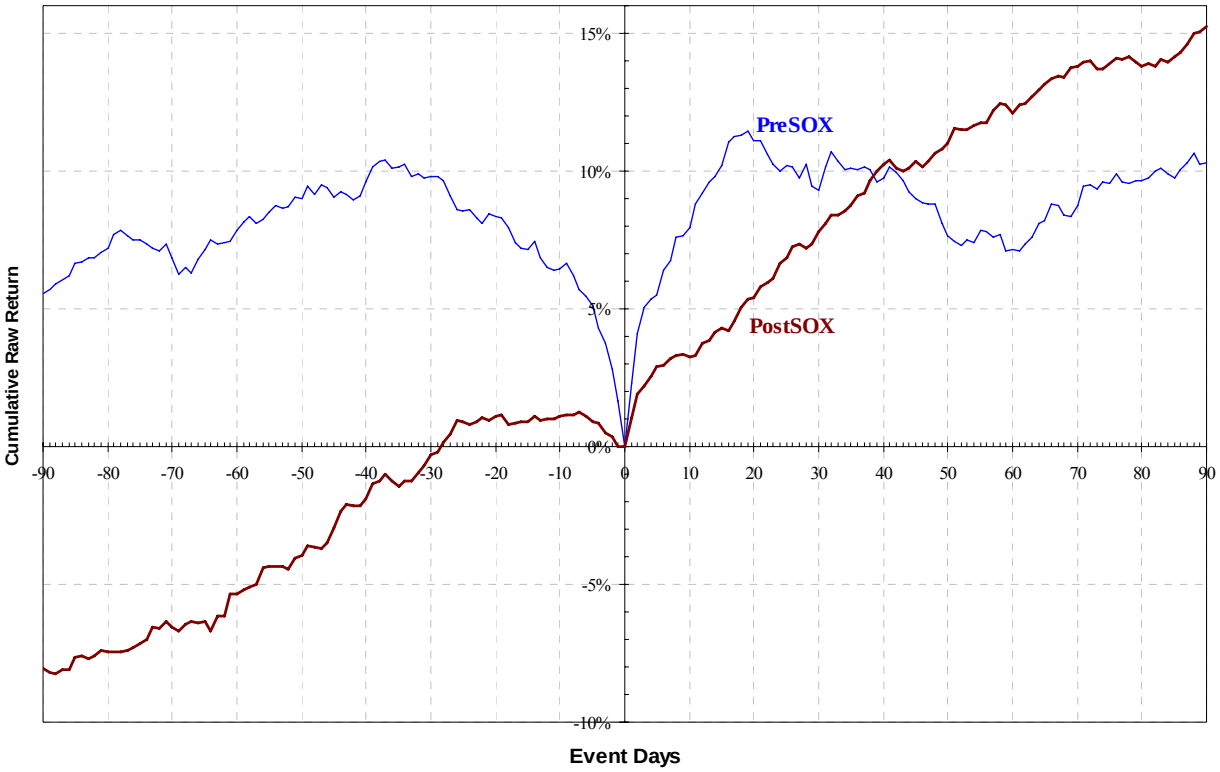

Figure 2

Stock returns around grant date of stock options (observation unit: firm-grants)

The figure plots cumulative raw abnormal stock returns around the option grant date (day 0) of 48 firms listed on the Wall Street Journal web site on June 28, 2006 as having been implicated in dating games. The sample includes grants reported by insiders on Form 4 to meet Section 16(a) requirements of the Securities and Exchange Act of 1934. The sample is limited to grants by firms with daily returns available in the Center for Research in Security Prices (CRSP) database. The observation unit is the firm-grant date: each grant date of a firm is treated as an event. The sample contains 746 firm-grant dates during the period of from January 1, 2000 through December 31, 2004, with 413 firm-grant dates pre-SOX and 333 firm-grant dates post-SOX. Event days are trading days. Cumulative market-adjusted abnormal return is computed as the difference between raw return and the return to an equally-weighted index of NYSE, AMEX and NASDAQ stocks.

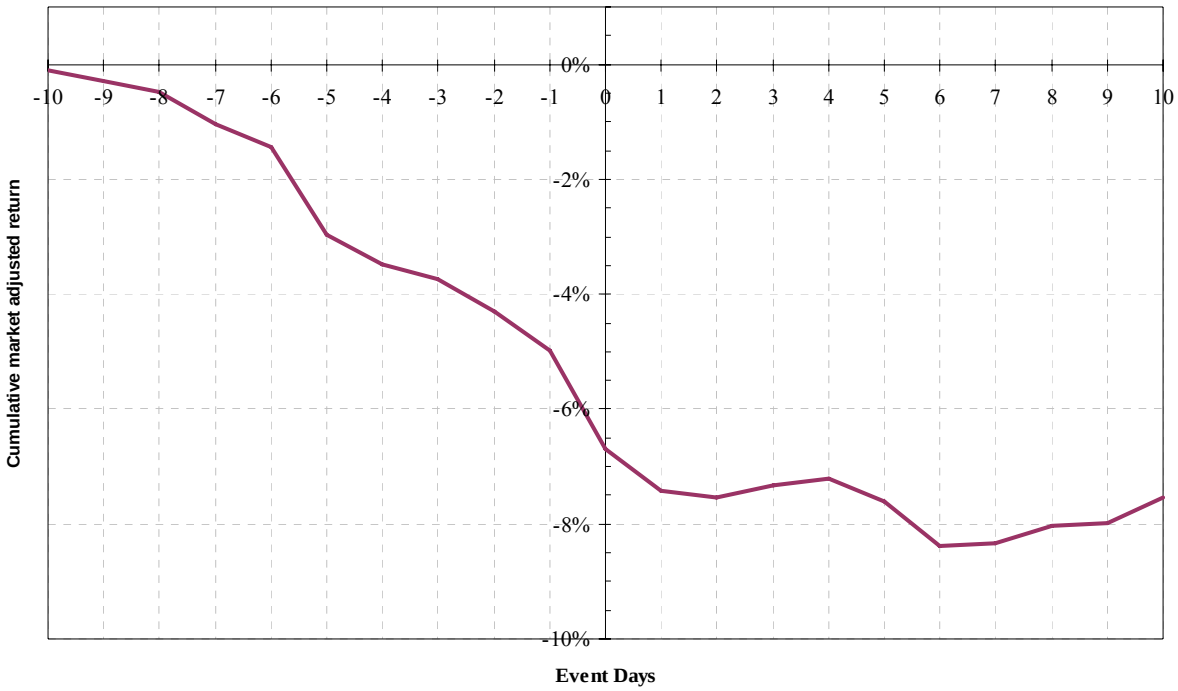

Figure 3

Market-adjusted returns around announcement date of implication in dating games

The figure plots cumulative market-adjusted abnormal stock returns around the announcement date that the firm is implicated in dating games (day 0). The sample includes 45 public firms listed on the Wall Street Journal web site on June 28, 2006 as having been implicated in dating games. Event days are trading days. Cumulative market-adjusted abnormal return is computed as the difference between raw return and the return to the Standard and Poor's' 500 index. The announcement date is the earliest of the one of the following three dates: (i) the date the firm acknowledges backdating; (ii) the date it is first reported that the SEC is formally or informally investigating the firm for irregularities in options dating; (iii) the date it is first reported that the Justice Department is investigating the firm for irregularities in options dating.