A Sure Bet Stock Option Repricing Creates Perfect Payday

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An investigation is currently underway regarding a widespread and flagrant corporate scandal that has defrauded corporations and their shareholders billions of dollars. The scheme involves the administration of stock options that are routinely granted to corporate executives as part of their compensation package. At issue is whether company insiders manipulate the timing of stock-option grants to ensure padded payoffs to executives by improperly “backdating” the grants to coincide with low points in stock prices, or by granting options just prior to the announcement of positive corporate news, a scheme called “spring loading.” Stock options become more valuable as the market price rises above the exercise price, thus “backdating” or “spring loading” fattens the value of executives’ pay when they exercise their options and sell.

Granting an option at below-market value through backdating (without disclosing the discount or taking steps to conceal the discount) violates the U.S. securities laws and is a breach of fiduciary duties owed to the company and its shareholders. Backdating “represents the ultimate in greed,” said former SEC Chairman Arthur Levitt in a recent Wall Street Journal article. “It is stealing, in effect. It is ripping off shareholders in an unconscionable way.” When executive stock options are mispriced or the price is manipulated, the company receives far less money for the exercised options than it is entitled to. These pricing differences are costing shareholders hundreds of millions of dollars.

Stock-option plans, which outline how many shares are to be granted as options and how they are to be awarded, are subject to shareholder vote and approval. “Spring loading” the options grant represents a new form of insider trading, since the stock option is provided to the corporate executive at a time when they have inside information that the stock price will rise. Once approved, it is left to the Board’s compensation committee to approve individual option grants. If options are backdated to a lower, more advantageous price, the company is obligated to report the spread between the lower price and the trading price at the time the options were granted. That spread is required to be entered on the company’s books as a compensation expense and would thereby result in lower earnings. Dozens of companies have now been exposed for having failed to report those expenses, concealing them or improperly accounting for them. These companies may now have to restate their financial results, in some cases going back many years. As a result, companies using backdated options could face the prospect of revising prior years’ tax returns and could be ineligible for the deductions they planned to take in the future on executive option gains. Thus, companies caught up in this scandal may face higher tax bills, fines and other substantial liabilities – all paid for with shareholder money.
When questioned about why stock options seem to be granted just before a rise in the stock price and often at the bottom of a steep drop, some executives claim that they are simply lucky. A recent Wall Street Journal analysis of stock option grant timing looked at the odds that such favorable patterns of grants would occur purely by chance. In the case of Louis Tomasetta of Vitesse Semiconductor, the WSJ estimated the odds that his favorable option dates (granted at the time when the stock hit record lows in 1995, 1996 and 1997, and just before steeply rising shortly thereafter) would have occurred by chance were one in six billion. Similarly, in an analysis of Jeffrey Rich of Affiliated Computer Services, who received six grants on very favorable dates, the WSJ estimated the odds of these options grants being dated by chance at one in six billion. Mr. Rich claims that none of his grants were backdated, calling his options jackpot “blind luck.”

“In essence the executives are betting on yesterday’s horse races, knowing the outcome,” said John Freeman, former SEC special counsel, in a recent L.A. Times article. “There is no risk whatsoever.” Among the companies that are currently being investigated by the SEC and several U.S. Attorneys’ offices are well-known names like UnitedHealth Group Inc. and Caremark Rx, Inc. Many firms under investigation for backdating are from the high-tech world, where stock options have long been a prized perk and incentive for executives and employees alike: Affiliated Computer Services, Inc., Juniper Networks, Inc., KLA-Tencor Corp., Openwave Systems Inc., Vitesse Semiconductor Corp., McAfee, Quest Software, Rambus, Sycamore Networks and others.

Lerach Coughlin is currently representing various institutional investors in shareholder derivative actions against a number of companies that have manipulated the pricing of stock options to its executives. In addition to recovering money for the defrauded firms and shareholders, Lerach Coughlin hopes that the derivative lawsuits will result in significant corporate reforms to the stock-option plans and increase internal controls on executive compensation.

E.g., Heavy & General Laborers’ Local 472 & 172 Pension & Annuity Funds v. George Samenuk, Case No. 5:06-CV-03620-JF (N.D. Cal. 2006).