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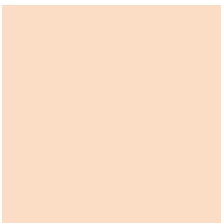

Timing Is Everything: Stock Option Practices Under Scrutiny

The timing of stock option grants to corporate officers, directors, and employees has been the subject of non-stop news coverage recently. Prosecutors and regulators, including the IRS, are examining the options granting practices of at least 80 companies, and it has been reported that the practices of almost one-third of the public companies that granted stock options between 1996 and 2005 may be subject to scrutiny. Companies whose stock option practices are challenged (and their directors, officers, employees and shareholders) face a variety of legal problems including:

- **Sarbanes-Oxley Issues:** If options are determined to have been “in-the-money” (at a discount to market price) on the date they were actually granted, this may require substantial earnings restatements to recognize the newly accounted-for expense, which, in turn, may put CEOs and CFOs at risk of a violation of the Sarbanes-Oxley certification requirements (and may trigger its disgorgement provisions).
- **Securities Law Issues:** Challenges to options practices may raise questions about the integrity of the company’s financial statements and the executive compensation reported in the company’s proxy statements and in Section 16 filings.
- **Civil Litigation:** Shareholder lawsuits may be brought against companies and their officers and directors based on, among other things, claims of false financial statements, breach of fiduciary duty, corporate waste and violations of state corporate or securities laws. Where self-dealing and bad faith are alleged, there is the risk that exculpation and indemnity protections for directors and officers will be voided.

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- **D&O Insurance Coverage Issues:** Certain D&O policies (i) exclude coverage for “intentionally wrongful acts” (or are construed by the carrier to contain such an exclusion), (ii) contain “options exclusions,” which exclude policy coverage for claims relating to the issuance or use of stock options, or (iii) contain “personal profit” exclusions, which exclude coverage for claims involving an insured person who gained a personal profit to which he or she was not legally entitled.
 - **Tax Issues:** Improper stock option practices may create liability for back taxes and penalties. Options intended to qualify as incentive stock options with favorable tax treatment for employees do not so qualify if they are below the market price at the time of the grant. Below-market options granted after October 3, 2004 or vesting after December 31, 2004, including those not intended to qualify as incentive stock options, are also subject to adverse treatment under recently enacted legislation, including potential acceleration of income and imposition of an additional 20% tax on the employee. (Certain of these consequences may be avoidable in some circumstances if corrective action is taken before the end of 2006.) Employers are potentially subject to withholding obligations with respect to tax imposed on their employees. The employer may also lose the ability to claim deductions for compensation paid to certain highly compensated employees if back-dating occurred.

Getting Ahead of the Issue



Publicly-traded companies that granted stock options (and their officers and directors) must get ahead of this situation now. In many cases the practices under scrutiny may be defensible. While each situation is different, the following steps should be considered:

- **Investigate** historic and current option grant policies in order to preemptively discover and address any issues of concern.
- **Preserve** appropriate documents because changes in criminal rules relating to document destruction have expanded the reach of the preservation requirements to include contemplated investigations. Given the heightened scrutiny of options practices, it is advisable to put in place a document preservation instruction with respect to company option documents.

- **Regularize** option grant practices and documentation requirements to ensure that option grants are issued on a regular, systematic basis, preferably at duly organized meetings rather than by written consent.
- **Review** all applicable plan documents to ensure grants are being made in compliance with any applicable limitations.

This Advisory is for informational purposes only and is not intended as legal advice. For more information on this subject or Hughes Hubbard's interdisciplinary stock options team, please contact:

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