KNOW YOUR options

Mitigating the risks of backdating and springloading.

BY CHRISTINA MEDLAND

Backdating options is, at best, indicative of poor governance and, at worst, illegal. The practice could result in director liability, executive terminations and a dramatic decrease in share price. It is vitally important for plan sponsors to understand how option backdating and springloading is done and to know what steps to take to ensure that companies they invest in do not engage in these activities.

There are several ways companies can backdate options. They can use a grant date that precedes the date on which the board approved the grant or they can use a grant date that is "effective as of" a date before the actual grant. Companies can also use a grant date that precedes the date on which all signatures on a written resolution were obtained. Or, they can simply change the date of board resolutions approving the option grant. Equally problematic to that are springload options, which involves granting a properly dated option with a current fair market value exercise price doesn't reflect material undisclosed information that would increase the share price.

To bar against these practices, the Toronto Stock Exchange (TSX) has rules stating that options of listed issuers must have a fair market exercise price and can not be set on the basis of market prices that do not reflect material undisclosed information. For example, the TSX will not permit an issuer to grant options if it is considering or negotiating strategic alternatives, such as a material acquisition. If these rules are breached, the TSX may require that the options be cancelled, forfeited, re-priced or, in egregious cases, that the issuer be de-listed. The TSX is also concerned about options granted during blackout periods or outside trading windows.

A case for sponsors

Plan sponsors and other shareholders may have a legal basis for making a claim in cases where companies backdate or springload options. The most effective resolution would be the recision of the improper grants, which will return the company to the pre-grant status quo, thereby restoring the share value lost by the grants. Or, the executives who exercised backdated option grants and those directors who approved them could be required to repay their profits to the company—another effective way to restore the share value lost by the grants. In previous cases in both Canada and the U.S. there has been judicial reluctance to order directors to personally pay damages resulting from their actions, mainly because directors have not personally profited.

Finally, shareholders could resort to class action lawsuits. An active and informed plaintiff's bar can make this route viable even for sponsors of smaller pension plans seeking action against companies that have backdated or springloaded options.

Rather than commence legal action after the fact, plan sponsors and other investors should take steps to minimize the risks of investing in a company that engages in options backdating by carefully examining governance regarding the option granting process for companies they invest in. Specifically, plan sponsors seek to ensure that companies: avoid making grants during blackout periods or when the board has material undisclosed information; document and date option grants in writing at the time of grant; file insider reports in a timely fashion; have a defined timeline for granting regular and new hire option grants; and conduct periodic internal "audits" of option grants.

As well, particularly in Canada, sponsors of smaller pension plans can benefit from the governance analysis conducted by organizations such as Institutional Shareholder Services, Canadian Coalition for Good Governance and Ontario Teachers' Pension Plan. These organizations have the resources to conduct more in-depth reviews of governance practices than smaller pension plans. ■

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