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Option Backdating and Its Implications

Jesse M. Fried

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Abstract

Thousands of U.S. companies appear to have secretly backdated stock options. This Article analyzes three forms of secret option backdating: (1) the backdating of executives' option grants; (2) the backdating of nonexecutive employees' option grants; and (3) the backdating of executives' option exercises. It shows that each type of backdating less likely reflects arm's length contracting than a desire to inflate and camouflage executive pay. Secret backdating thus provides further evidence that pay arrangements have been shaped by executives' influence over their boards. The fact that so many firms continued to secretly backdate after the Sarbanes-Oxley Act, in blatant violation of its reporting requirements, also suggests recent reforms may have failed to adequately curb such managerial power.

Table of Contents

* Professor of Law, University of California, Berkeley; Faculty Co-Director, Berkeley Center for Law, Business and the Economy. I am grateful to Lucian Bebchuk, Brian Broughman, David Cicero, Mel Eisenberg, Jeffrey Gordon, Ed Labaton, David Walker and seminar participants at Columbia University for comments; to Michael Rosen-Prinz and Aditya Khanna for excellent research assistance; and to Columbia University Law School and the Boalt Hall Fund for financial support.

I. Introduction

Evidence has emerged that several thousand publicly traded firms used hindsight to secretly backdate stock option grants to both executives and nonexecutive employees, boosting the options' value.[1] Many of these firms, it turns out, also allowed executives to covertly backdate the *exercises* of their options, further inflating their option pay.[2] Because both types of secret hindsight backdating are illegal,[3] over a hundred companies have become the targets of federal investigation, and dozens of managers have been forced to resign.[4]

This Article begins by examining the implications of option backdating for the debate over how managerial pay in publicly traded firms is determined. Under the dominant "arm's length" view, executive compensation packages are largely shaped by market forces: Boards bargain at arm's length with executives to secure arrangements that serve shareholders' interests.[5] According to the alternative "managerial power" approach, executives have power over their boards and use their influence to obtain pay that is both excessive and overly decoupled from performance.[6] Under this view, the main limit on executives' ability to obtain excessively favorable pay arrangements is fear of shareholder outrage.[7] The desire to minimize shareholder outrage, in turn, causes firms to "camouflage"—hide or obscure—both the amount and performance-insensitivity of executive compensation.

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1. *See infra* Parts II.B and IV.A.
2. *See infra* Part V.A.
3. *See infra* Parts II.B.2 and V.B.
4. *See infra* Part II.B.3.
5. *See generally* John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005); Bengt Holmstrom, *Pay Without Performance and the Managerial Power Hypothesis: A Comment*, 30 J. CORP. L. 703 (2005); Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002).
6. *See generally* LUCIAN A. BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004); Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003); Lucian A. Bebchuk & Jesse M. Fried, *Stealth Compensation via Retirement Benefits*, 1 BERKELEY BUS. L.J. 291 (2004); 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); Lucian A. Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283 (Summer 2005); Lucian A. Bebchuk & Robert Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823 (2005); Lucian A. Bebchuk & Yaniv Grinstein, *Firm Expansion and CEO Pay* (Harvard Law & Econ., Discussion Paper No. 533, 2007), *available at* http://ssrn.com/abstract=838245; David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587 (2005).
7. *See* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 64–66.

The Article describes and analyzes three types of secret backdating: (1) the backdating of executives' option grants; (2) the backdating of nonexecutive employees' option grants; and (3) the backdating of executives' option exercises. It shows that each type of covert backdating is unlikely to reflect arm's length contracting. However, all have the effect of inflating and camouflaging managerial pay. Thus, secret backdating is better explained by—and provides further support for—the managerial power approach to executive compensation.[8]

The Article then considers the implications of secret option backdating for a second, related debate: Whether the Sarbanes-Oxley Act (SOX) and accompanying stock exchange reforms obviate the need for further corporate governance improvements. Lucian Bebchuk and I have shown that these reforms, while a step in the right direction, still leave managers with considerable power over their boards.[9] Managerial power should be reduced, we have suggested, by making it easier for shareholders to replace directors who fail to serve their interests.[10] Our critics have argued that SOX and recent reforms have adequately addressed U.S. corporate governance problems, making further reforms unnecessary.[11]

The phenomenon of secret option backdating, I explain, suggests that these critics were mistaken. Among other things, SOX put in place new option transaction disclosure requirements that, if followed, should have put an end to secret backdating.[12] In particular, firms were required to disclose each executive option transaction within two business days. This two-day disclosure requirement made it impossible for complying firms to backdate these transactions more than two days.

However, thousands of firms continued to secretly backdate options by weeks or months after SOX, even though it entailed—in addition to other legal

8. Other commentators have recognized that the backdating of executives' option grants provided them with extra stealth compensation. *See, e.g.*, Lucian Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky CEOs* (Harvard Law & Econ., Discussion Paper No. 566, 2006), *available at* http://ssrn.com/abstract=945392; Lucian Bebchuk, *Insider Luck*, HARVARD MAGAZINE, (Mar.–Apr. 2007) at 34; M.P. Narayanan, Cindy A. Schipani, & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597 (2007); David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561 (2007). However, none of these other works aimed to show, as I do here, that all three forms of option backdating inflated and camouflaged managerial pay, and that the persistence of backdating after SOX (in blatant violation of its reporting requirements) has important implications for the need for further corporate governance reforms.

9. *See, e.g.*, BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 28–29.

10. *See, e.g.*, *id.* at 201–16.

11. *See, e.g.*, Bainbridge, *supra* note 5, at 1619.

12. *See infra* Part V.B.

violations—a blatant disregard of the Act's two-day reporting requirement. The fact that secret backdating persisted after SOX provides evidence that, as Lucian Bebchuk and I have argued, managers indeed continue to have excessive power over their boards. Further reforms aimed at increasing shareholder power may thus be needed.

The remainder of the Article proceeds as follows. Part II describes the first form of secret backdating: The practice of covertly backdating executives' option *grants*. It begins by explaining that most stock options have been granted to executives at-the-money (with a strike price set to the grant-date market price) rather than in-the-money (with a strike price set below the grant-date market price). It then shows that option grant backdating was used to disguise executives' in-the-money options as at-the-money options, and discusses the legality and prevalence of the practice.

Part III considers the implications of the covert backdating of executives' option grants for the ongoing debate over whether executive compensation reflects arm's length contracting or managerial power. It first casts doubt on the arm's length explanation for the practice. It then shows how the backdating of executives' option grants is consistent with the camouflaging predicted by the managerial power approach to executive compensation. In particular, it shows that backdating executives' option grants allowed firms to (a) claim they were providing executives with at-the-money options while they were in fact giving them more valuable, less performance-based in-the-money options, and (b) report a lower dollar value for managers' option compensation. Thus, option grant backdating allowed firms to give executives more value while simultaneously reporting less. It also discusses the evidence that the secret backdating of executives' grants was more likely to occur at firms where managers had more power. The fact that the secret backdating of executives' option grants camouflaged the amount and performance-insensitivity of managerial pay, and the fact that such backdating was more common in firms with more powerful executives, provide further evidence that executive compensation arrangements have been shaped by managerial influence.

Part IV discusses the second form of secret option backdating: The backdating of grants of *nonexecutive employees*' options. It explains why the *secret* backdating of lower-level employees' option grants was not necessary to attract and retain such employees. Next, it shows how the backdating of nonexecutive option grants *indirectly* allowed executives to boost their own pay in a manner that was hidden from shareholders. Among other things, such backdating allowed firms to inflate reported earnings, boosting executives' bonuses and enabling them to unload their stock at a higher price. Thus, the secret backdating of nonexecutive option grants, like the backdating of executive option grants, is less consistent with arm's length contracting than with the managerial power approach to executive compensation.

Part V turns to the third form of secret option backdating: The lesser known but also widespread practice of backdating executives' option *exercises*. It describes two types of option exercises—"cash exercise & hold" and "stock exercise"—and explains how both types of exercises were secretly backdated. It then shows how both forms of secret exercise backdating, like secret grant backdating, more likely reflect the desire to boost and camouflage executive pay than a desire to benefit shareholders.

Part VI considers the implications of the persistence of secret option backdating after SOX for the debate over whether additional corporate governance reforms are needed. A conclusion follows.

II. Backdating Executive Option Grants

This Part describes the first form of secret option backdating: The backdating of managers' option grants. Section A explains that boards generally give executives at-the-money options, even though executives would prefer in-the-money options. Section B shows how secret grant backdating enabled boards to give executives in-the-money options disguised as at-the-money options. It also discusses the legality and scope of the practice.

A. The Widespread Use of At-the-Money Options

Stock options have become one of the most important parts of the compensation package of public company executives. They are often the largest single component of an executive's pay arrangement.[13] For many CEOs, stock options account for over half of their total compensation.[14]

These stock options provide a recipient with the right to exercise the options and purchase shares of her firm's stock at a predetermined exercise (or strike) price. This right is not immediate. Rather, the options become exercisable ("vest") only after the recipient has served for a specified period, usually a year or more. The options then typically expire ten years after they are issued.

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13. *See* Walker, *supra* note 8, at 567.

14. *See, e.g.*, Ken Bolson, *Executive Pay: A Special Report*, N.Y. TIMES, Apr. 7, 2002, at R8–9.

The value of an option depends critically on the exercise price. The higher the exercise price, the less likely it is that the option can be exercised profitably, and the lower the profit from exercising the option will be. The option's incentive effects also depend on the exercise price: The higher the exercise price, the more shareholder value the executive must create to profit from the option.

In the United States, almost all of the stock options issued to executives are reported to be issued at-the-money:[15] The strike price is set to the market price of the stock on the grant date. Only a handful of companies use out-of-the-money options[16]—options with a strike price above the grant-date market price. And firms rarely report giving managers in-the-money options—options with a strike price below the grant-date market price.

One important reason for the widespread use of at-the-money options was the historically favorable accounting treatment given such options relative to in-the-money options. Currently, all options must be expensed—that is, deducted in determining firms' accounting profits. Prior to 2005, however, the only expense firms had to recognize for options with a fixed exercise price was the difference between the exercise price and the grant-date stock price. Firms thus did not need to recognize an expense for at-the-money options. In-the-money options, on the other hand, gave rise to an accounting expense. The use of at-the-money options, rather than in-the-money options, thus allowed firms to report higher earnings.[17]

B. Grant Backdating: Disguising In-the-Money Options as At-the-Money Options

We will now see how, by secretly backdating a manager's option grant, a firm was able to give the executive more favorable in-the-money options while reporting them to shareholders as at-the-money options.

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15. *See* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 159–64.

16. *See, e.g.*, Kevin J. Murphy, *Executive Compensation*, *in* HANDBOOK OF LABOR ECONOMICS 2485, 2509 & tbl.5 (Orley Ashenfelter and David Card eds., 1999). Companies using out-of-the-money options represent approximately 1.5% of companies in Murphy's sample.

17. Part II describes other reasons why firms tended to use at-the-money options rather than in-the-money options. Among other things, such options helped camouflage the degree to which executives' pay was decoupled from their own contribution to firm value.

1. Mechanics

Companies disclose, in their financial statements and discussion of their executive compensation arrangements filed with the SEC, how they set the exercise price of options granted to executives. Most firms purport to grant their options at "fair market value" (or "at-the-money"): The exercise price is set to the market price on the date of grant.[18] Thus, if the stock is trading for $100 per share on the grant date, the fair market (or at-the-money) exercise price would be $100.

For accounting purposes, the "date of grant" or "grant date" is the first day on which both (a) the key terms of an option grant—including the strike price—have been fixed and (b) the grant has been approved.[19] When the key terms of the grant are fixed and the grant is approved on the same day, that day is the grant date. However, if the grant is approved before the terms are finalized, the grant date does not occur until the terms are finalized. Similarly, if the terms are fixed before formal approval, the grant date does not occur until the date such approval occurs.

Backdating an option grant is the practice of reporting a grant date that is not the actual date of grant, but rather an earlier date that, with the benefit of hindsight, is chosen because the stock price on that false, hindsight-chosen date is lower. The options' strike price is set to the market price on the false grant date, rather than the actual grant date, creating options with a lower strike price. The company then pretends that options were issued at-the-money on the grant date, and the company accounts for the options as if they had actually been granted at-the-money on the false grant date.[20]

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18. Walker, *supra* note 8, at 567.

19. *See* Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123, Appendix E (Dec. 2004).

20. Not all grant backdating necessarily involved the use of hindsight to secretly inflate option pay. First, some backdating may not have been driven by hindsight. Consider, for example, what might be called "administrative backdating:" retroactively approving a grant that had been promised to an executive on an earlier date with that earlier date's strike price. The reported grant date is not chosen with the benefit of hindsight but rather on the reported date; formal approval and the actual grant date, however, occur later. *See* Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 26 VA. TAX. REV. 1031, 1038 (2007). In such a case, the promise-date (and reported grant date) stock price may be higher or lower than the actual grant-date stock price. Second, some backdating, while involving hindsight, may not have been secret. Several firms openly set exercise prices for nonexecutive employee stock options to the lowest price within a look-back window period; this practice generally ended when the firms learned that they could not treat such options, for accounting purposes, as at-the-money options. *Id.* However, in this Article, I use the term "backdating" to refer specifically to secret hindsight backdating designed to inflate the value of options in a way that is hidden from investors.

Suppose, for example, that on June 1, the stock is trading for $100 and the board wishes to give the CEO stock options. On May 1, the stock traded for $90 per share. If the firm wishes to avoid giving the CEO in-the-money options and honestly report the grant date (June 1), the board must use a strike price of no less than $100, the trading price on that date. However, if the firm falsely reports that the grant date was May 1, it can use a strike price of $90 and pretend that the options were issued at-the-money.

Essentially, backdating enables the firm to give in-the-money options while reporting them as at-the-money options. Returning to our example, the use of a May 1 grant date when the options are actually granted on June 1 allows the firm to give the executive options that are $10 in-the-money on the actual grant date (strike price of $90, market price of $100) while reporting them as at-the-money options (strike price of $90, market price of $90).

Backdating thus gives executives in-the-money options that are more likely to pay out, and will yield a larger profit if they do pay out, than at-the-money options. Shareholders, on the other hand, are told that managers get at-the-money options. And these secretly backdated options are not expensed even though, as in-the-money options, they should be.

2. *Legality*

The backdating of stock option grants to lower the exercise price is not per se illegal. Firms generally have complete discretion over the setting of stock option exercise prices. They can use any exercise price-setting methodology they wish, including ones—such as hindsight backdating—that make options in-the-money.

However, *secret* option grant backdating—reporting a grant date that is not the actual grant date but rather an earlier date chosen with the intent to lower the strike price—is likely to violate the securities laws, the tax laws, and corporate law. The precise legal implications of a particular grant backdating scheme will, of course, depend on the facts and circumstances of that scheme. However, it is worth briefly describing some of the potential legal implications of this practice.

Securities Laws. The use of disguised in-the-money options is likely to be inconsistent with representations made in a firm's SEC filings about the nature of the firm's option compensation practices in general and executive compensation in particular. To the extent that in-the-money options were granted but not properly expensed and reported under the accounting rules then in effect, the company's financial reports may misstate the company's compensation expense. Deliberate misstatements arising from backdating may violate the anti-fraud rules of the securities laws,[21] and constitute false statements to the SEC.[22] In addition, grant backdating usually involves illegal falsification of books and records,[23] and a violation of the requirements to (1) keep accurate books and records,[24] (2) maintain adequate internal accounting controls,[25] (3) give accountants information necessary to prepare proper financial statements,[26] and (4) properly report executives' equity positions under Section 16(a).[27]

Tax Laws. Disguising in-the-money options as at-the-money options can violate a number of tax laws. To begin, in-the-money options are not considered "performance-based compensation" under Section 162(m) of the Internal Revenue Code. Thus, they are not deductible if an executive's total nonperformance-based compensation (including salary) exceeds $1 million per year. In contrast, at-the-money options are considered "performance-based compensation" and therefore are always deductible.[28] Disguising in-the-money options as at-the-money options could thus lead the firm to take an improper deduction. In addition, giving an executive in-the-money options while reporting them to the IRS as at-the-money options can cause the executive to underreport his or her tax liability, and the firm to under-withhold income and FICA taxes.[29]

Corporate Law. Backdating may violate directors' and executives' fiduciary duties of loyalty and candor under corporate law. A Delaware court has ruled that the intentional violation of a stock option plan would constitute a bad faith breach of the duty of loyalty.[30] According to the court, backdating is

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21. In legal complaints filed against backdating firms and executives, the SEC has alleged violations of antifraud provisions in Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b)), Rule 10b-5 (17 C.F.R. § 240.10b-5), Section 17(a)(1), (a)(2), & (a)(3) of the Securities Act (15 U.S.C. §§ 77q(a)(1)-(a)(3)) & Section 14(a) of the Exchange Act (15 U.S.C. § 78n(a)) (concerning false or misleading proxy statements). *See, e.g.*, Complaint at 12, SEC v. Schroeder, No. 07-3798, 2008 WL 152227 (N.D. Cal. 2008).

22. *See* Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a).

23. *See* Section 13(b)(2)(a) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(A).

24. *See* Section 13(b)(5) of the Exchange Act, 15 U.S.C. § 78m(b)(5).

25. *See* Section 13(b)(2)(B) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(B).

26. *See* Rule 13b2-2, 17 C.F.R. § 240.13b2-2.

27. *See* Section 16(a) of the Exchange Act, 15 U.S.C. § 78p(a), & Rule 16a-3, 17 C.F.R. § 240.16a-3.

28. *See* 26 U.S.C. § 162(m).

29. For an accessible description of the tax implications of backdating, see Fleischer, *supra* note 20, at 1039–42.

30. *See* Ryan v. Gifford, No. 2213–N, 2007 WL 416162 (Del. Ch. Feb. 6, 2007).

one of those "rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists."[31]

3. *Scope of Secret Grant Backdating*

Because secret option grant backdating is illegal, the federal government began looking into the practice after it came to light. Over 100 companies have come under investigation for backdating by the SEC, the Department of Justice, and the Internal Revenue Service; several hundred more have hired law firms to conduct internal investigations in order to avoid or reduce legal sanctions.[32] Almost 100 senior executives and directors have been forced to resign, and dozens of companies have announced that they will have to restate their earnings as a result of secret backdating.[33] Some CEOs have been convicted of criminal violations of the securities laws.[34]

Unless a thorough investigation is conducted at every public firm that uses stock options to compensate executives, the precise amount of managerial option grant backdating will never be known. However, as I explain below, the evidence that has emerged so far suggests that the practice was quite widespread, involving thousands of firms: The companies that have made the headlines likely represent just the tip of the iceberg. Moreover, it involved the transfer of significant amounts of value from shareholders to executives.

a. *Frequency*

Although hundreds of firms have announced investigations into their own option-granting practices, *thousands* of firms appear to have engaged in the secret hindsight backdating of executive option grants. One study looked at 7,800 firms during 1996–2002—about 50% of publicly traded firms. The study concluded that nearly 30% of the sample firms—over 2,000—manipulated executives' option grants in a manner consistent with backdating during this period.[35] If this

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31. *Id.* at 10.

32. *See Perfect Payday; Options Scorecard*, WALL ST. J. ONLINE, http://online.wsj.com/page/2_1227.html (last visited Aug. 13, 2007).

33. *See id.*

34. *See, e.g.*, Steve Stecklow & Peter Waldman, *Brocade Ex-CEO Found Guilty in Backdating Case*, WALL ST. J. ONLINE, Aug. 8, 2007, http://online.wsj.com/article/SB118651238986990721.html (last visited Sept. 22, 2008).

35. *See* Randall A. Heron & Erik Lie, *What Fraction of Stock Option Grants to Top*

sample is representative of the entire population of approximately 15,000 publicly traded firms, the study suggests that over 4,000 such firms engaged in the covert backdating of managers' grants during this period.

Another study, using a different methodology, focused solely on CEO option grants during 1996–2005. It estimated that 12% of the firms secretly backdated CEO option grants.[36] Given a population of about 15,000 publicly traded firms, this finding suggests that almost 2,000 firms backdated CEO option grants. Moreover, the methodologies used in these studies are unlikely to detect all instances of backdating. Thus, as the authors of these studies have emphasized, these estimates are likely to be lower bounds on the actual amount of secret, hindsight-driven backdating of executive option grants.[37]

b. Amounts

The lowering of strike prices via grant backdating can substantially increase the value of executives' options at public investors' expense. When these lower-priced options are exercised against the corporation, the corporation receives less cash than it would otherwise, which in turn reduces the value of all outstanding shares.

In most cases, grant backdating shifted significant amounts of value to executives. One study finds that backdating managers' option grants, by giving executives in-the-money options, boosted the value of the average backdated CEO's option compensation by 20%, and the value of her total reported compensation by 10%.[38] Thus, the secret backdating of executives' option grants was not only common but economically significant.

III. Backdating Executive Option Grants: Arm's Length Contracting or Managerial Power?

Part II explained how the secret backdating of managers' option grants enabled thousands of firms to give executives in-the-money options disguised

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Executives Have Been Backdated or Manipulated?, at 4 (2006), www.biz.uiowa.edu/faculty/elie/Grants-11-01-2006.pdf (last visited Sept. 22, 2008); *see also* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005) (estimating that 30% of option grants were backdated among a large sample of option grants in the period 1992–2002).

36. *See* Bebchuk et al., *supra* note 8, at 2 (reporting that in the period 1996–2005 12% of sample firms engaged in backdating of CEO option grants).

37. *See, e.g.*, Heron & Lie, *supra* note 35, at 23.

38. *See* Bebchuk et al., *supra* note 8, at 5.

as at-the-money options. This Part considers the implication of the secret backdating of managers' option grants for the ongoing debate over whether executive pay in public companies reflects arm's length contracting or managerial power.

Section A examines—and casts doubt on—the view that the backdating of executive option grants reflects arm's length bargaining between managers and boards. Section B shows that such backdating is more consistent with the managerial power approach. It begins by describing the importance of camouflage in the managerial power account of executive compensation. It then explains that, consistent with the camouflaging predicted by the managerial power approach, secret grant backdating has enabled firms to disguise the performance-sensitivity of executive pay and give executives more option pay while reporting less. Section B concludes by discussing the evidence that the secret backdating of managers' option grants was more likely to occur in firms where managers had more power.

A. Arm's Length Contracting?

The dominant view among economists is that boards are loyal to shareholders, not managers. Thus, executive compensation packages are produced by an arm's length bargaining process between directors and executives.[39] This arm's length view is shared by many other academics,[40] compensation consultants,[41] and business journalists.[42]

A number of these commentators have asserted that the covert backdating of executives' option grants, like other aspects of managers' compensation arrangements, reflected such arm's length bargaining. They argue that secret grant backdating profits are just another form of compensation.[43] On this account, if executives did not receive extra value in the form of covertly backdated options, they would simply get such value in another form. Thus, it is claimed, secret option grant backdating imposed no cost on shareholders.

However, this arm's length "substitution" argument suffers from two serious flaws. First, there is no evidence that hidden grant backdating profits

39. *See, e.g.*, Core et al., *supra* note 5; Holmstrom, *supra* note 5; Murphy, *supra* note 5.

40. *See, e.g.*, Bainbridge, *supra* note 5.

41. *See, e.g.*, Ira T. Kay, *CEO Pay for Performance: The Solution to "Managerial Power,"* 30 J. CORP. L. 785 (2005).

42. *See, e.g.*, Holman Jenkins, *Business World: The "Backdating Witch Hunt,"* WALL ST. J., June 21, 2006, at A13.

43. *See id.*

served as a substitute for other forms of managerial compensation. Indeed, there is evidence to the contrary: Profits from grant backdating went to CEOs who appear to be overpaid relative to their peers.[44] Thus, the available evidence suggests that secret grant backdating profits confer an extra benefit on managers rather than serve as a substitute for other forms of compensation.

Second, the arm's length account cannot explain why the backdating of managers' grants was done *secretly*. A firm using shareholder-serving arrangements would not be expected to deceive its shareholders about these arrangements, especially since such deception puts the firm at legal risk. Boards that believed that giving executives in-the-money options benefited shareholders would have openly awarded such options and, if challenged, would have sought to convince investors that these options served investors' interests. The fact that firms hid the backdating of executives' grants from shareholders suggests that such an arrangement did not in fact benefit public investors.

B. Managerial Power

We have just seen that the secret backdating of managers' option grants is unlikely to be explained by arm's length contracting. However, as this Section shows, it is consistent with the managerial power approach to executive compensation. This Section begins by briefly describing the role of camouflage in the managerial power approach to executive compensation. It then shows that option grant backdating served to camouflage both the performance-insensitivity and amount of executive pay. It concludes by surveying the evidence that the likelihood of executive grant backdating was higher at firms where executives had more influence. These studies provide further evidence that the secret backdating of managers' option grants can better be explained by the managerial power approach than by arm's length contracting.

1. The Managerial Power Approach and Camouflage

As an alternative to the arm's length view of executive compensation, Lucian Bebchuk and I, along with several other scholars, have put forward and developed an account of executive compensation based on managerial power.[45]

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44. *See* Bebchuk et al., *supra* note 8, at 1 (reporting that backdating profits accrued to CEOs who were already receiving high pay relative to peers).

45. *See* sources cited *supra* note 6.

We have shown that executives have had power over their boards, and have been able to use their influence to obtain pay arrangements that served their own interests rather than shareholders'. As a result, executive compensation is higher and more decoupled from performance than it would be under arm's length bargaining.

The main limit on executives' ability to obtain favorable pay arrangements, we have argued, is fear of shareholder outrage—or what we have called the "outrage constraint."[46] If boards approve pay arrangements that are considered egregious, they will face criticism and ridicule. This criticism and ridicule, in turn, can impose social and other costs on directors.

To minimize shareholder outrage and the resulting costs, boards have sought to obscure and justify—in short, camouflage—executive pay, so that shareholders cannot easily see the full extent to which pay deviates from what is optimal for shareholders. Two important forms of camouflage are (1) masking the performance-insensitivity of pay and (2) hiding the total amount of an executive's pay. Below, I explain how the secret backdating of managers' option grants obscured both the performance-insensitivity and total amount of their option-based pay.

2. *Camouflaging the Performance-Insensitivity of Option Pay*

As Lucian Bebchuk and I have shown, even *at-the-money* options provide a significant amount of performance-decoupled pay.[47] Most stock price movements have nothing to do with executives' own contribution to firm value, but are rather due to industry and market fluctuations. Under normal market conditions, even the stock price of an underperforming company is likely to increase over the ten-year life of an option. Thus, as Warren Buffett has aptly put it, at-the-money options are "a royalty on the passage of time."[48]

Nevertheless, boards using at-the-money options have been able to avoid shareholder outrage. Setting the strike price equal to the grant-date market price has a plausible justification: Managers profit only if the stock price rises and shareholders make money. Moreover, since at-the-money options have become widely adopted, they generate little outrage: A firm using such options does not risk being singled out for criticism, since most other firms also use them.

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46. *See* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 64–66.

47. *Id.* at 137–46.

48. Shawn Tully, *Raising the Bar*, FORTUNE, June 8, 1998, at 272 (quoting Warren Buffett).

However, giving executives in-the-money options would have subjected boards to considerable criticism. While at-the-money options can generate huge windfalls, in-the-money options are much more blatantly decoupled from managers' contribution to firm performance: In-the-money options may enable executives to profit even if the stock price falls. As a result, institutional investors have made clear their opposition to in-the-money options.[49] Thus, boards were reluctant to openly give executives in-the-money options.[50] Indeed, many firms, in order to secure shareholder approval of option plans, promised not to issue executives in-the-money options.[51]

As we saw in Part II, the secret backdating of executives' option grants gave executives in-the-money options disguised as at-the-money options. Such secret backdating thus enabled boards to give managers secretly what they were unwilling to give them openly because of fear of shareholder outrage. And shareholders had no way of knowing how performance-insensitive executives' option pay actually was.

3. *Camouflaging the Amount of Executive Pay*

In addition to hiding the performance-insensitivity of executives' option pay, backdating executive option grants camouflaged the amount of executive pay. In particular, grant backdating allowed firms to boost the value of executives' stock options without revealing to shareholders that they were increasing managers' compensation. In fact, as David Walker has shown, grant backdating actually allowed firms to report smaller pay packages.[52] Thus, conveniently, option grant backdating simultaneously allowed firms to pay executives more while reporting lower compensation.

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49. *See, e.g.*, CalPERS Global Principles of Corporate Governance, http://www.calpers-governance.org/principles/international/global/page05.asp (last visited Sept. 22, 2008) (requiring that option grants be "performance-based" and established by formal pricing methodology) (on file with the Washington and Lee Law Review).

50. For other reasons the use of in-the-money options would have increased shareholder outrage, *see* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 162–63 (explaining how the use of in-the-money options, which would have been expensed, would have exposed as hollow boards' accounting rationale for not using windfall-reducing options that would tie pay more closely to managers' own performance: that such options would have to be expensed).

51. *See, e.g.*, KLA-Tencor Co., 1982 Stock Option Plan (Nov. 18, 1996) (requiring that the "exercise price of each option granted under the Option Plan must equal at least the fair market value of a share of the Company's Common Stock on the date of grant").

52. *See* Walker, *supra* note 8, at 588–91.

For concreteness, consider a purported October 2001 stock option grant to the CEO of Brocade, Gregory Reyes.[53] Options covering 1.2 million shares were given to Reyes. The reported grant date was October 1, 2001, when the firm's stock was trading at around $13 per share, the lowest closing price for the year. A week later, the stock was trading at $20 per share, and a month later the stock closed at almost $26 per share.

Brocade disclosed this grant to investors in its 2002 proxy statement in a table titled "Option Grants in the Last Fiscal Year,"[54] prepared in the format specified by SEC rules.[55] Among other things, the table describes the details of this and other grants to executives, including the number of shares covered by the option grants, the exercise price, and the options' expiration date.[56] The information in this table is used by analysts, including those assembling Standard & Poor's well-known ExecuComp database, to calculate the Black Scholes value for each option grant on the date of grant. In calculating the value, the analysts assumed, based on the firm's representations about its procedure for setting exercise prices, that the options were granted at-the-money. The calculated value was then widely used by shareholders, researchers, and the media to estimate the CEO's total pay. The Black Scholes value calculated for Reyes' 1.2 million stock option grant, which analysts assumed was at-the-money, was $13.2 million.[57]

However, the SEC has concluded that the option grant to Reyes was backdated,[58] and the market price on the actual date of grant may have been around $26 per share.[59] Let us assume that the stock was in fact trading at $26 per share when the options were actually granted. Thus, if Brocade had adhered to its policy of giving only at-the-money options, it should have given Reyes options with a strike price of $26 per share. Instead, it gave Reyes

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53. *See* Brocade Communications Systems, Inc., 2002 Proxy Statements (Form Def 14A), filed Feb. 25, 2002, at 18 [hereinafter, Brocade 2002 Proxy]. This example is taken from Walker, *supra* note 8, at 588–91. Reyes was convicted in August 2007 of criminal securities fraud in connection with the backdating of other employees' options. *See* Steve Stecklow & Peter Waldman, *Brocade Ex-CEO Found Guilty in Backdating Case*, WALL ST. J., Aug. 8, 2007, at A3.

54. *See* Brocade 2002 Proxy, *supra* note 53, at 18.

55. *See* Reg. S-K, Item 402, 17 C.F.R. § 229.402 (2006).

56. *See* Brocade 2002 Proxy, *supra* note 53, at 18. Although it is not required for corporations to disclose the grant date, it is easy to infer from the required disclosure of the expiration date, as most options expire ten years from the grant date. *See* Reg. S-K, Item 402, 17 C.F.R. § 229.402 (2006).

57. *See* Walker, *supra* note 8, at 590.

58. The civil complaint against Reyes alleges that this particular grant was backdated. *See* Complaint at 2, SEC v. Reyes, No. 06-4435, 2008 WL 3916247 (N.D. Cal. 2008).

59. *See* Walker, *supra* note 8, at 590.

options with a strike price of $13 per share, so that the options were $13 in the money. And it reported the grant as if it had given Reyes at-the-money options when the stock price was $13 per share.

Had Brocade given Reyes at-the-money options at a strike price of $26 per share, the Black Scholes value of the option grant would have been approximately $26 million.[60] But because the options were $13 million in the money, they were even more valuable. According to one estimate, they were worth $28 million.[61] Thus, if analysts had been told that Reyes received options with a strike price of $13 when the stock was trading for $26, they would have reported their value as $28 million rather than $13.2 million. In short, backdating this particular option grant, in the scenario just described, would have enabled Brocade to give Reyes $2 million *more* in options (Black Scholes value) while reporting an amount that was $15 million *less*.[62]

4. *The Association Between Grant Backdating and Managerial Power*

We have just seen that, consistent with the camouflaging predicted by the managerial power approach, the secret backdating of managers' option grants hid the performance-insensitivity and amount of executive pay. If the covert backdating of managers' option grants were associated with managerial power, we would expect to see a link between the extent of managerial power and the propensity to backdate. In fact, there is a documented correlation between managerial power and the likelihood of managerial option grant backdating.

One study found that grant backdating was more likely to occur if the board did not have a majority of independent directors and the CEO had a longer tenure.[63] Another study found that grant backdating is more likely when

60. The Black Scholes value of at-the-money options, which is the amount reported to shareholders, is proportional to the grant-date market price of the stock. The higher is the grant-date price, the higher is the value of the options: An option issued at-the-money when the stock is trading for $20 has twice the value of an option issued at-the-money when the stock is trading for $10, everything else equal.

61. *See* Walker, *supra* note 8, at 590.

62. Reyes apparently never exercised these options, a point emphasized by the lawyers defending him. *See* Motion for Summary Judgment for Defendant at 32, S.E.C. v. Reyes, 491 F. Supp. 2d 906 (N.D. Cal. Feb. 5, 2007) (No. 06-04435). However, the fact that Reyes was unable to exercise his backdated options *ex post* tells us little about his motive for secretly manipulating the grant date *ex ante*. Obviously, he hoped to profitably exercise the options, and understood that by lowering their strike price he was increasing the options' *ex ante* value.

63. *See* Bebchuk et al., *supra* note 8, at 3 (reporting that in the period 1996–2005 firms were more likely to backdate CEO option grants if the board did not have a majority of independent directors and the CEO had a longer tenure). A 1997 study shows that more powerful managers were more likely to get "lucky" (low price) options. *See* David Yermack,

the CEO is chair of the board.[64] Yet another study found that backdating is also more likely when there are more inside directors, and when more of the outside directors are hired by the CEO.[65] Finally, there is an association between the likelihood that CEO options are backdated and the likelihood that director options are backdated.[66] The link between grant backdating and executive power provides further evidence that this form of manipulation was not part of an arm's length bargain between shareholder-serving boards and CEOs, but rather a scheme to provide executives with additional performance-decoupled compensation below shareholders' radar screen.

In short, grant backdating disguised potentially outrage-triggering in-the-money options as more acceptable at-the-money options, hid the total amount of executives' pay, appears to have supplemented rather than substituted for other types of pay, and is associated with managerial power. All of this suggests that secret backdating of managers' options grants was not designed to serve shareholders but rather, as predicted by the managerial power approach, to covertly increase executive pay.

IV. Backdating Nonexecutive Option Grants: Arm's Length Contracting or Managerial Power?

Many firms secretly backdated not only managers' option grants but also those of lower-level employees. Some commentators have argued that this form of option grant backdating did not enrich executives but rather, consistent with arm's length contracting, was designed to help firms attract and retain talented employees. Section A explains that the secret backdating of

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Good Timing: CEO Stock Option Awards and Company News Announcements, 52 J. FIN. 449 (1997). However, Yermack's study cannot distinguish between backdating and springloading, the practice of giving managers options ahead of good news.

64. *See* John Bizjak, Michael Lemmon & Ryan Whitby, *Option Backdating and Board Interlocks* 3 (Feb. 2007) (unpublished manuscript, on file with the Washington and Lee Law Review), *available* at http://ssrn.com/abstract=946787 (finding that firms are more likely to engage in backdating when the CEO is chair of the board); *see also* Daniel W. Collins, Guojin Gong & Haidan Li, *Corporate Governance and the Backdating of Executive Stock Options* 5 (Apr. 2007) (unpublished manuscript, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=934881 (finding that the likelihood of backdating increases when there are more inside directors, when more of the outside directors are hired by the CEO, and when the CEO is the board chair).

65. Collins, Gong & Li, *supra* note 64, at 5.

66. *See* Lucian Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky Directors* (Harvard Law and Economics Discussion Paper No. 573, 2006) (finding a positive correlation between a "lucky"—or opportunistic—grant to a director and a lucky grant to the CEO in the current or prior year).

nonexecutive option grants cannot be explained by arm's length contracting. Rather, as Section B shows, the secret backdating of nonexecutive option grants, like the backdating of executives' own grants, enriched executives under shareholders' radar screens, and is thus consistent with the camouflaging predicted by the managerial power approach.

A. Arm's Length Contracting?

Firms backdated not only executives' option grants but also nonexecutives' option grants.[67] In other words, firms also gave nonexecutives in-the-money options disguised (and accounted for) as at-the-money options. Indeed, the amount of nonexecutive option grant backdating may well have exceeded the amount of executive option grant backdating.

According to several commentators, the purpose of backdating nonexecutive options was to help build a talented workforce.[68] On this view, backdating grants increased the value of the options offered to lower-level employees, making it easier to attract and retain them. In fact, in hi-tech firms with volatile stock prices, the ability to "look back" for lower-price grant-dates may have enabled employers to substantially boost the value of the options offered to new hires.

However, the desire to boost the value of lower-level employees' options cannot explain why firms backdated their option grants *secretly*. Firms are free to use any exercise-price setting methodology they desire, as long as it is properly disclosed. If in-the-money options were needed to recruit top-tier workers, firms could have *openly* given them in-the-money options.

To be sure, in-the-money options would have had to be expensed (like the workers' cash salaries). Such expensing, in turn, would have reduced reported earnings. But that should not have prevented firms from attracting high quality workers. At the end of the day, employees care about how much they are paid, not how their compensation is reflected on the firm's financial statements. Thus, even if arm's length contracting could explain why firms backdated nonexecutives' options, it cannot explain why they did so *covertly*.

B. Managerial Power

While the secret backdating of nonexecutive option grants cannot easily be explained by arm's length contracting, it is consistent with the managerial power

67. Walker, *supra* note 8, at 607–14.

68. *See, e.g.*, *Collared*, THE ECONOMIST, Aug. 11, 2007, at 54.

approach to executive compensation. In particular, such backdating enabled executives to indirectly boost their own pay in a manner hidden from shareholders.

To begin, the secret backdating of nonexecutive option grants made possible the secret backdating of executive option grants in many cases. Executives' option grants were often part of broad-based option grants—grants to many of the firms' employees. When executives' grants were part of these broad-based grants, the only way to secretly backdate executives' grants was to secretly backdate all employee grants. In other words, the backdating of lower-level employees' option grants may sometimes have merely been the means to the end of backdating executives' option grants.[69]

In addition, the secret backdating of employee option grants indirectly boosted executive pay by increasing reported revenues. The bulk of CEOs' cash compensation comes in the form of short- and long-term bonuses that, in turn, are heavily tied to earnings.[70] Moreover, executives frequently sell shares in their firms, and the price at which they can unload their stock also depends on reported earnings. These two compensation sources—bonuses and stock sales—create a strong link between executive pay and reported earnings. The secret backdating of lower-level employees' option grants inflated these earnings by enabling firms to give in-the-money options without expensing them. These higher earnings, in turn, enabled CEOs to covertly fatten their bonuses and increase their profits from selling shares.[71] Thus, even if executives could not backdate their own option grants, their pay arrangements—which were heavily tied to reported earnings—gave them a strong incentive to secretly backdate grants of nonexecutive options.[72]

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69. For example, executives at both Comverse Technology Inc. and Monster Worldwide were alleged to regularly participate in broad-based option grants that were backdated to reduce strike prices. *See* Walker, *supra* note 8, at 613; Affidavit in Support of Arrest Warrants at 19–20, United States v. Alexander, No. M-06-817 (E.D.N.Y. July 31, 2006). Monster Worldwide's CEO also participated in several suspiciously timed firm-wide option grants, including a two million share broad-based option grant dated April 4, 2001, the date of the lowest closing price of the first half of the year. *See* Charles Forelle & Mark Maremont, *Monster Worldwide Gave Officials Options Ahead of Share Run-Ups*, WALL ST. J., June 12, 2006, at A1.

70. BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 122–26.

71. One might argue that firms could have delivered the same value to employees, with the same accounting results, simply by giving them a larger number of at-the-money options. But this alternative might have been difficult given limits on the size of firms' option pools, and in any event would have reduced "pro forma" earnings in the footnotes of the firms' financial statements with possibly negative consequences for managers' bonuses and the price at which they could sell their shares. Walker, *supra* note 8, at 611–12.

72. In some cases, executive bonuses may have been tied to the firm's cash performance, not accounting earnings. However, the use of backdating to provide lower-level employees with disguised in-the-money options could also have boosted executives' cash-based bonuses. For

Firm-wide backdating of option grants substantially boosted many firms' reported earnings. Such backdating caused several firms to overstate income by more than a billion dollars.[73] Among the 100 firms that have so far restated earnings due to backdating, earnings were inflated by an aggregate amount of over $12 billion.[74]

In short, while the covert backdating of nonexecutive option grants did not directly camouflage or inflate executive pay, it often facilitated the secret backdating of executive option grants and indirectly boosted executive pay by inflating current earnings, allowing executives to reap larger cash bonuses and sell their shares for a higher price.

V. Backdating Executive Option Exercises: Arm's Length Contracting or Managerial Power?

In addition to inflating and hiding executive pay by secretly backdating managers' option *grants*, firms also boosted and camouflaged executive pay by covertly backdating managers' option *exercises*. This Part explains how firms used hidden exercise backdating to give managers additional performance-decoupled pay under shareholders' radar screen. Section A explains how executives benefited from such backdating under two common methods of exercising stock options against the firm: (1) cash exercises; and (2) stock exercises. It also describes the scope of both types of exercise backdating. Section B discusses the legality of these practices. Section C explains that secret exercise backdating, like secret grant backdating, is more consistent with the managerial power approach to executive compensation than with the arm's length contracting view.

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example, giving employees in-the-money options rather than at-the-money options could improve a firm's cash performance by enabling the firm to reduce the cash portion of employees' compensation packages.

73. As of this writing, the three largest restatements of income due to backdating have been: $2.24 billion, by Broadcom Corp.; $1.7 billion by UnitedHealth Group Inc.; and $900 million by Juniper Networks, Inc. Jarod A. Favole, *Broadcom Ex-CEO Sells Millions in Stock*, WALL ST. J., Aug. 1, 2007, at C2; James Bandler & Charles Forelle, *Embattled CEO To Step Down At UnitedHealth*, WALL ST. J., Oct. 16, 2006, at 1; *Juniper Plans $900 Million Charge Related to Misdated Stock Options, a Wall Street Journal Online News Roundup*, WALL ST. J. ONLINE, Dec. 20, 2006, http://online.wsj.com/article/SB116664940179855993.html (last visited Sept. 22, 2008) (on file with the Washington and Lee Law Review).

74. Eric Auchard & Duncan Martell, *Jury Convicts Brocade Ex-CEO in Options Trial*, REUTERS, Aug. 7, 2007, http://www.reuters.com/article/ousiv/idUSN0724454620070807 (last visited Sept. 22, 2008) (on file with the Washington and Lee Law Review).

A. Types of Exercise Backdating

After options have vested and become exercisable, an executive is free to exercise the options by paying the firm the options' strike price. Upon exercise, the executive receives the underlying stock, which she can then hold or sell. I focus on two common ways in which such exercises are effected: (1) "cash exercise & hold:" the executive pays the firm the strike price in cash, and holds the stock; and (2) "stock exercise:" the executive pays the firm the strike price with already-held stock (valued at the exercise-date market price), and either sells or holds the acquired stock. As we will see, executives backdated both types of option exercises to inflate their pay in a way that was hidden from shareholders.[75]

1. Cash Exercise & Hold

In a cash exercise & hold ("cash exercise") transaction, the executive pays the option exercise price in cash and holds the stock for at least one day.[76] Executives in over 60% of public firms have used cash-exercise transactions.[77] Approximately 30% of option exercises fit this pattern before the Sarbanes-Oxley Act, and about 15% afterward.[78]

To understand why executives might wish to backdate a cash-exercise transaction, it is necessary to understand the tax consequences of such a transaction. For most options, the manager is subject to ordinary income tax on the difference between the strike price and the market price of the stock on the

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75. A third form of stock option exercise is "cashless exercise:" The stock is sold to a third party through a broker, and the executive receives the difference between the sale price and the exercise price. *See* Jie Cai, *Executive Stock Option Exercises: Good Timing or Backdating?* 3 (Feb. 2007) (unpublished manuscript, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=951693. Cashless exercise generally involves an outside party and a broker. Any misreporting of the transaction for the benefit of the executive would generally be at the expense of these other parties. Hence, it would be difficult to arrange the backdating of such transactions. *Id.*

76. In some cases, the executive must also pay the firm an amount to cover the firm's tax withholding obligation.

77. *See* David C. Cicero, *Strategic Timing and Backdating of Executive Stock Option Exercises: Before and After the Sarbanes-Oxley Act* 20–21 (Feb. 2007) (unpublished manuscript, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=961289 (studying a sample of 3,078 companies during the period from August 15, 1996 to September 30, 2005).

78. *See id.* at 20; *see also* Cai, *supra* note 75, at 13 (finding in a sample of 12,721 option exercises during the period from January 1997 to December 2005 that approximately 20% of the exercises fit this pattern).

date of exercise.[79] This tax is typically withheld by the company. Any appreciation that occurs between the exercise date and the date the stock is sold may be taxed at the capital gains rate, which is generally lower than the ordinary income tax rate if the stock is held at least one year.[80] The firm gets a deduction for the difference between the strike price and the exercise price of the stock. Thus, the lower the market price on the date of exercise, everything else equal, the less tax the manager pays and the more tax the firm pays.

Because the exercise-date market price affects the allocation of tax costs between the executive and the firm, the firm can provide additional value to the executive by backdating the exercise to a date when the stock price is lower. Suppose that, on May 1, ABC stock trades at $90 per share, and on June 1 it trades at $100 per share. If an executive exercises his stock options on June 1 at a strike price of $E, and sells the stock that day for $100 per share or holds the stock, he must pay ordinary income tax on $100 - $E. ABC will in turn be able to deduct $100 - $E per option as compensation expense.

However, if ABC falsely reports the exercise grant date as May 1, the executive will pay ordinary income tax on a smaller amount, $90 - $E. The firm, in turn, gets a smaller compensation deduction: $90 - E, rather than $100 - E. If the executive then holds the stock for one year, he will pay capital gains on the difference between the reported exercise-date market price ($90 in this example) and the price for which the stock is eventually sold.

Although cash-exercise backdating has received less attention than grant backdating, a number of firms have been implicated in the practice. For example, the SEC determined that executives at Symbol Technologies engaged in cash-exercise backdating,[81] and Mercury Interactive reported in its amended 2004 Annual Report that "exercise dates for options exercised by certain executives appear to have been incorrectly reported" and the misreporting "reduced the executives' taxable income considerably."[82]

More importantly, there is considerable statistical evidence of cash-exercise backdating to obtain a lower exercise price. One study finds that during 1997–2002 cash exercises were preceded by abnormal returns of -2%

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79. *See* Fleischer, *supra* note 20, at 1042.

80. *See generally* Cicero, *supra* note 77, at 12.

81. S.E.C. Litigation Release 18734 (June 3, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18734.htm (alleging that Symbol and other defendants engaged in fraudulent misconduct with a cumulative impact of over $530 million on pre-tax earnings and $230 million on income from 1998 until 2003) (on file with the Washington and Lee Law Review).

82. Mercury Interactive Corporation, 2004 Form 10-K/A (filed July 3, 2006), *available at* http://www.secinfo.com/d14D5a.v4a2u.htm (on file with the Washington and Lee Law Review).

over the prior fifteen-day period and followed by abnormal returns of 5% over the subsequent fifteen-day period,[83] a pattern very similar to that around option grants, where managers also benefit from a low stock price. The study estimates that, prior to the Sarbanes-Oxley Act, about 12% of cash exercises appeared to be manipulated in order to provide a lower exercise price.[84] The figure for CEO cash exercises is higher: About 14% appear to be backdated.[85] Moreover, the likelihood of such backdating increases when the potential tax savings to the executive is higher.[86]

2. *Stock Exercise*

We now turn to consider the backdating of stock-exercise transactions. In a stock exercise, the executive pays the option exercise price by tendering already-owned stock, and either keeps or sells the stock acquired through the exercise of the option. Executives in about 25% of public firms have used this form of option exercise, with about 12% of option exercises taking this form before the Sarbanes-Oxley Act, and 8% after.[87]

In essence, a stock exercise is a cash exercise combined with a stock sale to the firm. The tax treatment of the cash-exercise component of the transaction is the same as in a regular cash exercise: The employee is taxed at the ordinary income rate on the difference between the exercise price and the market price on the exercise date. If the executive holds the stock for at least one year, the difference between the exercise price and the disposition price is treated as long-term capital gain. Thus, assuming the executive will hold the stock for at least one year, the lower the market price on the exercise date, the less tax the executive will pay and the more tax the firm will pay.[88]

However, focusing solely on the stock-sale component of the transaction, a higher market price on the exercise date means the executive must tender fewer shares to pay the exercise price. Thus, unlike in the cash-exercise component of the transaction, the executive is better off when the market price on the exercise date is higher. This second effect—the stock-sale effect—generally

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83. *See* Cai, *supra* note 75, at 4.

84. *Id.*

85. *See* Dan Dhaliwal, Merle Erickson & Shane Heitzman, *Taxes and Backdating of Stock Option Exercise Dates* 3 (Sept. 2007) (unpublished manuscript, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=954974.

86. *Id.* at 6.

87. *See* Cicero, *supra* note 77, at 20.

88. If, however, the executive sells the stock on the date of exercise or within one year of the exercise date, the exercise-date market price may not affect the executive's tax liability.

outweighs the cash-exercise tax effect. Thus, an executive using a stock exercise is better off if the market price on the exercise date is higher, even if he plans to hold the stock for at least one year after exercise.[89]

Executives using stock exercises can thus profit by backdating the exercise to a high-price date, in essence allowing them to sell their stock back to the company at an inflated price. Indeed, there is evidence of backdating to inflate the exercise price in stock exercises. One study finds that, while in the pre-SOX period cash exercises were preceded by average abnormal returns of -2% over the fifteen days leading up to the exercise date, and followed by an average abnormal return of 5% over the fifteen days following the exercise date, in that same period the pre-exercise and post-exercise average abnormal returns for stock exercises were 4% and -0.65%, respectively.[90] That study estimated that 5% of stock exercise dates were manipulated to enable executives to sell their shares back to the company at a higher price.[91]

B. Legality

Like secret option *grant* backdating, both forms of secret *exercise* backdating are likely to violate the securities, tax, and corporate laws. The precise legal implications of a particular exercise backdating scheme will, again, depend on the facts and circumstances of that scheme. However, it is worth briefly describing some of the potential legal implications of this practice to give the reader a sense of the risks entailed in inflating and hiding executive pay in this manner.

Securities Laws. The use of manipulated exercise dates may be inconsistent with representations made in a firm's SEC filings about the nature of the firm's option compensation practices in general and executive compensation in particular. Deliberate misstatements arising from secret exercise backdating may violate the anti-fraud rules of the securities laws,[92] and constitute false statements to the SEC.[93] In addition, exercise backdating usually involves illegal falsification of books and records,[94] and a violation of

89. Cai, *supra* note 75, at 3.

90. *Id.* at 4.

91. *Id.*

92. *See, e.g.*, Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b)), Rule 10b-5 (17 C.F.R. § 240.10b-5), Section 17(a)(1), (a)(2), & (a)(3) of the Securities Act (15 U.S.C. §§ 77q(a)(1)-(a)(3)) & Section 14(a) of the Exchange Act (15 U.S.C. § 78n(a)) (prohibiting false or misleading proxy statements).

93. *See* Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a).

94. *See* Section 13(b)(2)(A) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(A).

the requirements to keep accurate books and records[95] and maintain adequate internal accounting controls.[96]

Tax Laws. Misrepresenting the exercise date can lead to a violation of a number of tax laws. For example, reporting a false exercise date to lower the reported exercise-date stock price causes the executive to underreport ordinary income. It can also cause the firm to under-withhold income and FICA taxes.

Corporate Law. As indicated earlier, a Delaware court has ruled that the intentional violation of the terms of a stock option plan through grant backdating would constitute a bad faith breach of the duty of loyalty.[97] Similarly, exercise backdating may violate directors' and executives' fiduciary duties of loyalty and candor under corporate law.

C. *Arm's Length Contracting or Managerial Power?*

1. *Arm's Length Contracting?*

Secret option exercise backdating has not yet attracted the same attention as secret option grant backdating. That may explain why defenders of current governance and executive compensation arrangements have not yet been heard to assert that such exercise backdating, like secret grant backdating, reflects arm's length contracting. But one could make the same argument that has been made in connection with option grant backdating: Exercise backdating profits are just another form of compensation.[98] If executives did not receive extra value in the form of backdated exercises, the argument would go, they would get it in another. Thus, secret option exercise backdating imposes no cost on shareholders.

However, as with secret option grant backdating, this arm's length "substitution" argument suffers from serious flaws. There is no evidence that exercise-backdating profits served as a substitute for other forms of compensation. Moreover, it is unlikely that executives and boards seeking to serve shareholders by backdating exercises would feel the need to deceive shareholders by doing it *secretly* (especially since, as Section B explained, such secret transactions put the firm and its officers in legal jeopardy). If backdating exercise prices benefited shareholders, firms would have done so *openly*.

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95. *See* Section 13(b)(5) of the Exchange Act, 15 U.S.C. § 78m(b)(5).

96. *See* Section 13(b)(2)(B) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(A).

97. *See* Ryan v. Gifford, C.A., No. 2213, 2007 WL 416162 (Del. Ch. Feb. 6, 2007).

98. *Supra* Part II.B.1.

2. *Managerial Power*

While secret option exercise backdating is unlikely to be explained by arm's length contracting, it is consistent with the managerial power approach to executive compensation. As indicated earlier, the managerial power approach suggests that, because officers and directors fear shareholder outrage over executive-favoring compensation arrangements, boards will take steps to hide—or camouflage—executive pay.[99]

Both forms of covert exercise backdating—like secret grant backdating—served to camouflage the amount of executive pay. By shifting tax costs from executive to the firm, *cash-exercise backdating* allowed firms to boost the (after-tax) value of executives' options without revealing that they were increasing executives' compensation at firm expense. By forcing the firm to buy their stock for a higher price, executives engaged in *stock-exercise backdating* directly shifted value to themselves from the firm and its shareholders. Conveniently, none of this extra value was reported in the summary compensation tables that shareholders, researchers, and the media use to determine the amount of executive pay—or anywhere else.

The link between secret exercise backdating and managerial power has not yet been studied. However, those firms that have come under public scrutiny for backdating option grants (in part because their practices have been most obvious and egregious) appear to be twice as likely to have engaged in secret option exercise backdating as other firms.[100] Because there is a link between managerial power and option grant backdating, this finding suggests an indirect connection between managerial power and option exercise backdating. Such a link would not be surprising, given that secret exercise backdating, like secret grant backdating, was used to camouflage executive pay in a manner consistent with the managerial power approach to compensation.

VI. Backdating and the Need for Further Corporate Governance Reforms

As we have seen, each of the three types of secret option backdating examined—the backdating of executive option grants, the backdating of nonexecutive option grants, and the backdating of executive option exercises—is more consistent with the desire to inflate and hide managerial pay than with the desire to serve shareholders. In the debate over how executive

99. *Supra* Part II.B.I.

100. *See* Dhaliwal et al., *supra* note 85, at 5.

compensation is set, backdating thus provides support for the managerial power approach, not arm's length contracting.

This Part considers the implications of option backdating for a second and related debate: Whether, as some have argued, the Sarbanes-Oxley Act of 2002 and accompanying stock exchange reforms have sufficiently reduced managers' power over directors. Section A briefly describes this debate. Section B shows that secret option backdating persisted after SOX, even though it entailed—in addition to a host of other legal violations described in Parts III and V—a blatant and easily detectible violation of SOX's new reporting requirements. Section C explains why the persistence of secret backdating after SOX suggests additional corporate governance reforms may well be needed to adequately curb managerial power.

A. The Debate

Following Enron and the other corporate governance scandals that erupted at the beginning of the decade, Congress enacted the Sarbanes-Oxley Act of 2002.[101] In 2003, at the prodding of the SEC, the stock exchanges adopted a variety of new requirements for listed firms aimed at increasing the number, role, and independence of outside directors.[102]

Since SOX and the accompanying stock exchange reforms were adopted, there has been a debate over whether further corporate governance improvements are needed. Some commentators have argued that SOX and the stock exchange reforms should fully address any remaining problems in the corporate governance of US firms. Going forward, it is promised, boards can be expected to make shareholder-serving decisions.[103]

Others, such as Lucian Bebchuk and I, have contended that SOX and accompanying stock exchange reforms do not go far enough. Executives continue to have too much power over their boards, which they can use to obtain pay arrangements that serve their own interests rather than shareholders' and, more generally, run companies in ways that benefit themselves rather than investors.

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101. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

102. *See* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 28–29.

103. *See, e.g.*, Martin Lipton & Steven A. Roseblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003); Bainbridge, *supra* note 5, at 1637–42.

To curb managerial power, Lucian Bebchuk and I have suggested that shareholders be given more power to replace directors.[104] The heightened possibility of being ousted by shareholders dissatisfied with board decision-making is likely to make directors more sensitive to shareholder interests. Increasing shareholder power can thus help counterbalance—at least to some degree—managerial influence, improving executive compensation arrangements and corporate governance more generally.

B. Post-SOX Backdating

Have SOX and the accompanying stock exchange reforms improved corporate governance? If so, we would expect secret option backdating to virtually disappear after these laws were passed. As this Section explains, however, thousands of firms continued to engage in secret option backdating even after these reforms, notwithstanding the fact that it involved a flagrant violation of SOX's new reporting requirements.

1. Sarbanes-Oxley's New Reporting Requirements

The Sarbanes-Oxley Act implemented an important change in firms' option reporting requirements that should have made both executive grant and executive exercise backdating much more difficult: All high-level executive stock option grants and exercises occurring on or after August 29, 2002 had to be reported within two business days.[105]

Prior to August 29, 2002, executives' stock option grants and exercises generally did not have to be reported until the tenth day of the month following the transaction. Certain executive option grants did not need to be reported until 45 days after the end of the firm's fiscal year.[106] Thus, firms had at least ten days, and often as long as a year, to report these option transactions.

104. *See, e.g.*, BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 207.

105. Securities Exchange Act of 1934 § 16(a)(2)(C), 15 U.S.C. § 78p(a)(2)(c).

106. Before August 29, 2002, option grants had to reported by the tenth day of the following month rather than forty-five days after the end of the fiscal year unless three conditions were met: (1) The option grant was made pursuant to a shareholder-approved written plan; (2) The options were to be held for at least six months from the grant date; and (3) The stock option plan was administered by a board or committee composed of independent directors. *Compare* Rule 16a-3, 17 C.F.R. §§ 240.16a-3(f)(1) (2000) and Rule 16a-3, 17 C.F.R. §§ 240.16a-3(f)(1) (2007).

Because pre-2002 executive stock option grants and exercises did not have to be reported any earlier than the tenth day of the following month, and some grants could be reported up to a year later, firms had substantial ability to use hindsight to choose favorable option grant and exercise dates and still meet the reporting deadline. Consider, for example, an option grant that had to be reported by the tenth day of the following month. On June 10, a firm could backdate a grant as far as May 1 and still meet the June 10 reporting deadline for the (falsely-reported) grant.

The two-day reporting requirement imposed by SOX would, if followed, have made backdating an executive option grant or exercise by more than two business days impossible. For example, a firm actually granting an option on June 10 could not comply with the two-day reporting requirement and report a grant made earlier than June 8.[107] If the grant were backdated to June 7 or earlier, and reported on June 10 or thereafter, SOX's two-day reporting rule would be violated.

At the time SOX's two-day reporting requirement was imposed, shareholders and regulators were unaware that firms had been secretly backdating executives' option grants and exercises. However, it was believed that firms should more promptly disclose executive option grants and exercises to regulators and investors to increase transparency. Thus, the effect of these new reporting requirements on firms' ability to backdate, while desirable, was wholly unintended.

2. *The Effect of SOX on Backdating*

Did SOX eliminate executive option backdating? SOX did reduce the amount of both executive option backdating and executive exercise backdating. About half of the firms that had been engaged in backdating were unwilling to continue backdating once it required a blatant and easily detectible violation of SOX's reporting requirements.

However, after SOX was passed, between 15–20% of publicly traded firms—between two and three thousand in number—simply disregarded the new disclosure requirements. Many disclosed executive option grants as long as a month after the transaction supposedly occurred.[108] Such late

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107. I assume June 8, 9, and 10 are all business days.

108. Almost 25% of executive option grants are reported late, and about 10% are reported more than a month late. *See* M.P. Narayanan & H. Nejat Seyhun, *Effect of Sarbanes-Oxley Act on the Influencing of Executive Compensation* 4 (Nov. 2005) (unpublished manuscript, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=852964; M.P. Narayanan & H. Nejat Seyhun, *The Dating Game: Do Managers Designate Option Grant-*

reporting enabled firms to continue backdating executive option grants.[109]

Indeed, there is evidence that firms disclosed late so that they could continue backdating grants in order to inflate and camouflage executive pay. Late-reporting executives were engaged in grant backdating, and those reporting the latest (after the supposed grant date) were most likely to be engaged in backdating.[110] One study found that approximately 16% of a sample of 4,000 firms engaged in executive option grant backdating after SOX's new disclosure requirements were put in place.[111] Extrapolating to the full universe of approximately 15,000 publicly traded firms, this finding suggests that over 2,000 firms continued to engage in grant backdating after SOX, even though it involved a blatant violation of the two-day reporting requirement. Such post-SOX backdating enabled firms to secretly boost the value of executive options by around 10%.[112]

C. Implications of Post-SOX Backdating

We have seen that, even after SOX and the accompanying stock exchange reforms aimed at increasing board independence, thousands of firms continued to secretly backdate executives' stock options. Moreover, this backdating persisted even though it was in blatant violation of SOX's new option disclosure requirements. The failure of these reforms to put an end to secret backdating suggests, as Lucian Bebchuk and I have argued, that these measures are unlikely to have adequately reduced managerial power.

The inability of SOX and the accompanying reforms to put an end to secret option backdating should not be surprising. The fundamental problem in U.S. corporate governance, first identified by Berle and Means over seventy years ago,[113] is that executives of widely held firms exert too much influence

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Dates to Increase Their Compensation 3 (Apr. 2006) [hereinafter Narayanan & Seyhun, *The Dating Game*] (unpublished manuscript, on file with the Washington and Lee Law Review), *available at* http://ssrn.com/abstract=896164. *See generally* Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 83 J. FIN. ECON. 271 (2007).

109. For example, if a firm is willing to violate the SOX disclosure rules by reporting a grant thirty days after it was supposedly made, the firm can backdate that grant by up to thirty days.

110. Narayanan & Seyhun, *The Dating Game*, *supra* note 108, at 3.

111. Heron & Lie, *supra* note 35, at 21.

112. Narayanan & Seyhun, *The Dating Game*, *supra* note 108, at 3. Exercise backdating also continued, although on a more significantly reduced scale. Cai, *supra* note 75, at 17.

113. *See generally* ADOLPH A. BERLE JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

over their boards. The Sarbanes-Oxley Act, which was intended primarily to improve the reliability of public firms' financial disclosures, did almost nothing to address this problem. And the stock exchange reforms aimed at increasing the number of "independent directors" on boards are unlikely to substantially reduce the Berle-Means problem, given the extent to which executives retain influence over board nomination and compensation decisions.[114]

To be sure, secret option backdating itself is unlikely to continue to be widespread. The glare of publicity—along with several criminal prosecutions and convictions—are likely to substantially reduce the frequency of both grant and exercise backdating. We can thus expect secret option backdating to become largely a thing of the past.

However, secret backdating is simply one example of a long-standing practice of boards favoring managers through executive pay arrangements, and then seeking to hide the amount and performance-insensitivity of the compensation from shareholders. More broadly, it reflects a general tendency on the part of directors to favor executives in many aspects of corporate governance decision-making, one that arises because directors are insufficiently accountable to shareholders. This tendency will not go away just because one problematic (and illegal) pay practice has been identified and largely suppressed.

Addressing the fundamental problem in U.S. corporate governance will require making it easier for shareholders to replace directors.[115] Recent efforts by shareholders to compel several dozen firms to adopt majority voting standards are a step in the right direction.[116] But such efforts, which are undertaken on a "retail basis"—corporation by corporation—are unlikely to achieve much in a market with 15,000 or so public companies. More sweeping "wholesale" measures are necessary, such as changes in the proxy rules that would allow shareholders holding a minimum number of shares to place director candidates on the corporate ballot.[117]

The political obstacles to such reforms are significant. Corporate executives wield considerable power not only in the boardroom but in Washington as well. For example, supporters of management, led by the

114. *See, e.g.*, BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 28–29.

115. *See id.* at 201–16.

116. For a description of majority voting, see Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 702 (2007).

117. The SEC considered (and rejected) such proposals in 2003 and in 2007. *See* Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (Oct. 14, 2003); Shareholder Proposals, Exchange Act Release No. 56,160, 72 Fed. Reg. 43,466 (July 27, 2007).

Business Roundtable, have until now been able to block federal efforts to give shareholders more power to replace directors.[118]

For reform efforts to succeed, investors need to exert enough effort to overcome managers' political power. Investors will exert such effort only if they recognize that, even after the Sarbanes-Oxley Act and accompanying reforms, executives still have too much power over their boards. The option backdating scandal may turn out to be a blessing in disguise if it helps contribute to such a recognition.

VII. Conclusion

This Article has explored three types of secret option backdating that were widely practiced by U.S. firms: the backdating of executive option grants, the backdating of lower-level employee option grants, and the backdating of executive option exercises. It has shown that such secret backdating, which was generally illegal, was unlikely intended to serve shareholders' interests. However, each type of secret option backdating boosted and camouflaged managerial pay. Secret backdating thus provides further support for the view that managerial power has played an important role in shaping executive compensation arrangements.

The Article has also considered the implications of option backdating for the need for further corporate governance reforms aimed at reducing managerial power. Some have argued that the Sarbanes-Oxley Act and the accompanying stock exchange reforms designed to increase board independence would be sufficient to improve corporate governance in publicly traded firms. The fact that thousands of firms continued secretly backdating after these measures, even though such backdating was not only still illegal but also required a blatant violation of SOX's new option reporting requirements, suggests these commentators may have been mistaken. Further steps may be needed to make boards less susceptible to managerial influence and more accountable to shareholders. By refocusing attention on the persistent problem of managerial influence in U.S. firms, the stock option backdating scandal may beneficially pave the way for such reforms.

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118. *See* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 6, at 208–10.

THE RESTITUTION ROUNDTABLE