

## Lessons from the Backdating Scandal and the Mannesmann case

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### Equity Grant Practices – US and Europe in Perspective

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- History of Equity Grant Failures in US
  - Widespread identification of US companies who granted equity awards where the exercise price was less than the fair value of the shares on the date of grant
  - Causing civil and criminal culpability, financial accounting restatements and tax increases
- History of Equity Grant Failures in Europe
  - Repricing of stock options
  - Grant of appreciation awards in violation of the German Criminal Code

## **Option backdating in the US arises from multiple sources**

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- Deliberate, selective retroactive option pricing based upon most favorable stock pricing
- Policies that granted options at the most favorable price for a fixed pre-grant period
- Options granted at a price prior to employment contingent on subsequent employment
- Options granted that were then repriced to take into account stock price declines
- Options granted that were allocated to employees at a later date
- Options granted whose administrative approval occurred at a later date



## **Equity Grant Practices – The Issues**

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- Governance
- Process
- Accounting
- Legal
- Tax



## Best Practices – Option Grant Process

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- Adopt a formal, written grant policy
- Avoid conflicts of interest (direct or indirect) when granting options
- Appoint two or more persons to any committee with grant authority
- Grant options on regularly scheduled, pre-determined dates
- Unfailing compliance with public disclosure requirements (e.g., Form 4)
- Standardize and automate the internal process of granting and tracking option grants
- Standardize the internal process of communicating grant awards
- Avoid granting options by unanimous written consent
- Do not retrospectively correct “clerical errors”
- Clearly document delegation of authority and any limitations

## NASPP Grant Practices Survey – February 2007 Results

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### Who approves option grants to non-executives? (n=498)

|     |                               |
|-----|-------------------------------|
| 18% | <b>Board of Directors</b>     |
| 48% | <b>Compensation Committee</b> |
| 6%  | <b>Committee of officers</b>  |
| 20% | <b>CEO</b>                    |
| 8%  | <b>Other</b>                  |

### For new-hire grants, what date is vesting based on? - where the grant date is not the hire date (n=457)

|     |                   |
|-----|-------------------|
| 70% | <b>Grant Date</b> |
| 24% | <b>Hire Date</b>  |
| 6%  | <b>Other</b>      |

## NASPP Grant Practices Survey – February 2007 Results

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### When are grants to new hires (non-execs) approved?

- select all that apply, may total more than 100%

(n=494)

|     |  |
|-----|--|
| 23% | Once a month (same time every month)     |
| 11% | Once a quarter (same time every quarter) |
| 5%  | After earnings are released              |
| 5%  | Only during open window periods          |
| 13% | When the Board meets                     |
| 29% | When the Compensation Committee meets    |
| 21% | Other                                    |
| 17% | No set schedule                          |

## Accounting Requirements

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- Accounting for prior misdating based upon old APB 25 accounting
  - Charge was spread at grant
- Issues not as significant under FAS 123R
- Key issue now is that of the “Measurement Date”
  - Measurement date is when employer and employee have mutual understanding of key award terms
  - No requirement to “agree” to terms, but communication of key terms must be made within reasonable period of time

## Legal Issues

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### Potential Criminal and Civil Liability



## Legal Issues

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### Criminal

- Securities Fraud
- Sarbanes-Oxley
- Tax Fraud
  - 162(m) violations
  - Improper qualifications of ISOs under Section 422
  - Section 409A
- Federal Wire/Mail Fraud
- Conspiracy



## Legal Issues

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### Civil

- Derivative lawsuits
  - Breach of duty of loyalty
- Class action lawsuits
  - Securities actions under anti-fraud provisions
- SEC Civil Enforcement Actions
  - Accounting fraud, providing false information, insider trading



## Legal Issues

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### Protect Yourself:

- Self-report
- Conduct independent internal investigation
- Share results with government
- Implement new controls designed to prevent recurrence of fraudulent conduct



## **Tax Considerations**

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- Loss of ISO status
- Inadequate tax withholding
- Inadvertent creation of IRC Section 409A deferred compensation
- Loss of tax deduction



## **Tax Considerations outside the US**

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- Violation of approved share scheme requirements in the UK
- Loss of 50% Section 110(1)(d) exclusion in Canada
- Excess discount under French qualified plan rules
- Violation of Italian pricing where tax-qualified result is desired



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## Lessons from the "Mannesmann" case concerning appreciation awards

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### Introduction

- **"Benefits"** granted to board members must be adequate to members' duties and responsibilities to comply with German Stock Corporation Act
  - "Benefits" in that context are all fixed and variable payments, bonuses, emoluments, reimbursements, pensions and similar payments
  - Supervisory board decides on compensation and benefits packages for management board members

Generally, such awards are common practice and considered necessary to reward outstanding performance and achievements. But.....

## Recent conflict between the Stock Corporation Act and the German Criminal Code

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- Since the "Mannesmann" decision, certain benefits like appreciation awards or severance payments can be considered fraud or "breach of trust" under the German Criminal Code – even though they are in compliance with the German Stock Corporation Act

### **Problem:**

**Determining the conditions for legally granting appreciation awards to top executives**



## The Court decision

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Appreciation awards only comply with the German Criminal Code if either...

... a **clear** provision in the management service agreement entitles the board member to said award:

- all cases and circumstances to earn the award must be described
- method of calculation for the award/bonus must be shown

or

... the **company** simultaneously receives a benefit or advantage which is adequate to the value of the benefit granted to the board member.

In all other cases appreciation awards are ruled illegal and may constitute the criminal offense of fraud or "breach of trust".



## How to legally grant awards after the "Mannesmann" decision

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In light of the "Mannesmann" decision of the *Bundesgerichtshof*, the following alternatives to grant rewards or appreciation awards can be suggested:

- Include a provision in the management service agreement that allows them (according to the Court's guidelines)
- Grant them only if the company simultaneously receives an adequate benefit (according to the Court's guidelines)
- Grant them not on company level but on shareholder level

## Questions?

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Thank you for your participation

## Contact Information

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