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Morrison & Foerster
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The cost of compliance

Over 200 US-registered public companies have announced they are conducting stock option issuance investigations to determine whether options were issued according to regulation and company practices. The principal focus of these investigations is to determine whether option prices were established at the grant date or retroactively. Many investigations now have been in process for over a year, others for more than two. Affected companies range from large well-respected US companies to microcap companies on various continents.

During recent years, we have read a great deal about backdating, spring loading, bullet dodging, suspicious issuances, forensic auditors, options consultants, SEC enforcement actions, shareholder litigation and criminal prosecutions. The SEC has offered some admittedly imprecise guidance concerning the documentation companies should routinely produce to show proper grants. For most companies undergoing investigations, we have read more lately about these investigations than about their business operations.

Amidst all this press coverage and expert commentary, a main aspect of the process that has received scant attention is the often debilitating challenge of operating a US public company undergoing an investigation.

Among the first things that a company must do upon learning that it should investigate option awards that might have been made years ago (in some cases before its IPO) is to inform its auditors, the SEC, its security holders and other constituencies that an investigation has begun. The company will then advise that it is no longer appropriate to rely on its audited financial statements for the relevant past years. Its auditors will withdraw their audit reports for these years. From then on, the company will be unable to provide audited historical financial statements and will not be able to prepare current audited financial statements. So the company will no longer be able to furnish financial statements to lenders, usually resulting in a material breach of its loan agreements. If lenders are pleased with the loan, the company usually can compensate lenders and obtain a waiver. This waiver can be expensive. If the company is not so fortunate, this could result in a default that cannot be quickly cured. Activist hedge funds have used such defaults to precipitate the restructuring of high-yield arrangements. The prevalence of cross-default provisions in debt instruments complicates matters and increases the likelihood that the company will not be able to keep its credit arrangements intact.

The inability to furnish financial statements prevents the company from satisfying SEC periodic reporting requirements. This creates a fresh set of difficulties. It will render the company unable to sell securities in a public offering as registration requirements include furnishing current financial information. It also makes it impossible for the company to hold an annual shareholders meeting, as required by federal securities and state corporate law. Meetings require a proxy statement. Proxy rules require that audited financial information be furnished to shareholders when seeking their vote.

The absence of financial statements complicates M&A activity. In all but a handful of situations, it will make it difficult and impractical to effect an acquisition or be acquired. Nothing prevents a company from identifying possible acquisition opportunities or conducting preliminary discussions while audited financial statements are unavailable, but little beyond preparatory work can be completed.

Just when a company has absorbed all this news, it will be advised that the securities exchange on which its securities are quoted will initiate a hearing process to consider delisting the company's common stock for failure to timely file periodic reports. The delisting process takes a long time. Most companies aspire to resolve these issues before their securities are delisted. But it does not always work that way.

As the investigation moves along, the company will be in close communication with the SEC enforcement division. Depending on the investigation results, the SEC may initiate enforcement activity leading to SEC sanctions. The US Department of Justice might become involved if it believes criminal prosecution is appropriate. Lastly, a company will often find that plaintiffs' lawyers will initiate class action litigation alleging, among other matters, that shareholders were damaged by options issuance practices. However the situation plays out, the company will not be able to avoid the cost, diversion of management time and board focus, and unpleasantness of dealing with regulatory and litigation matters.

Most companies involved in the investigations process will survive. Their financial statements will be restated to give effect to non-cash charges to income. Their SEC filings will eventually be brought current. Their regulatory issues are likely to be resolved and related shareholders' litigation will ultimately be put behind them. But it might take much longer to assess the actual cost that this process will exact from those companies that have, by necessity, become more focused on dealing with option issues than addressing business opportunities.