

**BACKDATING:
LEGAL AND ETHICAL CONSEQUENCES OF TEMPORAL MODIFICATIONS
Tax Update XXXI**

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I. INTRODUCTION

Not all temporal modifications are illegal, unethical or even ineffective. Some ineffective but nonfraudulent temporal modifications may not be illegal or unethical. All fraudulent backdating is illegal, unethical and ineffective. This outline considers the circumstances in which an attempt to assign a date to an action that is different than the date on which the action actually took place will be illegal, unethical and ineffective.

A. Definitions.

1. Temporal Modification.

Circumstances in which a document or action attempts to have an effect at a time other than a time at which the action is taken. Generally, the action is sought to be effective at a time that precedes the time of the action, although under some circumstances it may be intended to be effective as of a subsequent date.

2. Backdating.

Assigning an event to a date prior to that of actual occurrence; or dating a document “as of” a time prior to execution. The two are not mutually exclusive.¹

3. Rescission.

The abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made.²

B. Types of Temporal Modification

1. *Nunc pro tunc* initial action.

An action having legal consequences or an action organization is sought to be created, a person sought to be treated as admitted or removed as an owner or agent of an organization, or a contract or transfer is sought to be effective prior to the time that the legal steps to create the organization, admission or removal of the or enter into the contract occurs.

2. *Nunc pro tunc* change.

An action having the effect of changing the terms of an existing arrangement of contact.

3. Rescission.

An action having the effect of undoing another action which, but for the rescission would be effective.

¹ For a comprehensive analysis on backdating (not focusing primarily on partnership/partner matters), see Jeffrey L. Kwall and Stuart Duhl, Backdating, 63 ABA Business Lawyer 1153-1186 (August 2008), available at SSRN: <http://ssrn.com/abstract=1112845>.

² 2 Rev. Rul. 80-58, 1980-1 CB 181. See also, Sheldon I. Banoff, *Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud?*, 62 TAXES 942, 980 (1984).

C. Reasons for Temporal Modifications.

There are several circumstances in which temporal modifications may take place; not all of them are inappropriate.

1. Defrauding a third party.

To the extent a third party's rights are determined by the date on which an action occurs, temporal modification may be intended to, or may serve to attempt to change the third party's rights. For purposes of this paper, the third party generally concerned is the Internal Revenue Service ("Service"). The use of temporal modification to obtain a tax or other benefit to which the actor would not be applicable were

2. Non fraudulent memorialization of past actions.

There are several ways in which past actions may be reduced to a written document, even though they were taken. Among the most common memorialization is the preparation of minutes of a meeting at which an action was taken.

Memorialization reflecting a modification of a partnership or operating agreement through course of conduct may also be appropriate. For example, when A and B are partners under a partnership agreement calling for each to receive 50% of the profits of the organization

3. Ratification of past action.

If an agent takes an action on behalf of a principal with appropriate authority, under some circumstances the principal can ratify the action. For example, a party who is not bound by a voidable contract may elect to ratify the contract, in which case the contract will be retroactively enforceable.³

4. Definition of ambiguous situation. A more gnarley situation arises when the actor is not clear as to his or her intentions at the time of the action and the intention behind the action needs to be established at a later time. If the owner of a closely-held business puts cash into (is it a contribution to capital or a loan?) or takes cash out of the organization (what is the character of the payment, is it a distribution, repayment of a loan to the organization by the shareholder, or a loan from the organization to the shareholder?). If the owner actually has an intention and subsequently changes his mind about the intention, it is a temporal change which would be subject to the legal, ethical, and tax rules described below. But what if the owner never actually thought about the reason for the action until confronted later

5. Formal modification or correction of a legally defective situation. To the extent the transaction is ambiguous, void or voidable, the action which clarifies, or remedies the defect may constitute a temporal modification. Circumstances in which this sort of correction might be necessary include ambiguous or incompletely documented actions and defectively authorized actions. Often such defects can be cured in such a way as to make the cure effective retrospectively.

³ See Restatement (third) of Agency § 4.02 (Effect of Ratification)

(1) Subject to the exceptions stated in subsection (2), ratification retroactively creates the effects of actual authority.

(2) Ratification is not effective:

(a) in favor of a person who causes it by misrepresentation or other conduct that would make a contract voidable;

(b) in favor of an agent against a principal when the principal ratifies to avoid a loss; or

(c) to diminish the rights or other interests of persons, not parties to the transaction, that were acquired in the subject matter prior to the ratification.

II. LEGAL CONSIDERATIONS

A. Efficacy of Temporal Modification

1. Statutory recognition.

There are statutes that expressly contemplate that documents will be backdated, thereby acknowledging the effectiveness of such documents. For example, Delaware has acknowledged that an operating agreement,⁴ or limited partnership agreement,⁵ may be made retroactively effective. Similarly, the Uniform Partnership Act (1997) expressly provides for “undissolving” a dissolved general partnership.⁶

2. Common law recognition.

Retrospective modification of an agreement is legally permissible.⁷

B. Protection of Third Parties.

Many of the provisions allowing temporal modification expressly protect the rights of third parties.⁸

C. Criminal Sanctions.

The non-tax criminal sanctions with respect to temporal modification are applicable to fraudulent conduct generally apply to fraudulent backdating. In addition to tax penalties, there are criminal penalties for fraud, conspiracy, securities fraud, mail fraud, and many other sanctions.

III. TAX CONSIDERATIONS

A. Efficacy

1. Partnership agreement.

IRC § 761(c) provides that for purposes of the IRC, the term “partnership agreement” includes:

any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

⁴ 6 Del. Code § 18-201(d) provides:

A limited liability company agreement shall be entered into or otherwise existing either before, after or at the time of the filing of a certificate of formation and, whether entered into or otherwise existing before, after or at the time of such filing, may be made effective as of the formation of the limited liability company or at such other time or date as provided in or reflected by the limited liability company agreement.

⁵ 6 Del. Code § 17-201(d).

⁶ Uniform Partnership Act (1997) § 802(b)(1) provides:

At any time after the dissolution of a partnership and before the winding up of its business is completed, all of the partners, including any dissociating partner other than a wrongfully dissociating partner, may waive the right to have the partnership’s business wound up and the partnership terminated. In that event . . . the partnership resumes carrying on its business as if dissolution had never occurred, and any liability incurred by the partnership or a partner after the dissolution and before the waiver is determined as if dissolution had never occurred;

⁷ Restatement (second) of Contracts § 33.

⁸ See, e.g., Restatement (third) of Agency § 4.02(2)(c) and Uniform Partnership Act (1997) § 802(b)(2) which provides that on the even the dissolution of the partnership is rescinded:

the rights of a third party accruing under Section 804(1) or arising out of conduct in reliance on the dissolution before the third party knew or received a notification of the waiver may not be adversely affected.

The effect of this provision is to allow amendments to be effective for a period before the amendment.⁹ Such amendments are not effective to change the existence and ownership of the partnership.

2. Rescission.

Rev. Rul. 80-58,¹⁰ 10 citing *Penn v. Robertson*,¹¹ 11 provides the general rule that a taxpayer may take a reconveyance of property without recognition of gain provided: (1) the reconveyance occurs before the end of the taxable year and (2) the parties agree that the effect of the reconveyance is to restore the parties to the circumstances that existed before the reconveyance.

3. Backdating as an indication of lack of business purpose.

Beyond seeking to obtain a tax benefit in itself, backdating may also be an indication of lack of business purpose. In considering a Son of BOSS transaction, the Federal Court of claims in *Stobie Creek Investments, LLC v. U.S.*¹² the court noted:

The backdating of the legal documents, creating the structures through which Jeffrey Welles carried out his transactions, reveals an intentional emphasis on ensuring the proper implementation of the J&G strategy, rather than a motive of turning over an economic profit on an investment that could have been executed outside of the order required by the J&G strategy. This focus on the sheltering aspect of the transactions by backdating the order in which the transactions actually occurred further belies the claim that the FXDOTs were motivated by a business purpose of making a profit.

B. Penalties.

There are no tax penalties for temporal modification, the penalties are applicable to fraud and negligence with respect to misrepresentation or misreporting of tax matters.

IV. ETHICAL CONSIDERATIONS

A. Circular 230

- 1. Section 10.21 (knowledge of client's omission).**
- 2. Section 10.22 (diligence as to accuracy).**
- 3. Section 10.33 (best practices, including evaluating reasonableness of representations).**
- 4. Section 10.37 (written advice and unreasonable factual representations).**

B. Model Rules of Professional Conduct

- 1. Rule 1.3 (diligence).**
- 2. Rule 3.3 (candor toward tribunal).**
- 3. Rule 3.4 (fairness toward opposing party).**

⁹ Treas. Reg. § 1.761-1(c) (“A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return.”).

¹⁰ 1980-1 CB 181.

¹¹ 115 F.2d 167 (4th Cir. 1940).

¹² 102 AFTR 2d 2008-5442 (2008).

4. Rule 4.1 (truthfulness in statements to others).

5. Rule 8.4(c) and (d) (prohibition on conduct involving dishonesty, fraud, deceit or misrepresentation and reporting thereof).

V. EXAMPLE: BACKDATED STOCK OPTIONS.

See Appendix, III.

VI. BEST PRACTICES

1. Do not misrepresent the facts.

2. Perform factual due diligence

3. Carefully analyze applicable legal standards permissible

4. Recognize that the facts and law may not be clear. In these cases, consider whether backdating could be construed as a fabrication and evaluate propriety

5. “Disclosure”?

Appendix
BACKDATING:
Legal and Ethical Consequences of Temporal Modifications

I. Fundamental Rules

- 1. Don't lie.** Not only is it morally, ethically, and legally wrong, but in an era of E-mail and electronic documents that last forever, the lie will get caught. If you can't do it legally, don't do it.
- 2. Don't mislead.** If you can attain the result you are trying to legally, you shouldn't need to mislead. Remember the lesson of Watergate.
- 3. Understand the legal consequences of the action.** Analyze the consequences of the action if rather than changing the deal nunc pro tunc, it is treated as a new taxable transaction. As with any transaction having tax or economic significance, you should understand and counsel on the stakes and likelihood of the modification's not being respected.
- 4. Understand the available legal processes.** Both tax and state laws have become increasingly accommodating of changes. State laws often allow the retroactive correction of documents (if there was a mistake at the outset) and the curing of such problems as inadvertent dissolutions. The fallibility and changing nature of deals is also recognized in IRC § 761(c). In particular, understand agency and contract law.

II. Bases for Non-Fraudulent Temporal Modifications

A. Memorialization.

For business corporations, a consent resolution of a corporation is generally effective at the time the last required shareholder signs the consent.¹ On the other hand, action taken at a meeting at which all shareholders are present or with respect to which notice is waived² are effective at the time of meeting, regardless of when the minutes are actually prepared and approved. With alternative entities, the statutes generally simply call for consent of members or partners – for extraordinary actions, generally unanimous consent of the members or partners – and don't require the formality of a meeting,³ and the partnership agreement or operating agreement may provide for informal approval of actions.

B. Clarification.

To the extent that a transaction is documented with incomplete or ambiguous terms, it may be possible to rectify the ambiguity by agreement, provided: that the ambiguities are not so great as to cause the contract to be invalid to begin with. In this respect, it is worth noting that all contracts are not created equal. For example, the formation of a partnership or limited liability company, while requiring an intent of the member, members or partners may not require more than the agreement to form an organization as many of the provisions of the

¹ Model Business Corporation Act (“MBCA”) § 7.04 Comment 2, 8 Del. C. § 228.

² MBCA § 7.06, 8 Del. C. § 229 (“Whenever notice is required to be given under any provision of this chapter or the certificate of incorporation or bylaws, a written waiver, signed by the person entitled to notice, or a waiver by electronic transmission by the person entitled to notice, whether before or after the time stated therein, shall be deemed equivalent to notice.”).

³ But see, 8 Del. C. §§ 18-302(d) (“Unless otherwise provided in a limited liability company agreement, on any matter that is to be voted on, consented to or approved by members, the members may take such action without a meeting, without prior notice and without a vote if a consent or consents in writing, setting forth the action so taken, shall be signed by the members having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all members entitled to vote thereon were present and voted.”).

arrangement are supplied by the statute in the absence of a contrary provision of the partnership or operating agreement.

C. Correction.

To the extent there is an inadvertent mistake in the manner in which the written documentation reflects the transaction, a correction to the written documentation should be retroactively effective.

D. Ratification.

Often actions are taken by agents without full authority. These transactions may be avoided by the principal – unless the agent had sufficient apparent authority or inherent agency power to bind the principal – or the principal may ratify the transaction in which case the transaction may cause the action to be retroactively effective to the date it was taken by the agent.

E. Void and Voidable Transactions.

A voidable contracts is one where one or more parties have the power, by a manifestation of election to do so, to avoid the legal relations created by the contract, or by ratification of the contract to extinguish the power of avoidance.⁴ Generally a voidable transaction will be considered a completed transaction while a void transaction will not. For an attempt use the concept of voidable transactions to effectively cause a transaction not to have happened see *Linton v. U.S.*, 104 AFTR 2d 2009-5176 (DC Wash. 2009). The service has ruled that in order so a dividend to be disregarded, it must be void, not merely voidable.⁵ In Rev. Rul. 71-269⁶ minor students who borrowed money for education sought to treat repayment of the loans as charitable contributions because their agreement to repay the loans was voidable as a result of their status as minors. The ruling held that they were not entitled to the charitable deduction even if the loan documents were voidable.

III. Example: Backdated Stock Options.

As of mid-2007 over 100 public companies had confirmed backdating stock options.⁷ Using misdated or undervalued stock options caused averse tax consequences for the issuing corporation,⁸ and for the service provider.⁹ As with other temporal modifications, it is not the misdating that creates the problem, it is failure to disclose the misdating.¹⁰

⁴ Restatement (Second) of Contracts § 7 (1981).

⁵ Rev. Rul. 75-375, 1975-2 CB 266 citing *Charles G. Duffy*, 2 T.C. 568 (1943) “Before the Federal income tax effect of a declaration and payment of a dividend may be ignored, the action of a corporation’s board of directors in declaring and paying the dividend must be void and not merely voidable.”).

⁶ 1971-1 CB 93.

⁷ Industry Director Directive on Backdated Stock Options Directive #1 (LMSB Control No. 04–0407–036) (June 15, 2007) (“This issue was identified from media reports of a practice among some publicly traded companies to backdate stock option exercise prices to a date that provides a lower cost to acquire the underlying stock. This issue also exists for stock options described as discounted, mis-priced, mis-dated, or in-the-money, and may arise from clerical or other errors in addition to deliberate backdating. Over one hundred companies have confirmed backdating stock options in SEC filings and press releases.”)

⁸ Because the option did not equal or exceed the per share value on the grant date, the compensation attributable to the option exercise to be subject to the \$1 million deduction limit or IRC § 162(e). Treasury Regulations § 1.162-27(e)(2)(vi).

⁹ Because the option was in fact “in the money” at the time issued, it will not qualify as an incentive stock option under IRC § 422 (so the employee may have income tax at the time of issuance and time of exercise and the employer will have withholding obligations) and may be subject to IRC § 409A..

¹⁰ Backdating is not itself illegal, provided that the benefit to the employees is recorded on the corporate books as a non-cash compensation expense to the corporation, in accordance with an accounting convention promulgated in 1972 referred to as Accounting Principles Board Opinion No. 25.

Discounted stock options subject to backdating are not subject to transitional relief under IRC § 409A.¹¹ Civil and criminal penalties have been asserted by the SEC and the IRS in connection with misrepresentations concerning backdated options. As noted in the outline, it is the misrepresentation, not the backdating that has given rise to sanctions.

In EMISC 2009-006, citing Treas. Reg. § 1.421-1(c)(1) dealing with the effective date of statutory options, the service considered the date of issue of options. The date of actual issue determines whether the options were issued with a strike price equal to fair market value of the optioned stock. It ruled:

For purposes of § 162(m), the date of grant of a stock option is the date the granting corporation completes the corporate action constituting an offer of sale to an individual of a certain number of shares of stock at a fixed price per share. The grant dates LMSB examination used to compute adjustments, which are generally based on the measurement dates the taxpayers used for accounting purposes, are reasonable and appropriate dates under the present circumstances to use for purposes of applying § 162(m).

In other words, whether the option is “in the money” will turn on the date on which the corporate action approving the issuance of the option is taken. Thus, in order to determine whether a “backdated” option is effective, the date of valid corporate action will govern.

¹¹ Treasury Press Release HP-128 (October 4, 2006).