Opinion

The Compensation Game

By GERALD H. SILK AND NOAM MANDEL

With hundreds of public companies facing SEC investigations, the scandal over backdated stock option grants continues to grow, illustrating once again that the state of governance over executive compensation is in shambles.

Imagine you could travel back in time to pick your stocks. Just think what a successful investor you would be! You could sit comfortably in your living room reviewing old editions of The Wall Street Journal, identifying equities that used to trade low and now trade high. Then simply travel back to a day when your chosen stock was at or near its absolute low, and buy a nice position. Fast-forward to the present, and you've got a handsome locked-in profit — all because you were vested with this very special power.

Buying stocks with perfect hindsight is not, however, a privilege generally available to any investor. Indeed, recent developments make clear that the capacity to purchase stocks retroactively was reserved for the chosen few — the senior managers, directors and other insiders who, through their domination of the machinery of the companies they manage, seem able to extract compensation on whatever terms they desire.

Of course, these individuals aren't actually traveling back in time to purchase stocks. Rather, for many years, insiders at many corporations across the country did the next best thing: backdated stock options. These revelations have sparked wide-ranging investigations by the Securities and Exchange Commission, Department of Justice and other federal regulators and have drawn the ire of institutional investors, many of whom have initiated civil lawsuits.

And for good reason. Despite recent claims by some in the financial community that the scandal is overblown, backdating stock options harms corporations and their shareholders in several key respects. Stock options are not Monopoly money — they represent real corporate obligations with a real impact on a company's finances and financial reporting. As a Department of Justice representative testified to the Senate Banking Committee on Sept. 6, stock option backdating, "can only be seen as a brazen abuse of corporate power to artificially inflate the salaries of corporate wrongdoers at the expense of shareholders."

A stock option is a right to buy a particular stock at a fixed price, called the "exercise" or "strike" price. When the stock's market price is higher than this strike price, the option is "in the money," and the option holder may exercise the option at a profit, paying the strike price and pocketing the difference. Thus, the lower the exercise price, the more profitable the option. When public companies issue stock options as compensation, they must do so according to the terms of formal stock option plans that are publicly filed and approved by shareholders. Importantly, these plans almost universally require that stock options issued to insiders carry exercise prices no lower than the market price of the underlying stock on the date the options are granted.

A review of stock option grants to executives at public companies across the United States reveals a disturbing trend: Since at least the mid-1990s, executives and other insiders at an alarming number of public companies have regularly received stock options on dates when the public trading price of the stock was unusually low. The dates of these grants were typically at or near annual or periodic lows, immediately before a substantial run-up in the stock price or immediately after a sharp decline.

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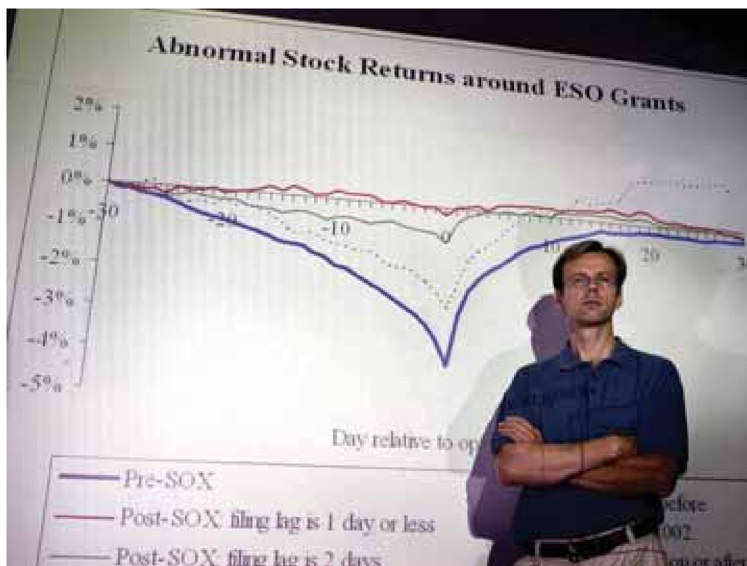
ABOVE: FORMER COMVERSE TECHNOLOGY INC. CFO DAVID KREINBERG FACES CHARGES FOR ALLEGEDLY MANIPULATING STOCK OPTIONS. LEFT: SECURITIES AND EXCHANGE COMMISSION CHAIRMAN CHRISTOPHER COX APPEARED BEFORE A SEPT. 6, 2006, SENATE BANKING COMMITTEE HEARING ON THE STOCK-OPTIONS BACKDATING SCANDAL. BELOW: AUTHOR GERALD H. SILK REPRESENTS INSTITUTIONAL INVESTORS IN A SHAREHOLDER DERIVATIVE ACTION AGAINST UNITEDHEALTH CORP. OVER ALLEGED OPTIONS BACKDATING.

Indeed, one need only mark the claimed grant dates on line graphs of stock prices to note the remarkable consistency with which grants appear at "valleys" or other periodic lows in the historic stock price. These all too frequent patterns seem to trail off after August 2002, when the SEC promulgated rules under Sarbanes-Oxley requiring disclosure of stock option grants within two business days of the grant.

Common sense alone suggests that more than simple coincidence is behind the highly auspicious — and suspicious — timing of these stock option grants. An example, and one of the most striking fact patterns yet to emerge from the burgeoning backdating scandal and associated investigations, is the case of Minnesota-based health care provider UnitedHealth Group Inc.

Photo by Hugh Williams



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THE WORK OF UNIVERSITY OF IOWA FINANCE PROFESSOR ERIK LIE IS CREDITED WITH EXPOSING THE BACKDATING SCANDAL THAT HAS RATTLED WALL STREET. HIS EXAMINATION OF SEC FILINGS REVEALED A PATTERN IN WHICH EXECUTIVE STOCK OPTIONS WERE GRANTED AT PRICE DIPS IMPOSSIBLE TO PREDICT.

Between 1997 and 2002 the current chief executive and chief operating officers of UnitedHealth Group Inc. received stock option grants on the single lowest trading day of the year four years in a row and within pennies of that low in the other two years. As of the close of UnitedHealth's last fiscal year, these two officers by themselves owned stock options worth in excess of $2 billion — much of which was directly attributable to the low-cost options they received during these years.

Statistical studies conducted by academics, securities analysts and the financial press likewise demonstrate that it is virtually impossible for the fortuitous patterns of stock option grants claimed by numerous companies to have occurred randomly. For example, The Wall Street Journal, working with several professors of finance and statistics, concluded that the likelihood of grants to UnitedHealth's chief executive officer occurring as claimed were one in 200 million. By contrast, according to the same article, the "odds of winning the multi-state Powerball lottery with a $1 ticket are one in 146 million."

In another classic example, the former president and chief executive officer of Affiliated Computer Services, Jeffrey A. Rich, reaped more than $60 million from improperly backdated option grants. Specifically, from 1995 to 2002, Rich received more than 1 million stock option grants, each awarded at or near the lowest annual stock price for those years, and typically immediately before a substantial run-up in the stock price. The results of a statistical analysis of the grants to Rich recently published in The Wall Street Journal concluded that the chances of the grants actually occurring as claimed were 1 in 300 billion.

The backdating scandal is but the latest in a long line of outrages in the area of executive compensation at public companies — abuses that shareholders have been largely powerless to combat. Courts in Delaware and other states have traditionally reviewed executive compensation under the "business judgment rule," a standard that leaves compensation to directors' business discretion and renders it very difficult for the investing public to challenge even the most absurd and excessive compensation packages.

The essentially unhindered authority of corporate boards to determine executive compensation has become so ingrained that managers of public companies now routinely extract tens and often hundreds of millions of dollars in unjustifiable compensation in full view of their shareholders and with complete impunity. Such was the case earlier this year when ExxonMobil announced the $400 million retirement package given its departing chairman and CEO in the face of much public outcry. It seems plain that shareholders' views on compensation are given scant consideration in the board suite.

In this context, the revelations about stock option backdating add insult to injury and underscore the utter lack of effective governance over executive compensation practices that exist in the United States today. As this story continues to develop, it appears that the regular backdating of stock option grants could only have been achieved through incredible failures by corporate boards — and compensation committees in particular — to live up to their fiduciary obligations and provide the governance and oversight for which they are ostensibly elected.

In another egregious example from UnitedHealth, the chief executive's employment contract contained a highly unusual provision allowing him to choose the dates of the grants by "oral notification" to the chairman of UnitedHealth's compensation committee. In the case of Comverse Technology Inc., former Chairman and CEO Jacob "Kobi" Alexander made off with almost $140 million in cash from exercising backdated stock options and created a slush fund of backdated options to spread the wealth among a cadre of loyal employees. There is no question that option backdating practices such as these could not exist if compensation committees were doing their jobs.

The backdating scandal is also a symptom of the self-interested notion long held among many corporate insiders and their advocates that stock options are basically free — costless enterprises with no real price tag. For years an analogous debate regarding the proper accounting treatment of stock option grants raged, with corporate insiders insisting against all reason that stock options granted as compensation to executives have no real value and, therefore, should not be treated as expenses.

But stock option backdating causes a direct and continuing waste of valuable corporate assets. Public

companies are the counterparties of stock option contracts with members of their management, and the gains obtained by insiders through exercising backdated options are therefore siphoned, on a dollar for dollar basis, directly from the companies and their shareholders. A simple hypothetical example crystallizes the point.

Assume that the chief executive officer of X Corp. receives a grant of 100,000 options to purchase X Corp. stock, which is today trading at $100 per share. Three months ago, however, X Corp. stock was trading at $50 per share. Finally, assume that the stock price increases to $200 per share, at which time the CEO exercises the options. If the stock options were granted at the appropriate exercise price of $100, the CEO will need to pay the company $100 per share to exercise those options, for a total payment of $10 million ($100 x 100,000). If, on the other hand, the stock options are backdated to the date three months ago when the stock price was at $50, the CEO will pay the company only $5 million ($50 x 100,000) to obtain the same amount of shares — a loss of $5 million to the company.

Thus, by backdating the options, X Corp.'s chief executive obtains a sweetheart deal — $20 million worth of stock at half price without having to put in the sweat equity required to legitimately enhance the performance of the company and the stock price for the benefit of all shareholders.

The practice of backdating grants of stock options also causes companies to overstate earnings in their publicly filed financial statements. As SEC Chairman Christopher Cox testified to the Senate Banking Committee, "[r]ather obviously, this fact pattern results in a violation of the SEC's disclosure rules, a violation of accounting rules, and also a violation of the tax laws." The relevant accounting rules require that, when a company grants a stock option with an exercise price below the value of the underlying stock (i.e., an "in the money" option), the company must recognize the difference in value as an expense on its financial statements and charge that difference to earnings.

Returning to our hypothetical, when X Corp. grants the "in the money" stock options with an exercise price of $50, X Corp. is obligated to account for the $50 difference between the exercise price and current trading price as an expense. Thus, when a company backdates a stock option grant, it is overstating the company's earnings by failing to charge the "in the money" options as an expense.

Backdating also overstates earnings when companies improperly take federal income tax deductions on backdated stock option grants to executives. For example, when an executive exercises stock options, the company typically can take any gain pocketed by the employee as a deduction on its tax return, because the Internal Revenue Service views the profit as extra compensation paid to the employee. In contrast, "in the money" options do not qualify for this deduction. To the extent a company took advantage of such deductions on backdated options, those deductions were impermissible, resulting in overstated earnings.

Companies that engaged in backdating have begun to feel the consequences. Nearly 50 companies are expected to restate their previous financials, and many have been delisted from exchanges for their inability to file financials at all. The costs of conducting internal investigations — and of fending off investigations conducted by regulators and civil plaintiffs — will be staggering. The scandal has caused the loss of many millions of dollars for shareholders, and harmed the reputations of many companies.

To date, the SEC is investigating stock option backdating at over 100 public companies, while the Federal Bureau of Investigation is conducting at least 40 investigations and the Department of Justice has already charged a number of individuals with criminal violations. Shareholders have likewise asserted their rights, pursuing numerous derivative lawsuits on behalf of companies where these abuses occurred and where shareholders cannot reasonably rely on conflicted boards to seek the appropriate redress. Investors also have filed numerous securities class actions where revelations concerning backdating have caused stock price declines.

Nevertheless, it seems that almost every day brings news of yet another company involved in the backdating scandal, and the situation grows increasingly serious. In the end, the backdating story underscores, yet again, the shambles in which we find the state of governance over executive compensation in the United States. Cheating at the compensation game continues. ■

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FORMER COMVERSE TECHNOLOGY GENERAL COUNSEL WILLIAM SORIN EXITS BROOKLYN FEDERAL COURT WITH HIS WIFE. HE IS THE FIRST GENERAL COUNSEL TO FACE CRIMINAL CHARGES OVER AN ALLEGED BACKDATING SCHEME.