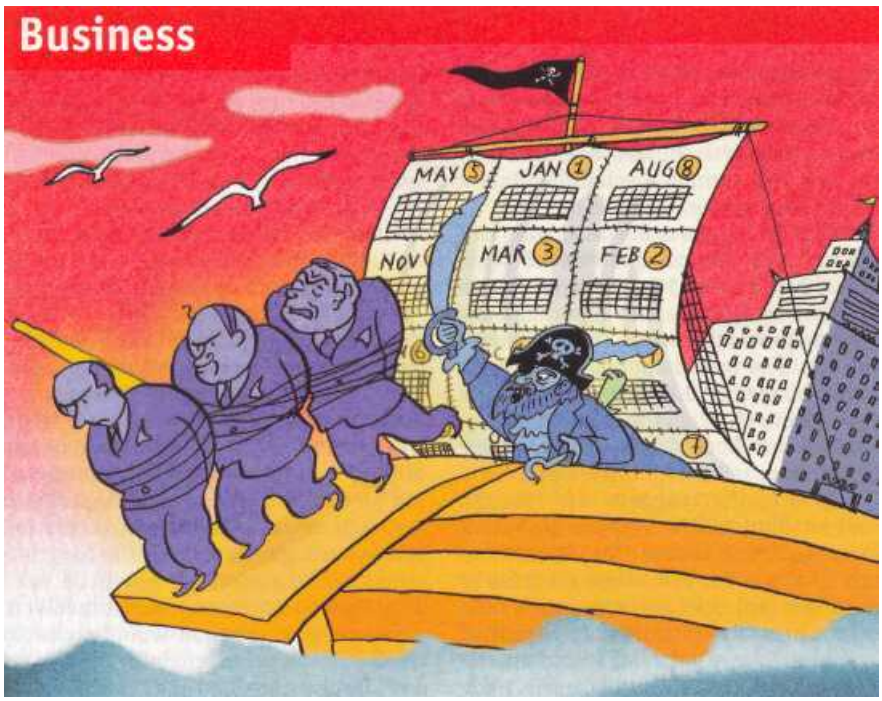

Options backdating

Walking the plank

NEW YORK

More chief executives lose their jobs amid America's options-backdating scandal

THE toll has now reached 34 top executives and directors, and counting, including no fewer than six chief executives in the past week. Corporate America has never seen anything quite like the carnage caused by the scandal over the backdating of employee share options. Over 100 companies are known to be under investigation for allegedly backdating options to value them at low points in their share prices, and several hundred more have come under suspicion.

On October 15th came the most significant departure so far. William McGuire, the boss of UnitedHealth Group-a health insurer with a stockmarket value of $63.4 billion-agreed to leave after a report to the board by a law firm concluded that he had benefited from backdated options and criticised him for apparently failing to disclose conflicts of interest arising from his financial dealings with William Spears, the chairman of UnitedHealth's compensation committee. This cloud has a silver lining for Mr McGuire, however: depending on the outcome of negotiations with the firm, he could walk away with options and other benefits worth over $1 billion. That is on top of the $53om he has earned since taking the top job at UnitedHealth in 1992.

Others to lose their jobs in recent days because of alleged backdating include the heads of McAfee and SafeNet, two computer-security firms, CNET Networks, an internet publisher, KLA-Tencor, a semiconductor firm, and Sapient, a consultancy. Speculation remains rife about the fate of Steve Jobs, the guiding light at Apple Computer. A subcommittee of Apple's board, which included Al Gore, a former vice-president, cleared Mr Jobs of any misconduct and said that he did not benefit personally from backdating or understand its accounting implications (backdated options should have been treated as a cost). But it noted that Mr Jobs "was aware that favourable grant dates had been selected" in some instances.

Pre-emptive strikes

The backdating scandal was triggered by several academic papers that identified suspiciously favourable patterns in the timing of option grants. Ominously, "Lucky Strike", a conference to discuss backdating on October 3Oth in Washington, DC, will air more academic research that raises questions about executive pay. For example, a study by Alan Jagolinzer of Stanford University has found that executives trading under SEC rule 10bs-1, which is designed to ensure they do not take advantage of insider information, has generated suspiciously high returns.

So far, only two firms-Brocade Communications Systems and Comverse Technology—have had charges related to backdating brought against their executives. That so many firms have removed top executives without any charges having been brought against them is unprecedented, and, according to some experts, the clearest proof yet that there has been a sea change in corporate governance during the past five years. Boards have come to understand that pre-emptively cleaning their own houses is likely to help in their dealings with regulators and prosecutors.

The limited action by regulators and prosecutors may also reflect the difficulty that they are having with demonstrating wrongdoing. Backdating itself is not illegal, though a lack of accurate disclosure of it may well be fraud. Moreover, backdating has become a byword for a whole series of activities, some of which seem unambiguously wrong (Comverse is alleged to have created a slush fund of options allocated to non-existent employees), but many of which may simply have resulted from negligence and disorganisation.

Some of the biggest users of share options for employees are entrepreneurial growth-oriented firms, which are often too preoccupied with trying to succeed to devote much time to internal controls and bureaucratic best practice. The report to UnitedHealth's board is a lot more convincing about the inadequacies of the firm's internal systems than it is in showing that Mr McGuire knowingly sought to benefit by backdating options or failed to disclose a conflict of interest. In the years before 2002, when backdating was common, there was a "different control environment, a different economic environment", firms were in a battle for talent in which a juicy option package was the best recruitment tool and "people just weren't thinking all that much about the details of option accounting", says Roman Darmer, a lawyer involved in the investigations

that led to the departures at McAfee.

Given the enthusiasm with which America's trial lawyers tend to sue at the first whiff of corporate wrongdoing, there have been surprisingly few lawsuits filed over backdating so far, says Frank Graves of the Brattle Group, an economic consultancy that provides expert testimony in court. One difficulty is that courts require a paper trail, not just statistical irregularities, to be convinced that wrongdoing occurred. Another challenge is demonstrating clearly what impact, if any, backdating had on the value of a firm's shares. Because of statistical lags, uncertainty about exact dates and accounting restatements by firms as they try to record their backdated option grants, "value impacts are often a little ambiguous", says Mr Graves.

This is underscored by the different ways in which markets have reacted to the various executive departures. Shares in McAfee jumped on news of the departure of its tainted bosses; CNET'S shares dropped on its announcement. UnitedHealth's share price, which has not recovered the ground it lost when allegations were first made against Mr McGuire, slipped again on news of his departure—which is perhaps not surprising given that, whatever his wrongdoings, Mr McGuire had made his shareholders a fortune over the years by turning a small firm into a hugely successful industry leader.

All of which raises the fascinating and entirely hypothetical question of what would happen if Mr Jobs could not remain the boss at Apple, which reported a big jump in profits this week. The company's shareholders would not want to lose the man who revived their firm with products such as the iPod, says Joe Grundfest, co-head of the Rock Centre for Corporate Governance at Stanford University.

Mr Grundfest suggests the "Martha Stewart solution". Having done time in jail for obstructing justice, Ms Stewart returned to run her firm while the roles of chairman and chief executive, with their particular legal responsibilities, were filled by others. Indeed, jokes Mr Grundfest, it is a wonder that the Martha Stewart solution-which lets the boss do the fun parts of the job while a "chief sacrificial lamb" shoulders the legal burdens-has not already become the norm. •

Fonte: The Economist, v.381, n.84500, p.73-74, 21 Oct. 2006.