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Executives backdating stock options, is this “blind luck” or the last straw?

Over the last few months, a scandal has erupted regarding executives at public companies back dating stock options to the lowest price of the year or the quarter. What is clear is that it is almost beyond any shadow of a doubt that the executives have done what the allegations say they have done, and there is a strong case that they have broken securities law. The fact that they have totally broken the trust of shareholders, and the spirit of the very reason why stock options are in existence, which is to provide incentives to executives to be rewarded for performance is not up for debate. The whole model of the American capitalist system over the last 25 years is that if you reward performance, there is some justification for the gross exorbitant pay of executives, and companies can be forgiven for their relentless crusade to fire workers, and to pay them less money with far fewer benefits. Now that it is out in the open that executives are in essence playing “back to the future” with options, it calls into question the whole structure of our economic system.

The goal of the article is not to discuss the moral or ethical implications of the actions of the executives, but to explain the implications of the option scandal as it affects investors, and how investors should absorb this new information and implement this into their stock selection process. We think that this scandal will have wide ranging implications that will have much more impact on the markets than what has transpired to date.

One of the most important aspects of investing due to the very ambiguous nature of accounting rules, and our securities laws is to have an understanding of what CEO’s can get away with, and how far they will push the envelope. Investors must know just how cunning and greedy the CEO’s are, because they are the ones giving out the numbers. And, with the current extremely lax regulatory environment you can’t count on the regulators to scare the executives into telling the truth. Thousands of investors spend thousands of hours analyzing the ability of companies to hit earnings targets published by Thompson Financial, yet all an executive has to do is to make one slight change to a reserve account or to a pension liability, or to slightly change the tax rate they are paying, and the company will make or miss numbers. And, in most cases, a CEO at any given time can make or beat the numbers unless they are experiencing an extremely bad quarter. Why study the underlying business or the technical charts if you don’t have a firm grasp on whether the numbers are legitimate? Investors that use technical analysis say that the price action will tell them what is going on with the company. But, isn’t technical analysis just the interpretation of the actions of hundreds or thousands of investors. If you are analyzing the decisions of thousands of investors, and they are all wrong, because they are basing their actions on inaccurate information given out by management, how can technical analysis work? How many technical analysts foresaw Enron or Worldcom? Yes, in the end, in most cases, companies are punished for ill gotten gains, but by then investors have already lost their money. And in some cases companies get away with it. GE and IBM are two companies that critics think have been egregiously aggressive in the presentation of their financial results, yet neither of these companies had to go through meaningful SEC investigations.

The Wall Street Journal has been at the forefront in exposing the stock option backdating scandal. In an article on March 18 th, many of the details of the scandal were exposed, and the details were extremely illuminating. What struck me was how brazen the companies were, both in their actions with the stock options, but just as importantly, in how they responded to the allegations. Two cases cited in the article involving United Healthcare and Affiliated Computer offer wonderful examples of just how greedy the executives are, and also how much they are willing to make up stories to distort the truth.

According to the Wall St. Journal article, on October 13, 1999, William W. Mcguire, CEO of United Healthcare was granted 14.6 million options, which were worth $717 million at the time the article was written in March of '06. The day of the grant was the day that United Healthcare's stock price was at its low for 1999. Options grants issued to the "good Doctor" in 1997 and 2000 were also issued on the day with the lowest stock price in the given years. You would think that he would at least try and hide it, and, say, pick out the 18 th lowest price of the year. He probably would have still made hundreds of millions. Obviously, it is impossible to be able to in three out of four years pick out the lowest price of the year for your stock option issue dates. But, the response by a United Healthcare spokes person is what is really interesting. According to the Journal, a compensation committee person from United Healthcare said the October 1999 option grant issued to Dr. Mcguire wasn't backdated, but was awarded concurrently with the signing of Dr. Mcguire's contract. He went on to explain a depressed stock price spurred directors to wrap up negotiations and get options to management. So, are we supposed to believe that the date in which the directors hurried up to get the options out was the exact date of the lowest price of the year? Can you imagine the audacity of him thinking people would really believe such a ridiculous excuse? What about the other two years, did they have perfect timing in rushing the options out on those two years as well?

The backdating issue with Affiliated Computer Services (ACS), as reported by the Journal is just as amusing and preposterous as the United Healthcare situation. Jeff Rich, the CEO of ACS, received 500,000 option grants at $11.53, adjusted for stock splits on October 8 th,1998. This happened to be a bottom of a steep plunge in ACS's stock price. The stock fell 28 % in the 20 days prior to October 8 th, and rose 60 % in the succeeding 20 trading days. According to the Journal, ACS's spokes person said that Mr. Rich was given the options as a reward for being promoted, but the promotion didn't go through until February of '99. How does she explain the fact the stock option issue date was October 8 th? Easy, she says that the October 8 th date was in anticipation of the promotion. It is interesting how the anticipation date was on the absolute bottom of a wild swing from low to high for the stock. Mr. Rich claims that his fortuitous issue dates were just "blind luck".

Here are the implications of what I have described. This is, number one, not a situation of "a few bad apples", as over 50 companies have come out and admitted inquiries in one form or another. CEO's have resigned, and penalties have been assessed by the SEC. Every day it seems like a new company comes out and admits a problem. Many have said that this is not illegal. This is an interesting presumption. Here is a description of its stock option plan in a recent 10 K filing from a company called Inter tel, " In each instance, director plan options must be granted at not less than 100% of the fair market value of our stock at the date of the grant". According to the Journal companies options are granted under a shareholder approved "option plan" on file with the SEC. The plans typically say that options will carry the stock price of the day the company awards them or the day before. If it turns out they carry some other price the company could be in violation of securities fraud. Why would Inter tel put that statement in its 10 k unless it is required by the SEC? They certainly wouldn't add in a new restrictive law for themselves. And then there is the issue of how this affects financial results. There is a law on the books that states that an option grant that is already many millions in the money represents an expense that must be described in a public company's 10 K. Obviously none of these backdated options was noted in SEC filings by the executives. By guaranteeing that they will make millions via backdated options, they are adding to the expense of the company by lowering earnings per share in the form of share dilution. And, just think of all the money that has been borrowed to buy back shares to offset the dilution from option grants.

Another very interesting side issue to this scandal is that Sarbanes - Oxley legislation made it a law that executives must notify investors via a filing with the SEC within 2 days of issuing stock options. This, in affect, takes away the executives ability to get away with the back dating, because you would know 2 days later exactly the date of the option issuance. It is interesting that business associations have been screaming bloody murder about the onerous provisions of Sarbanes - Oxley. They claim that many companies are not going public because of the high cost of adhering to Sarbanes - Oxley. This is interesting in light of the high number of IPO's over the last year. Could it be that the paying subscribers of the business associations don't want to have to report within two days that they have issued stock options? The larger business associations in the U.S. are typically supported by Fortune 500 companies. Since when did these companies care about a small start up trying to go public?

I believe that this scandal proves beyond a shadow of a doubt that many of the current crop of executives in America are fearless, and that they believe that their lawyers and paid off politicians can make any problem go away. And, I believe that many people including my self didn't think that so many CEO's were capable of committing such brazen acts of cheating. This could be the last straw for trust given to America's executives. Every word uttered by a CEO must be parsed, and analyzed, and it is as important, if not more important, to understand the quality of the numbers given as it is to understand the underlying business, and its industry. And what good is a model if all the numbers are faulty? This, ladies and gentleman is more proof that there is more than a "few bad apples" in corporate America. In my opinion this scandal proves that there is money to be made by understanding what these CEO's are capable of doing, and how far they will push the limits of accounting law.