

Backdated Options May Snare Some Directors as Critics Blast Rubber-Stamping

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As the pace of investigations quickens in the stock-option backdating scandals and companies kick off their annual shareholder meetings, there's mounting evidence that many directors failed in their roles as corporate watchdogs and may soon face consequences.

The backdating scandals — one of the most widespread federal crackdowns ever on U.S. companies — also have outraged high-powered shareholders who have been fighting for years to curb what they call lavish pay for executives.

With annual corporate meetings and the spring proxy season in full swing, shareholders are pressuring companies to stop backdating, and to link executives' pay to their performance, whether good or bad.

Corporate-governance experts and shareholders' attorneys say the breakdowns in oversight by directors were so blatant that they led straight to backdating and accounting problems.

Backdated options grants are not illegal if companies follow accounting and SEC disclosure rules.

"Directors need to be held accountable," says Dan Pedrotty, director of the AFL-CIO's Office of Investments. "When misconduct of this type takes place, it harms investors and creates a crisis of confidence in companies."

At least 257 companies have announced internal reviews, inquiries by the Securities and Exchange Commission or Justice Department subpoenas on stock options grants since the late 1990s, according to shareholder research firm Glass Lewis. Some 85 corporate officers and board directors at 46 companies have resigned or been fired or demoted.

By manipulating grants to dates when companies' share prices were low, some company officials increased the value of their options when they cashed them. Companies with backdating troubles have restated financial results and lost billions of dollars in stock-market value.

On the shareholder front this year, labor and public pension funds and other large investors have filed 270 pay-related resolutions, up from 175 last year, says Carol Bowie, vice president at Institutional Shareholder Services, a research firm.

The resolutions urge companies to give shareholders an advisory vote on executives' pay, and to strengthen their oversight of pay practices, including the backdating of stock options.

One shareholder, Amalgamated Bank LongView Funds, has filed backdating resolutions at nine firms, including Apple, Analog Devices and Caremark. The resolutions urge the firms to set a fixed date for grants, which would deter manipulation, say Julie Gozan, the bank's director of corporate governance.

In Apple's case, shareholders' lawsuits allege that the firm's compensation and audit committee members knew about a backdating scheme and breakdown in audit controls at the Silicon Valley company.

Apple said in December that an investigation by outside law and auditing firms found 6,400 backdated grants, including two large grants to CEO Steve Jobs.

Apple said that records showed Jobs' second grant was approved at a special board meeting on Oct. 19, 2001, but the records were improper and the meeting did not take place. The investigation found no misconduct by Jobs. Apple spokesman Steve Dowling said Apple's investigation "found that no grants after 2002 required adjustment, and Apple did make significant changes in its stock-option grant practices in response to evolving accounting and legal requirements."

Restive shareholders

In another sign of shareholder unrest, proxy-research firms ISS and Proxy Governance are advising investors to withhold their votes at today's shareholder meeting for several directors at Take-Two Interactive Software because of backdating and other issues.

Ryan Brant, the former CEO of Take-Two, the maker of the popular Grand Theft Auto video game, pleaded guilty last year to a criminal charge of falsifying business records and settled SEC charges.

Only a handful of executives have been indicted or charged, but more are expected. Last August, SEC Commissioner Roel Campos said he wouldn't be surprised to see charges brought against "outside" directors, who aren't corporate management.

What's emerged so far shows many boardrooms were filled with see-no-evil directors who condoned or ignored backdating, say governance experts.

"Directors failed in their fiduciary duties," says Paul Hodgson, senior research associate at The Corporate Library research firm. "They should have been aware that backdating would lead to improper accounting. Ignorance is no excuse."

The range of directors' backdating involvement alleged in court filings is eye-opening.

At high-tech firm Novell, for instance, a dozen current and former directors approved and backdated an unknown number of grants from 1997 to 2003 to inflate stock profits for officers and directors, according to a shareholders' lawsuit.

Former Novell CEO and chairman Jack Messman left the firm last summer, and Novell has hired a law firm to investigate its backdating practices. The company says it may restate its financial statements and faces possible delisting from the Nasdaq Stock Market.

In other cases, only one or two executives and directors seemed to run the grant process.

At Broadcom, former CEO and co-chairman Henry Nicholas and current Chairman Henry Samueli were a two-man committee that rubber-stamped hundreds of backdated grants to directors and employees over five years, lawsuits allege.

In still other cases, audit and compensation committee members — ideally, the independent-minded watchdogs of a company's practices — allegedly played a role in the backdating problems.

At Comverse Technology, former CEO and chairman Jacob "Kobi" Alexander and former chief financial officer David Kreinberg, also a former Comverse director, were charged with a stock-manipulation scheme that allegedly reaped them millions of dollars.

Three directors on the compensation committee — including Alexander's sister, Shaula Yemini, a former director — gave verbal consent to some grants in telephone calls, an FBI affidavit shows. The directors told the FBI they did not know the grants were backdated.

Jacob Alexander fled to Namibia but was arrested and faces an extradition hearing next month. Kreinberg pleaded guilty to securities fraud last fall.

An old practice

While most backdating problems have surfaced in the past year or two, backdating has been widespread for a decade, a recent study shows.

The "Lucky Directors" study, by scholars at Harvard and Cornell universities and the INSEAD business school, found that 9% of 28,764 dates when grants were awarded to one or more directors between 1996 and 2005 fell on days when their companies' stock prices hit a monthly low.

"A large number of directors — much larger than those named in legal proceedings — received stock-option grants that were opportunistically timed," says Lucian Bebchuk, a Harvard Law School professor who co-authored the study.

The study also found a strong link between backdating and weak corporate governance. Grants were more likely to be backdated when a board lacked a majority of independent directors with no business or personal ties to management.

Corporate-governance experts have long warned about timid directors' oversight. In the country club atmosphere of boardrooms, many directors are too chummy with CEOs to criticize their high pay.

A study last fall by The Corporate Library of "interlocking director relationships" concluded that 43% of the 120 companies under investigation at the time had directors who sat on more than one board among those firms. The study noted that backdating "may have been spread by word of mouth."

Charles Elson, head of the University of Delaware's Center for Corporate Governance, says backdating is symptomatic of wider corporate-governance problems. Firms plagued by backdating also have been criticized for excessive pay practices and other issues.

Often directors felt uncomfortable with backdating but failed to ask tough questions, says Roger Raber, president of the National Association of Corporate Directors. "They never thought to say, 'This doesn't smell right; something is wrong here,'" Raber says.

Another problem: Pay packages are so complex that boards rely on compensation consultants close to management, says Ralph Ward, publisher of the *Boardroom Insider* online newsletter.

"If your comp committee has guys with just a lay knowledge of pay practices, the directors go by what consultants tell them," Ward says. "And guess what? Those consultants have a vested interest in keeping the CEO happy."

But some big shareholders are taking countermeasures:

- The AFL-CIO labor federation — representing \$400 billion in union-sponsored pension plans — has launched a "Say on Pay" campaign and filed 40 shareholder resolutions calling for advisory votes on pay practices such as backdating.
- The Council of Institutional Investors (CII), which represents 140 pension funds with \$3 trillion in assets, has written 1,500 companies about their stock-option grant policies. So far, 82 firms say they're reviewing their grant-dating policies, says analyst Cambria Allen.
- The California Public Employees' Retirement System (Calpers), the largest U.S. public pension fund, with \$230 billion in assets, has urged 69 companies to disclose their findings on backdating, and to adopt stronger policies. Calpers spokesman Clark McKinley says some companies are improving only CEO pay packages, and that's not good enough. "We really want to see corporate bylaw changes with good controls and constraints for all officers down the road," he says.

Directors can't hide. If they don't act in "good faith" and investigate questionable pay practices, they can be found liable in the backdating scandals, say legal experts and recent rulings by the influential Delaware Chancery Court.

The backdating scandals, plus tougher regulation after the accounting disasters at Enron, Tyco and other companies, have jolted many directors once more.

At UnitedHealth Group, one of the largest companies under SEC investigation for improper backdating, new management has made sweeping reforms. The company will add five independent directors and require annual board approval of all stock awards.

After an internal investigation led by former SEC enforcement director William McLucas at the WilmerHale law firm, UnitedHealth said last fall that it will cut earnings by \$1.6 billion from 1994 to 2005, plus pay added income taxes of \$100 million.

"Since these revelations came to light, it does appear that directors are seizing control of compensation to a greater degree," says Amy Borrus, CII executive deputy director, speaking of backdating in general.

But governance experts want tougher steps. They want more independent directors, more evaluations of boards and more performance-based pay for directors, to give them a greater stake in their companies.

They also urge boards to hire directors with real pay expertise, and to use independent pay consultants who aren't buddies with CEOs.

"Some companies are taking steps in the right direction," says Gozan, "but there's still a long way to go."