Backdating Stock Options: A Primer in Social Irresponsibility

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Abstract: *Backdating stock options refers to the falsification of stock issuance documentation by corporate officials in order to receive a favorable stock price. A lower stock price provides assurance of a greater payoff once the option is exercised and sold. This paper argues that backdating stock options is representative of the intrinsic nature of those controlling the corporate form. Stock options are granted as an incentive of corporate ownership; however, corporate officials have circumvented this intent through the use of the backdating mechanism. Using a Veblenian analysis, it is presumed that backdating stock options represents another common practice of pecuniary coercion by those controlling "Captains of Industry and Finance" who have separated themselves from the instincts of ownership and workmanship. Current commentary focuses on the need to reinvigorate the social and political spheres with a desire to adapt to the ways of the business sphere.*

Keywords: backdating, stock options, pecuniary coercion, Captains of Industry and Finance

Every week, as a public, we are made aware of acts of corporate corruption—corporate inversion[i] and other tax avoidance schemes, insider trading, etc.—as well as information that we find questionable (even though not necessarily illegal) such as platinum parachutes[ii] and the astronomically out-of-kilter executive-to-worker pay ratio.[iii] The intent of this paper is to shed light on the extent of one such mundane yet egregious form of corporate malfeasance—the backdating of corporate stock options, a symptomatic example of a catholic corporate malaise.

The premise is simple: it does not take a leap of faith to surmise that today's "Captains of Industry and Finance," ultimately focused on pecuniary gain through stock price appreciation, will use similar creative manipulation techniques to line their own pockets. Further, it is proposed, as others have in the past, that such acts of corporate misconduct are indicative of an inherent flaw in the corporate form. The

analysis will be supported through a Veblenian framework supplemented by current commentary on the subject of corporate malfeasance. This paper will conclude with a consideration of reform proposals under this framework. The fundamental assertion being, given the premise, a shift in public perspective will need to occur, in conjunction with a refocusing of governmental bodies, news media, and trade unions. This shift will constitute a continuous, activist role of watchdog over the curs of our capitalist society.

Stock Options – An Attempt to Re-prioritize the Corporate Managers' Goals

The corporate hierarchy is upside-down: stockholders, the owners-in-interest of the shares in their respective corporate entities, bear the risks associated with these going concerns, while the managers of these particular entities control the well-being of these business enterprises. In other words, the risk-bearing, reward mechanism is no longer in operation. In this principal-agent relationship, the managers often reap great rewards and bear little risk in comparison to the pain/pleasure borne by the stockholders. Increasingly displeased with this predicament, stockholders rebelled in the 1980s, a decade which saw enormous increases in executive compensation and a continued emphasis on corporate empire-building by these executive managers. To alleviate this agency problem, the idea was to realign managerial incentives with those of the stockholders through the issuance of stock options in the very business enterprises these managers controlled. Re-prioritize the incentives of management and once again managers would be focused on the bottom line and profit maximization and would be less concerned with executive amenities:

> Stock options were hailed two decades ago as a remedy for runaway executive pay. Academics, politicians and investors, tired of seeing CEOs pocket big money for a so-so job, pushed to have stock options become a primary method of compensating executives. Options—granting the right to buy stock tomorrow at today's price—would pay off only if the company's stock went up. To advocates

> they were the ideal carrot, an incentive for good work that aligned executives' interests with those of shareholders.[iv]

According to an article in *The Economist* ("The Stockpot: The Story of Pay is Largely the Story of Share Options," January 20, 2007), "the story behind the growth of pay in the 1990s is really the story of the option." For example, the number of stock options issued by the S&P 500 companies escalated from $11 billion worth in 1992 to $119 billion worth in 2000 and $71 billion worth in 2002 (based on 2002 dollars).

Along with the theoretical underpinning of agency realignment, several other factors contributed to the increased use of stock option-grants. First, corporate entities are not required to treat unexercised options as a corporate expense; instead corporations merely have to footnote the existence of options under current Securities and Exchange Commission rules.[v] As noted by James V. Cornhels, this circumstance may be considered beneficial to the corporate entity, in that

> [t]his failure to count them as an expense inflates the book earnings of the corporation and can give a false impression of the corporation's profitability and financial health. They are, nonetheless, a liability for the corporation. The failure to expense them may serve to drive up the price of the stock and make the options more valuable.[vi]

Second, legislation passed in 1993 limited the tax break allowance for executive compensation. Under this new law, "companies could not deduct yearly compensation of more than $1 million for any one of their top five officers;" however, stock options and other forms of pay linked to compensation were exempted.[vii] Third, "Congress left alone an older law that gave companies a tax deduction whenever stock options were exercised," which meant that "the employer can deduct a dollar from its income for tax purposes for every dollar of option gains pocketed by employees."[viii]

These three reasons explain the attractiveness of stock options in comparison to other forms of compensation; however, the *WSJ* reporters (who broke the backdating story and are discussed in more detail later in this article) provide two other reasons for

the proliferation in size of those options granted. First, every board (as well as the managers themselves) considers its leaders above average, so it goes without much explanation that, if every board assigns grants based on pressure to pay their management above average amounts, then the average number of stock options granted will continually increase.[ix] Additionally, an escalating stock price will continue to inflate the value of stock options even if the same amount of options is granted each year; in other words, if each year one receives the same number of options but the stock price continues to increase, then the valuation of those options grows at an increasing rate.[x]

Backdating Stock Options – Isolated Incidents or Systemic Flaw?

To understand how backdating of stock options occurs, it is best to first explain the basic mechanics of stock options. Initially, the board of directors' compensation committee will grant executives stock options as part of the executive compensation package. The directors are giving the executives the right to buy shares in their particular company at a strike price, the market price of the stock on the date of issuance of the options. As noted above, the intent is that stock options provide an incentive for the executive to focus on stock price appreciation—the valuation of the stock options increases as the stock price goes up, if the stock price depreciates the stock options are worthless until a later date when and if the stock price appreciates above the strike price.

Stock options may be exercised (claimed) once vested (no longer contingent, usually one year from the issuance date) in which case the executive may buy the shares at the strike price and then hold them or if he or she chooses sell them at a profit. Those executives receiving options generally have ten years to exercise their options once vested. To give the reader an idea of the value of these options, let us note that, according to a 2006 survey of 350 large corporations by Mercer Human Resources

Consulting, 185 CEOs exercised options for a median gain of $3,299,193 (of these 350 corporations, 246 granted stock options to their CEOs).[xi]

If a stock option is issued on a date other than the grant date, it is referred to as a false date. A false date refers to falsifying documents in reference to the date of issuance of the stock options, which is an earlier date (a back date) when the stock price was lower. Effectively, false dating or backdating, is cherry picking, i.e., the stock options are granted at a favorable price so the executive's potential payoff is greater. Not only does backdating increase the potential payoff, it increases the likelihood of a payoff; both results are counter indicative of the goal professed.[xii] In other words, why do boards of directors secure payoffs to their executives when the goal of stock option granting is to promote stock option appreciation *by* the executives, not *for* the executives? Is the intent to give the executives head starts?

The illegality of backdating arises from the false disclosure of the stock option grant in violation of a company's shareholder-approved option plan on file with the SEC. An allegation of securities fraud usually arises if the plan states that options "will carry the stock price of the day the company awards [the stock options] or the day before," but the documentation carries a different date.[xiii] Additionally, accounting rules will have been violated in that the inflated paper gain, the valuation of the stock option being only a gain on paper until exercised and sold, constitutes "extra pay" which is a cost to the company.[xiv] This cost, if not booked properly, will have the effect of overstating profits. If caught, the company's financial results will need to be restated. Finally, recent allegations of tax fraud involve a derivative form of backdating; in these cases, company officials are accused of backdating exercise dates, rather than the grant dates, to take advantage of the lower capital gains tax. Instead of being completely subject to the short-term capital gains tax of 35% under an "exercise-and-sell" strategy, the offender backdates the exercise date giving the appearance of a "buy-and-hold" strategy and will have to pay 35% on the difference between the stock prices on the

grant date and exercise date, the short-term capital gain, but will only have to pay the 15% long-term capital gains tax on the gain made when the shares are sold.[xv]

The *Wall Street Journal* broke the story on backdating stock options in an article titled, "The Perfect Payday" dated March 18, 2006. In that initial article, it was released that several companies were under investigation by the Securities and Exchange Commission, including Affiliated Computer Services, UnitedHealth Group, Mercury Interactive, Analog Devices, Brooks Automation, Comverse Technology, and Vitesse Semiconductor. Although lengthy, the endnotes include the journalists' reporting of former CEO Jeffrey Rich's fall from Affiliated Computer Services as an example of the machinations involved in the production of such a scheme and then the cover-your-behind, yet still ultimately ill-advised, PR needed once a company has been found out.[xvi]

Academic research on the subject of backdating initially grew out of research pertaining to market timing—the notion that stock option grants may be issued to coincide with optimistic information releases.[xvii] Erik Lie, a finance professor at the University of Iowa's Henry B. Tippie College of Business, did a study of 5,977 CEO stock option grants from 1992 to 2002 that found, however, an abnormal pattern of movement in stock price before and after options were "granted," which he concluded was too fortuitous to have occurred by chance (or through market timing, the original hypothesis). He concluded that the grants must have been retroactively dated.[xviii] Lie was able to test his hypothesis with the passage of Sarbanes-Oxley in August 2002. Under Sarbanes-Oxley, companies granting stock options no longer have 45 days to report granting activity, rather such activity must be reported within two business days. In conjunction with Randall Heron of Indiana University's Kelley School of Business, Lie analyzed 3,735 stock option grants made after August 2002 through December 2004. Their research found a significant pattern change—for those following the new two-day deadline the abnormal pattern disappeared; however, for those not following the new

rule (approximately 20% of those studied had chosen to flaunt the rule) the abnormal pattern of movement around the "grant" dates continued.[xix] This research, in conjunction with SEC allegations pertaining to Mercury Interactive, precipitated the *Wall Street Journal*'s expanded investigation into backdating allegations.

Perhaps the most disturbing information arising out of the backdating beat at the *Wall Street Journal* consists of the *Journal*'s investigative reporting pertaining to allegations of backdating and opportunism in the wake of 9/11. According to a July 2006 report,

> [a] review of Standard & Poor's ExecuComp data for 1,800 leading companies indicates that from September 17, 2001, through the end of the month, 511 top executives at 186 of these companies got stock-option grants. The number who received grants was 2.6 times as many as in the same stretch of September 2000, and more than twice as many as in the like period in any other year between 1999 and 2003.
>
> Ninety-one companies that did not regularly grant stock options in September did so in the first two weeks of trading after the terror attack. Their grants were concentrated around September 21, when the market reached its post-attack low. They were worth about $325 million when granted, based on a standard method of valuing stock options.[xx]

The *WSJ* reporters go on to ask, "Did companies take unseemly advantage of a national tragedy?"[xxi] When questioned, some companies proposed that "they issued options to capture the new more favorable prices as a way of calming and motivating managers rattled by the terrorist attacks and ensuing economic fears;" others worried about the departure of key employees, while others said compensation committee meetings were already scheduled and who was to say that the stock prices may not have decreased even more than they did in the month of September.[xxii] The *WSJ* reporters note, however,

> [s]ome of the post-9/11 grants were extraordinarily timed, hitting the exact low for the period. At least six of the companies that granted options dated after the attack are under investigation in the wider options-timing probe. That raises the

> question whether some grants that appear to have been granted in the post-attack period were actually made later, then backdated.[xxiii]

As of March 30, 2007, 140 companies were under investigation for backdating stock options.[xxiv] And, according to the December 27, 2006 article in the *Wall Street Journal*, "[m]ore than 60 executives and directors of public companies [had] lost their jobs so far, 17 of them chief executive officers." For example, when UnitedHealth, a giant health insurer, was accused of backdating stock options, its CEO was forced to resign and forfeit $200 million in stock options; additionally, because of improper cost allocation associated with these backdated stock options, the company had to restate past earnings by $1.7 billion.[xxv]

Even though Sarbanes-Oxley has diminished the occurrence of backdating significantly,[xxvi] the long-term effects of backdating will be felt for many years to come since many options have yet to be exercised and/or sold.[xxvii]

Backdating Scandal is Representative of a Larger Issue

The history of the corporate chartering system is emblematic of the devolution of the corporate form. The chartering of a joint stock company, the predecessor to the corporate entity, was a rigorous process, obtained by few, and only if one could support the "public interest."[xxviii] Once a charter was granted the process did not end—a new corporate entity was subject to sunset clauses and dissolution for improprieties, "all investors had equal voting rights," and business activities outside the privy of the charter were prohibited.[xxix] Through lobbying efforts, however, industrial capitalists of the Civil War era were able to diminish the role of the corporate charter. "By the end of the nineteenth century, the instrument of corporate charters was transformed from a check on the activities of corporations into a device for raising revenues for the various states, who competed with each other to pass less and less restrictive general incorporation laws."[xxx] Today, this "race to the bottom" among the chartering states is

symbolic of the corporate form's lost public interest component.[xxxi] Given the lack of a strong public interest motive, backdating stock options is symptomatic of the private interest focus present in our corporate entities.

In *The Theory of Business Enterprise*, Thorstein Veblen paints an unsympathetic portrait of those leaders seated in the upper echelon of the corporate hierarchy. Developing his theory of the modern business enterprise, Veblen states that his aim is to outline "in what manner business methods and business principles, in conjunction with the mechanical industry, influence the modern cultural situation."[xxxii] Veblen begins his exposition with the introduction of the machine process and its effect on investment:

> [I]nstead of investing in the goods as they pass between producer and consumer, as the merchant does, the business man now invests in the processes of industry; and instead of staking his values on the dimly foreseen conjunctures of the seasons and the act of God, he turns to the conjunctures arising from the interplay of the industrial processes, which are in great measure under the control of business men.[xxxiii]

Veblen continues to elaborate on the shift in focus from industrial efficiency and industrial balance to business efficiency and the profit motive:

> In proportion as the machine industry gained ground, and as the modern concatenation of industrial processes and of markets developed, the conjunctures of business grew more varied and of larger scope at the same time that they became more amenable to shrewd manipulation. The pecuniary side of the enterprise came to require more unremitting attention, as the chances for gain or loss through business relations simply, aside from mere industrial efficiency, grew greater in number and magnitude. The same circumstances also provoked a spirit of business enterprise, and brought on a systematic investment for gain. With a fuller development of the modern close knit and comprehensive industrial system, the point of chief attention for the business man has shifted from the old-fashioned surveillance and regulation of a given industrial process, with which his livelihood was once bound up, to an alert redistribution of investments from less to more gainful ventures, and to a strategic control of the conjunctures of business through shrewd investments and coalitions with other business men. . . . The keeping of the industrial balance, therefore, and adjusting the several industrial processes to one another's work and needs, is a matter of

> grave and far-reaching consequence in any modern community, as has already been shown. Now, the means by which this balance is kept is business transactions, and the men in whose keeping it lies are the business men. The channel by which disturbances are transmitted from member to member of the comprehensive industrial system is the business relations between the several members of the system; and, under the modern conditions of ownership, disturbances, favorable or unfavorable, in the field of industry are transmitted by nothing but these business relations. Hard times or prosperity spread through the system by means of business relations, and are in their primary expression phenomena of the business situation simply. It is only secondarily that the disturbances in question show themselves as alterations in the character or magnitude of the mechanical processes involved. Industry is carried on for the sake of business, and not conversely; and the progress and activity of industry are conditioned by the outlook of the market, which means the presumptive chance of business profits.[xxxiv]

Having established the corporate structure as primarily a vehicle for pecuniary gain, Veblen repeatedly advises us that the corporate leader is apt to manipulate the industrial system through "interstitial adjustments" and is indifferent as to "whether his traffic affects the system advantageously or disastrously" since "[h]is gains (or losses) are related to the magnitude of the disturbances that take place, rather than to their bearing upon the welfare of the community."[xxxv]

These "Captains of Industry," as so named by Veblen, care little about the serviceability of their companies' production; rather their focus is upon the vendibility of said products.[xxxvi] Inevitably, these "Captains of Industry" are driven towards industry consolidation since market share attracts pecuniary gain.[xxxvii]

Discussing these businessmen, Veblen admits that they may be constrained to some extent by salutary factors such as equity, fair dealing, and workmanlike integrity, but, this is not the norm and such sentimentally is usually tempered by disassociation and the drive for pecuniary gain:

> Under modern circumstances, where industry is carried on a large scale, the discretionary head of an industrial enterprise is commonly removed from all personal contact with the body of customers for whom the industrial process

> under his control purveys goods or services. The mitigating effect which personal contact may have in dealings between man and man is therefore in great measure eliminated. The whole takes on something of an impersonal character. One can with an easier conscience and with less of a sense of meanness take advantage of the necessities of people whom one knows of only as an indiscriminate aggregate of consumers. Particularly is this true when, as frequently happens in the modern situation, this body of consumers belongs in the main to another, inferior class, so that personal contact and cognizance of them is not only not contemplated, but is in a sense impossible. Equity, in excess of the formal modicum specified by law, does not so readily assert its claims where the relations between the parties are remote and impersonal as where one is dealing with one's necessitous neighbors who live on the same social plane. Under these circumstances the adage cited above loses much of its axiomatic force. Business management has a chance to proceed on a temperate and sagacious calculation of profit and loss, untroubled by sentimental considerations of human kindness or irritation or of honesty.[xxxviii]

Veblen concludes his analysis of the modern businessman by addressing the uselessness of advertising and competitive selling in reference to industrial efficiency. Commenting on the misconstrued impact of such activities, Veblen states:

> In so far as its results are not detrimental to human life at large, such unproductive work directed to securing an income may seem to be an idle matter in which the rest of the community has no substantial interests. Such is not the case. In so far as the gains of these unproductive occupations are of a substantial character, they come out of the aggregate product of the other occupations in which the various classes of the community engage. The aggregate profits of the business, whatever its character, are drawn from the aggregate output of goods and services; and whatever goes to the maintenance of the profits of those who contribute nothing substantial to the output is, of course, deducted from the income of the others, whose work tells substantially.[xxxix]

The outcome of such "parasitic lines of business" is wastefulness on the part of the "Captains of Industry" and additional performance pressure applied to those "engaged in the industrial employments":

> While it is in the nature of things unavoidable that the management of industry by modern business methods should involve a large misdirection of effort and a very large waste of goods and services, it is also true that the aims and ideals to

> which this manner of economic life gives effect act forcibly to offset all this incidental futility. These pecuniary aims and ideals have a very great effect, for instance, in making men work hard and unremittingly, so that on this ground alone the business system probably compensates for any wastes involved in its working. There seems, therefore, to be no tenable ground for thinking that the working of the modern business system involves a curtailment of the community's livelihood. It makes up for its wastefulness by the added strain which it throws upon those engaged in the productive work.[xl]

Applying Veblen's perspective to today's scandal, it is not far-fetched to assume our "Captains of Industry" would stoop to manipulative, self-aggrandizing schemes given the necessary means of opportunity and disassociation.

In an article entitled, "Behavior and Rationality in Corporate Governance," Oliver Marnet discusses complicity on the part of the supposed gatekeepers monitoring today's chief executives. According to Marnet, boards of directors are heavily influenced by the CEO, especially since the CEO often has a part in the selection of board members. Such a relationship, referred to as "board capture," can have a significantly negative impact upon board independence.[xli] Additionally, impartiality on the part of external auditors is compromised by close working relationships with top executives of the companies being audited as well as through financial incentives.[xlii] In respect to the backdating mechanism, the *WSJ* reporters have uncovered instances where inattentive directors either were expected to ignore the favorable dates or approve blank paperwork; interestingly, in the UnitedHealth situation, the CEO was allowed to pick his own option grant date and then orally notify the chairman of the compensation committee.[xliii]

Clearly, opportunity is not an issue; the other necessary component to demonstrate is disassociation. As noted by Veblen, these modern businessmen have specifically disconnected from all aspects of industrial production. Shifting from concerns of serviceability to vendibility of the product, the "Captains of Industry"

continue to shift their pecuniary concerns into what today may be referred to as money manager capitalism.[xliv] These financiers, considering themselves part of a special class, continue to remove themselves from all other aspects of the industrial system, effectively eliminating interaction with engineers, workers, vendors, suppliers, and consumers, in the name of stock price appreciation. Many, having not risen through the ranks of their own companies, lack the paternalistic bent associated with pride in ownership. Therefore, given the corporate elites' propensity towards pecuniary gain through "pecuniary coercion," with an insulated, singular motive, it is not difficult to imagine that these financiers will use similar methods to promote their own monetary gains.[xlv] Several degrees of separation between ownership and control have provided ample opportunity to commit and very little accountability to avoid these offenses; the ramifications of such coercive activities must leave little impact on their psyche, since the profits are so great and easily accessible.

Reform Proposals and Conclusion

Observing the current predicament, one has to consider whether changes should be made to the make-up of the corporate hierarchy, i.e., what should be done to level the playing field?

John Groenewegen, analyzing work done by Paul Bush and Marc Tool, postulates that the firm's instrumentally and ceremonially warranted values should be evaluated and prioritized based on the values of the "community of stakeholders."[xlvi] Assuming this valuation would shift emphasis to the instrumentally warranted values pertaining to technological innovation over the ceremonially warranted values characterized by custom and practice (e.g., advertising), the interests of the stakeholders over capital would need to be addressed.[xlvii] Under this evaluation, the change leadership role would be administered by the government and any desired changes

should be administered in small increments due to the existing institutional arrangements to avoid volatility to the system.[xlviii]

Similarly, but with a significant difference in the change leadership role, Dell Champlin and Janet Knoedler, referring to the works of J. M. Clark and Karl Polanyi, expound upon how the "individualistic precepts" of mainstream economics have "permitted business enterprise to eschew its responsibility to the public interest."[xlix] Both authors believe that, through individualistic, naturalistic ideology, the business class was able to disenfranchise other stakeholders. The political class paying deference to the business class led to a feeling of powerlessness by the voters.[l] Their notion is that by the breaking of the link between the economic sphere and the social and political spheres, the common person judges his two-cents has little effect on the economic realm.[li] These authors conclude that in order to promote an embedded economy, social values need to no longer take a backseat to economic values, and that since political interests are often joined to business interests, change leadership must come through public opinion.[lii] In other words, stakeholders must mobilize, reinvigorate unions, and reorient the news media to the broader public interests.[liii]

It is clear that readjusting incentives does not significantly affect the corporate mentality. Reactive legislation such as Sarbanes-Oxley may alleviate the symptom of a malignant growth; however, active reform legislation addressing the needs of the broader community ought to be advocated. Public outrage is a formidable tool if it can be harnessed and directed into constructive avenues of change.

One such measure may be the implementation of sustainability reporting as part of a corporate tax restructuring. Sustainability development is defined as meeting the needs of the present without compromising the ability of future generations to meet their own needs.[liv] Sustainability reporting incorporates economic, social, and environmental valuation of the activities of the corporation; a high score would indicate greater contributions to society than a low score.[lv] A firm could then be taxed based on

its score, i.e., firms considered as contributors, meeting certain standards, would be taxed at a lower rate than those firms participating in activities deemed detrimental to the economy, society, and/or the environment.[lvi] Such a change should facilitate a shift in most corporate perspectives; away from a short-term earnings mentality towards one based on long-term planning. As Hyman Minsky often pointed out, however, with all reform the players involved are driven to innovate and circumvent the system, so continual monitoring, revaluation, and reformulation of policy is always a necessary component in our capitalistic economy.[lvii]

Once an emblem of public interest, the corporate form has been denigrated into a vehicle for stock price manipulation. Many of our "Captains of Industry and Finance," far removed from the motives of ownership, use their control of the corporations to manipulate financial positions for professional as well as personal gain. They are profit takers not profit makers. Backdating stock options, although an egregious example of how deceptive these individuals may be, is also an example of how easy and simple it is to manipulate the system to one's benefit. Reform may take on several different avenues of limitations to stifle such manipulative actions—reporting, taxing, ceilings, time and monetary limits, etc. The key to change reform is that the social and political participants must want enforcement of accountability from the corporate world, and be willing and able to monitor such changes.

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[i] U.S. corporations stand to gain tremendous amounts in tax savings when they move their corporate headquarters to tax-friendly locales such as Bermuda, Barbados, or the Cayman Islands. For example, Tyco International estimates that it saved "an average of $450 million each year after 1997, when it arranged to make Bermuda its tax headquarters while keeping its executive offices in the United States" (Johnston, 2003, p. 232).

[ii] An April 27, 2007 *Wall Street Journal* article entitled, "A Pension to Retire For: $158.5 Million Plus," indicates the unfathomable pension packages top executives receive, e.g., given his 43-year tenure, including 17 years as CEO, Edward Whitacre, Jr. of AT&T stands to receive upon retirement a pension package worth $158.5 million. In addition, Mr. Whitacre will receive $24,000 in annual automobile benefits, $6,500 worth of home security annually, ten hours a month access on AT&T's corporate jet, free health insurance for him and his family for life, and a consultancy fee of $1 million a year for three years and $25,000 in country club fees for those same three years. Tax liability for most of these benefits has been assigned to AT&T.

[iii] Citing a 2006 survey by the Institute for Policy Studies, a *Wall Street Journal* article titled, "Limits on Executive Pay: Easy to Set, Hard to Keep," (April 9, 2007), indicates that "[t]he gap between CEOs and other workers has been growing since the late 1970s. The average big-company CEO made $11.6 million in 2005, or 411 times the typical U.S. worker."

[iv] The group of reporters on the backdating beat for the *Wall Street Journal* who won the Pulitzer Prize for public service reporting on April 16, 2007, explains the theoretical purpose for stock option use in an article for the *Wall Street Journal* ("Bosses' Pay: How Stock Options Became Part of the Problem," December 27, 2006).

[v] An attempt to change legislation in order to treat stock-option grants as corporate expenses failed in 1994. Ibid.

[vi] Cornehls, 2004, p. 48.

[vii] It is a no-brainer that stock option grants subsequently became the payment of choice. Ibid.

[viii] Quoting Paula Todd, a compensation expert at consulting firm Towers Perrin, the *WSJ* reporters noted: "With rules like these, 'what wasn't there to like about stock options? You could grant them in unlimited amounts, with no expense, and claim a tax deduction. [Companies] would pay their dry cleaners if they could in stock options.'" Ibid.

[ix] Characterized the "Lake Wobegon effect," after the Garrison Keillor town where all the children are above average. Ibid.

[x] The *WSJ* reporters provide an example: assume an executive is granted one million options at a stock price of $20 and then in the course of a year it increases in value to $30. The executive has $10 million worth of stock options; but now if he is granted another one million options and the stock increases by 50% in the course of a year then this new set of options will be worth $15 million. The same number of options was granted, however, because of stock price appreciation the second set of options was worth 50% more. Ibid.

[xi] "The Pace of Pay Gains: A Survey Overview." 2007. *Wall Street Journal*. (April 9).

[xii] "The Perfect Payday." 2006. *Wall Street Journal*. (March 18).

[xiii] Ibid.

[xiv] Ibid.

[xv] Preliminary research by David Yermack, Erik Lie, and Randall Heron shows that "13% of the exercises by CEOs who followed an 'exercise-and-hold' strategy and didn't immediately report the actions to the SEC came at their stock's lowest price of the month. That percentage is nearly three times as great as would be expected if CEOs were exercising on random dates, Mr. Yermack said, and is highly suggestive that some were backdating exercises to avoid taxes." As reported in a *Wall Street Journal* article, "How Backdating Helped Executives Cut Their Taxes," December 12, 2006.

[xvi] At ACS in Dallas, Mr. Rich helped turn a small technology firm into one with more than $4.4 billion in annual revenue and about 55,000 employees. ACS handles paperwork, accounting, and data for businesses and government agencies. It is a major outsourcer, relying on global labor. "It is a pretty boring business," Mr. Rich told the University of Michigan business school in 2004, "but there is a lot of money in boring."

While most of Mr. Rich's stock-option gains were due to rises in ACS stock, the exceptional timing of grants enhanced his take. If his grants from 1995 through 2002 had come at each year's average share price, rather than the favorable dates, he'd have made about 15% less.

An especially well-timed grant, in which Mr. Rich received 500,000 options at $11.53, adjusted for stock splits, was dated Oct. 8, 1998. This happened to be the bottom of a steep plunge in the price. The shares fell 28% in the 20 trading days prior to Oct. 8, and rose 60% in the succeeding 20 trading days.

ACS's Ms. Pool said the grant was for Mr. Rich's promotion to CEO. He wasn't promoted until February 1999. Ms. Pool said there was a "six-month transition plan," and the Oct. 8 option grant was "in anticipation" of his promotion.

Mr. Rich would have fared far worse had his grant come on the day ACS announced his promotion. The stock by then was more than twice as high. The grant wasn't reported to the SEC until 10 months after the stated grant date. Ms. Pool said that was proper under regulations in place at the time.

A special board committee oversaw Mr. Rich's grants. Most years, its sole members were directors Frank Rossi and Joseph O'Neill. Mr. Rossi declined to comment. Mr. O'Neill said, "We had ups and downs in

our stock price like any publicly traded stock. If there were perceived low points, would we grant options at that point? Yes."

Mr. Rich said grants were made on the day the compensation committee authorized them, or within a day or so of that. He said he or Chairman Darwin Deason made recommendations to the special board committee about option dates.

Mr. Rich, who is 45 years old, resigned abruptly as ACS's chief executive on a Thursday in September to "pursue other business interests." Again, his timing was advantageous. In an unusual separation agreement, the company agreed to make a special payment of $18.4 million, which was equal to the difference between the exercise price of 610,000 of his outstanding stock options and the closing ACS stock price on the day of his resignation.

But the company didn't announce the resignation that day. On the news the next Monday that its CEO was departing suddenly, the stock fell 6%. Mr. Rich netted an extra $2 million by cashing in the options before the announcement, rather than on the day of it.

Mr. Rich said ACS signed his separation agreement on Friday, using Thursday's price for the options payout. He said it waited till Monday to release the news because it didn't want to seem "evasive" by putting the news out late Friday.

[xvii] David Yermack, a finance professor at NYU's Stern School of Business, did a 1997 study in which he concluded that abnormal upswings in stock prices after stock option granting dates must be due to the effect of "opportunistic grant timing." Heron, R. A. and E. Lie. 2005. "Does Backdating Explain the Stock Price Pattern around Executive Stock Option Grants?" *Journal of Finance Economics 83*, pp. 271-295.

[xviii] Ibid.

[xix] Ibid.

[xx] "Executive Pay: The 9/11 Factor." 2006. *Wall Street Journal*. (July 15).

[xxi] Ibid.

[xxii] Ibid.

[xxiii] Ibid.

[xxiv] "Options Sleuth's Own Slip." 2007. *Wall Street Journal*. (March 30).

[xxv] "Bosses Pay: How Stock Options Became Part of the Problem." 2006. *Wall Street Journal*. (December 27).

[xxvi] In addition, a new accounting rule instituted in 2006 requires companies to "record an expense when they make an options grant, and reduce profits accordingly," which should have a significant impact on the number of options granted. Ibid. See also "Tweaking the Stock-Option Grant." 2007. *Wall Street*

Journal. (April 30). According to a Mercer report, "[s]tock-option grants constituted 46% of chief executives' long-term incentive pay in 2006, versus 78% in 1999."

[xxvii] Many option contracts contain a caveat in which the holder is allowed to obtain additional shares at the time of the sale of the exercised options. This practice is referred to as reloading. For example, if a manager has chosen to exercise and sell 500,000 stock options, he or she may obtain, or reload, 500,000 new stock options at the current market price, a new strike price. "Bosses Pay: How Stock Options Became Part of the Problem." 2006. *Wall Street Journal.* (December 27).

[xxviii] Champlin and Knoedler, 2003, p. 306.

[xxix] Ibid.

[xxx] Ibid., p. 307, citing Baldwin, William. 1987. *Market Power, Competition, and Antitrust Policy*. Homewood, Ill.: Irwin.

[xxxi] Ibid.

[xxxii] 1904, Ch. 3, p. 1.

[xxxiii] Ibid.

[xxxiv] Ibid., p. 2.

[xxxv] Ibid., p. 3.

[xxxvi] Ibid., pp. 3-5, 9.

[xxxvii] Ibid., pp. 5-6.

[xxxviii] Ibid., pp. 6-7, 9-10.

[xxxix] Ibid., p. 12.

[xl] Ibid., pp. 5, 12-13.

[xli] Marnet, 2005, p. 616.

[xlii] Ibid. Changes to auditing firms due to the passage of Sarbanes-Oxley has significantly curtailed the financial incentives pertaining to consultancy fees but does not affect the financial incentives pertaining to the desire for repeat business.

[xliii] "The Perfect Payday." 2006. *Wall Street Journal*. (March 18).

[xliv] A Minskyian term, money manager capitalism, like Veblen's theory of the cycle based on loan credit, refers to the debt structuring commonly utilized in the post-WWII era. According to Minsky, our capitalist society is characterized by firms who utilize debt in the furtherance of investment

opportunities. Under Minsky's framework the possibility of overextension is intrinsic within the system, given the capitalists' intent to expand, whereas Veblen's view focuses more closely on the intent of the capitalists and their relative indifference to the effect of their actions upon other aspects of the economy.

[xlv] Veblen, 1904, p. 4.

[xlvi] 2004, p. 357.

[xlvii] Ibid.

[xlviii] Ibid., p. 358.

[xlix] 2004a, p. 546.

[l] 2004b, pp. 898-900.

[li] Ibid.

[lii] Ibid., pp. 901-904.

[liii] Ibid., p. 904.

[liv] "Our Common Future." 1987. *Brundtland Report*. United Nations World Commission on Environment and Development.

[lv] Zalewski, 2003, p. 505.

[lvi] Ibid., pp. 505, 507.

[lvii] Ferri and Minsky, 1991.