Inside Jobs

The Wall Street Journal
Lucian Bebchuk
January 6, 2007

Apple Computer announced a week ago the conclusions of a special board committee that examined the "improper dating" of over 6,000 option grants during 1997-2002. The committee found no basis for having less than "complete confidence in [CEO] Steve Jobs and the senior management team," placing full responsibility for past problems on the company's former CFO and general counsel. But the company's report fails to dispel concerns about Apple's governance.

In reviewing past grant awards, the report discusses separately grants awarded to directors and to Mr. Jobs, but it lumps grants to senior managers other than Jobs together with all other grants. The company is surprisingly silent on whether any of these senior managers received "improperly dated" grants.

The report indicates that Mr. Jobs "was aware or recommended the selection of some favorable grant dates," but states that "he did not receive or financially benefit from these grants." But even though Mr. Jobs did not personally benefit from these grants, it turns out that he did benefit from other improperly timed grants.

In particular, Mr. Jobs received in 2002 an award of at-the-money options to buy 7.5 million Apple shares, roughly 2% of the total shares then outstanding. The grant was backdated by two months, which significantly increased the award's value. Surprisingly, Apple did not disclose the backdating of this large CEO grant in October when it announced the committee's "key findings."

When reporting about this grant in 2003, Apple noted that the grant comprised 32% of the total options awarded to Apple employees during 2002, and explicitly stated that the grant's exercise price was equal to the stock price on the grant date. Apple's report does not provide any insight into why the special committee found as fully acceptable the failure by Mr. Jobs and all other directors to notice the erroneous recording and reporting of this significant grant.

The special committee concluded that Mr. Jobs did not appreciate the "accounting implications" that the improper dating of grants had for Apple's financial statements. But improper dating may be viewed as wrong for reasons other than the accounting consequences. Thus, it is unfortunate that the report says little about what Mr. Jobs and others current senior managers knew and believed about the improper dating beyond noting Mr. Jobs's failure to appreciate the accounting implications.

Finally, the account suggested by Apple's report leaves readers wondering what incentive the former CFO and general counsel had to engage in improper dating. CFOs and general counsels commonly do not have primary responsibility for attracting and compensating employees. Why would these two former executives engage in massive backdating of thousands of grants without at least tacit support from other members of senior management? Why would they act to increase the compensation of a CEO who was unaware of their having done so? These mysteries add to the questions posed by the company's report.

Steve Jobs's great accomplishments have well earned him a place in the pantheon of high-tech leaders and visionaries. And Apple's senior management has undoubtedly done very well for shareholders during the past several years. All of this, however, clearly does not compel the conclusion that Apple's governance has performed adequately with respect to option grants. And the company's report falls far short of providing a basis for accepting such a conclusion.

Beyond Apple Computer, there are many other apples in the barrel of companies whose past option grant practices raise serious questions. In a recent study, "Lucky CEOs," Yaniv Grinstein, Urs Peyer and I estimate that 12% of public firms were involved in lucky grants awarded at monthly lows that cannot be explained by sheer luck. In a subsequent study, "Lucky Directors," we further show that outside directors received lucky grants not produced by sheer luck in an estimated 7% of public firms.

We also find evidence linking lucky grants with governance problems. CEO lucky grants were more common when the board lacked a majority of independent directors. In contrast to claims that gains from backdated grants served as an efficient substitute for other forms of compensation, CEOs getting lucky grants received more, not less, total reported compensation. Lucky grants to outside directors were more common in firms with entrenching arrangements that protect incumbents from removal. And outside directors' luck was correlated with CEO luck.

For corporate America to improve its governance going forward, boards should face up to -- and fully share with shareholders -- past governance problems in their companies.

Mr. Bebchuk, director of Harvard Law School's program on corporate governance, is co-author of "Pay without Performance: The Unfulfilled Promise of Executive Compensation" (Harvard University Press, 2004).