Study Finds Outside Directors Also Got Backdated Options

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Board members were not just blissfully ignorant or willfully blind bystanders when they backdated stock option grants for corporate executives, according to a new study. Some 1,400 outside directors themselves may have received manipulated grants over the past decade.

The research, to be released today, sheds new light on the stock options manipulation that has entangled more than 120 companies in a nationwide scandal. It suggests that what has been widely seen as a dot-com phenomenon to enrich managers in the executive suite probably extended to directors in the boardroom as well.

The study, sponsored by the Harvard Law School Program on Corporate Governance, also raises serious questions about corporate governance if the outside directors, who are supposed to act as a final backstop against bad practices, received — and in many cases may have even approved — fraudulent option grants.

“Opportunistic timing of directors’ grants is unlikely to have large dollar significance,” said Lucian A. Bebchuk, a Harvard Law School professor who is one of the study’s three authors. “But it has a large governance significance.”

The study is the latest in a series of papers by academic and governance research groups to explain the size and scope of the stock option scandal. More than 120 companies are under investigation by the Securities and Exchange Commission, ranging from Apple to the United Health Group and dozens of technology companies. The Justice Department and the Internal Revenue Service are conducting separate reviews. At least 60 executives and directors have been forced out or fired.

The study looked at about 30,000 directors at some 6,500 companies who were granted stock options from 1995 to 2005. By comparing the percentage of grants made at monthly low prices with the portion they expected had they been randomly assigned, the researchers were able to identify the proportion of the grants that appeared to have been manipulated.

They concluded that board members at about 460 companies, or seven percent of all publicly traded companies, probably received manipulated options. About 1,400 outside directors, or about 4.6 percent of board members, probably benefited from manipulated option grants.

However, the researchers attempted only to identify broad patterns in the data, not specific companies or board members. Nor did they calculate the potential dollar amount of the backdating benefit for the directors, which was probably far less than the potentially six- or seven- figure pay increase that the average executive received.

Backdating options is not necessarily illegal and the practice has been reduced by tougher reporting requirements introduced with the Sarbanes-Oxley Act of 2002. But even today, it can raise serious accounting, disclosure and tax issues. Most governance experts consider it bad practice.

The new research also helps debunk the common belief that outside directors would be immune to receiving manipulated stock options because their grants were typically awarded around the time of a company's annual meeting.

In fact, about 29 percent of the time, a company's directors were granted stock options on the same date as those given to executives, the study found. Those grants were much more likely to have been awarded at a favorable price than random chance might predict, and those odds increased when a grant was made at the same time as the chief executive's.

Other studies, such as one by the Corporate Library, has looked at whether directors on the boards at companies where stock option manipulation was commonplace may have passed along the practice to other boards. However, this appears to be the first study to measure the extent of outside directors who directly benefited from the practice.

The study comes at a time when the S.E.C. is indicating that it may take action against other so-called gatekeepers, including outside directors. One of the researchers, Yaniv Grinstein of Cornell, is working as a visiting scholar at the agency. And last summer, one of its commissioners publicly put board members on notice.

"If the facts permit, and I want to emphasize that all of our enforcement cases are very fact-specific, it wouldn't surprise me to see charges brought against outside directors," Roel C. Campos, an S.E.C. commissioner, said last August.