'Lucky' Stock Options Not Limited to Executives

Study Finds Board Members Profit, Too

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Chief executives weren't the only ones enjoying near-guaranteed profits from stock options in the past decade. Outside directors at hundreds of American companies also received option grants that are likely to have been manipulated, a new study found.

According to the study, 9 percent of 29,000 option grants to outside directors from 1996 to 2005 were granted on a day when the company stock price was at a monthly low. The likelihood of such a concentration of "lucky" grants is so low as to be statistically impossible, the study's authors said.

"It's like going to Vegas thousands of times and betting on red every time and winning more than half the time," said Lucian Bebchuk, the Harvard University professor who co-authored the report, titled "Lucky Directors," with Cornell University's Yaniv Grinstein and Urs Peyer, a professor at the French business school Insead. "From a numerical standpoint, it can't be random. There has to be some manipulation of the outcome."

The study found the "lucky grants" at about 460 firms, involving about 1,400 outside directors.

Outside directors are board members who aren't management, and they are the shareholders' chief representatives, responsible for overseeing management and making sure executives don't profit unnecessarily at shareholder expense. The Securities and Exchange Commission, following similar studies in recent years that focused on executive stock option grants, has been investigating options backdating.

More than 130 such companies have disclosed probes of their options-granting practices, and a handful of chief executives have lost their jobs because of backdating.

Options give the holder the right to buy company stock at a preset price, usually on the date the option is awarded.

When options are awarded to executives, they allow executives to profit from the rise in the stock price.

But when an option is priced at a date in the past when the price was low, it essentially guarantees a profit, thus negating the rationale for options.

Until this study, however, no one had focused on option grants to directors.

Bebchuk said the lack of attention was because the vast majority of options awarded to directors fall on the date of the annual meeting and are typically much smaller than executive options.

"In the data, we found that directors' grants are equally susceptible to manipulation," Bebchuk said.

A lucky director grant was more likely at companies where executives received lucky grants, the study found. And firms with a higher incidence of lucky option grants were more likely to have governance practices considered unfriendly to shareholders, such as a minority of independent directors on the board.

The firms were also more likely to have "entrenching" bylaws, which make it difficult for shareholders to remove directors.

The study is not the first to raise questions about a possible link between options backdating practices and board governance practices. A study by the Corporate Library of 120 companies implicated in backdating found a high incidence of interlocking directors, or directors who served on more than one company that backdated.

The study suggested that backdating practices may have spread from company to company through these interlocking director relationships.