US Options Scandal Derails S&N Deal

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America's widening scandal over the manipulation of executive share options has prompted the British healthcare company Smith & Nephew to abandon an attempted $11bn (£5.6bn) takeover of a US manufacturer of prosthetic joints, Biomet.

S&N had been widely tipped as the frontrunner to buy Biomet - which makes artificial hips, knees and joints - in order to create a combined global player to tackle surging demand for prosthetics from ageing populations.

But in a rapid succession of announcements yesterday, S&N withdrew and Biomet agreed to a $10.9bn takeover by a private equity consortium led by Blackstone Group and Kohlberg Kravis Roberts.

A source close to the auction said S&N was dismayed to discover the extent of Biomet's involvement in a scandal over backdated stock options which has swept across corporate America. It is one of more than 150 companies investigating whether its option grants were manipulated in the past to maximise executive earnings.

The source said the final straw was a decision by Biomet to delay its half-year results, which were due this week, while it continues to investigate its potential liability arising from the scandal: "There is no set of audited accounts on which a public company buyer can rely. A private equity buyer doesn't have quite the same obligations as a public company."

S&N's withdrawal is likely to set off alarm bells in many US boardrooms about the international impact of the stock options debacle. The Wall Street watchdog, the securities and exchange commission, and the US justice department are considering whether firms acted illegally in backdating options - a practice which became popular in the technology boom.

A study by Harvard Law School yesterday found that as many as 460 companies had regularly issued share options on seemingly fortuitous dates and that 9% of all options granted between 1996 and 2005 were at monthly low points in the share price - which maximises the future payout for directors.

The research found that the practice extended beyond executives to benefit at least 1,400 non-executive directors - raising questions about their supposedly independent oversight of boards.

The study's author, Professor Lucian Bebchuk, told the Guardian: "Independent directors are fundamental to the governance of public companies - both in the US and the UK. This raises important questions over what role they play."

More than 60 company directors have resigned or been fired as a direct result of the furore and several are facing criminal charges. One company, Cablevision, even granted options to a dead director, while making it look as if he was still alive.

An update from a special committee investigating Biomet's exposure said that less than 20m shares were granted at backdated prices over 11 years up to 2006. It said the procedures from granting options were "not well documented", adding: "This may potentially indicate a lack of appropriate internal controls and a failure to keep adequate books and records relating to stock option grants."

The committee said sorting out the problem "may have a material effect" on Biomet's past and present accounts - which showed a 5% increase in second-quarter sales to $520m. S&N declined to comment except in a brief statement confirming that "discussions have now been terminated"

Its shares jumped by 39.25p to 521.75p as the prospect of a rights issue to fund the takeover evaporated.

Backstory

Stock options are supposed to be a carrot to motivate executives to lift a company's shares. But many US firms have been rigging them by rewarding executives retrospectively for past share price rises. Apple's boss Steve Jobs has apologised for manipulating options and the US's second-highest paid executive, Bruce Karatz of KB Homes, lost his job last month over options-dating. Kobi Alexander fled to Namibia to escape a criminal trial over a slush fund of options set up by his firm, Comverse Technologies. The retailer Home Depot understated the cost of options by $200m (£103m).