

# financial executive

## Key to Avoiding Compensation Suits Governance

Abuses of executive compensation provide no end to work for plaintiffs' lawyers pursuing class-action litigation against, and derivative suits on behalf of, companies that — in issuing options or stock to senior executives — expose themselves to the risk that these grants will be misused through backdating and insider trading.

While there is some skepticism about whether recent regulatory efforts at corporate governance reform have been effective in dealing with these problems, Prof. Jesse Fried of the University of California at Berkeley offers two new, practical approaches companies can adopt to help prevent insider trading and options backdating litigation.

Those are well worth reviewing. In 2007, the U.S. Securities and Exchange Commission (SEC) brought more insider trading cases than it had in the entire decade of the 1990s. And according to SEC Enforcement Director Linda Chatman Thomsen, this pace will increase in the near future.

Consider that in January 2008, current and former top officers of UnitedHealth Group agreed to pay a record \$887 million to settle stock-option backdating charges brought by government agencies and by shareholders bringing private actions. This agreement exceeded a previous backdating class-action settlement record set barely three months earlier, in a case involving Mercury Interactive Corp. and alleged backdating covering the years 1997-2005.

### Compensation Abuses And Board Independence

Recent scholarship has drawn striking conclusions about the relationship between director independence and the incidence of option manipulation. In a November 2006 study called "Lucky CEOs," Profs. Lucian Bebchuk, Yaniv Grinstein and Urs Peyer of Harvard University concluded that stock option manipulation was strongly associated with CEO influence on company pay-setting and governance processes.

After reviewing more than 40,000 grants of stock options, the authors concluded that manipulation was significantly more likely in companies that did not have a majority of independent directors and in companies whose CEOs had long tenure.

However, regulatory efforts to ensure board independence have been met with mixed reviews. While the Sarbanes-Oxley Act and listing rules at the major U.S. securities markets set out requirements for the formal financial independence of board members, lively debate exists as to whether such measures alone are sufficient.

Some commentators have suggested that a focus on the absence of any formal financial ties between an independent director and the corporation can neglect so-called "soft" ties to management, such as a social friendship or membership in the same club, which can, theoretically, be just as pernicious to shareholder interests. Moreover, some executive compensation experts suggest that even if board

In the wake  
of a host of  
class-action  
litigation over  
stock-option  
backdating  
and insider  
trading, two  
attorneys  
advise that  
stock-grant  
policies can  
help ward  
off such suits.

By Edward Labaton and Michael Stocker

members are independent when appointed, there is little to limit the influence CEOs to reward directors who permit management to retain power over executive compensation.

Even without systematic changes in board structure, however, there are practical measures that every company can undertake to police stock manipulations by company executives. In recent work, Prof. Fried suggests

What publicly held companies often do not realize is that this time-consuming and expensive litigation can largely be avoided with modest changes in corporate governance.

two simple approaches.

**Practical Suggestion:  
“Hands-Off” Options**

Prof. Fried proposes the use of option grants providing for the automatic cashing-out of stock incentive plans according to a schedule announced at the time the options are granted. By permitting the exercise of options only at pre-set dates, companies can virtually eliminate the improper practice of timing the exercise of options to take advantage of inside information.

Pre-set schedules that permit cashing out only a small fraction of the original grant at a time would further safeguard against improper use of inside information by limiting incentive to profit from such information. At the same time, executives receiving stock options pursuant to “hands-off” plans would still profit from increases in share prices that result from their labors on behalf of shareholders.

**Practical Suggestion:  
Advance Announcement of  
Options Grants**

Like his “hands-off” approach to exercising options, Prof. Fried argues that companies can avoid the temptations of backdating by announcing all stock option grants at a set period in advance of the grant. If companies follow this practice, there is no danger that the timing of the grant of options can be calibrated to take advantage of changes in stock price.

If such announcements are made sufficiently in advance of stock grants, companies can also

avoid liability associated with “spring loading” — that is, timing the options grant to precede positive news that will lift share prices.

The constantly changing nature of regulation over executive compensation certainly poses great challenges to companies seeking to avoid risk and maximize benefits to shareholders. However, approaches like those of Prof. Fried suggest that, as long as corporations think creatively about reform, many of these worries can be avoided.

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**TAKEAWAYS**

>> Plaintiffs’ lawyers are still busy pursuing class-action litigation and derivative suits against companies that expose themselves to the risk that payment in company stock will be abused through backdating and insider trading.

>> In an effort to avoid problems arising from stock grants, corporations have undertaken certain governance reforms — such as the requirement that insiders trade only during prescribed windows. But these have had limited success.

>> Governance reforms could help avoid such problems. These could include a defined schedule for exercising options and a set period in advance for announcing stock option grants.

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