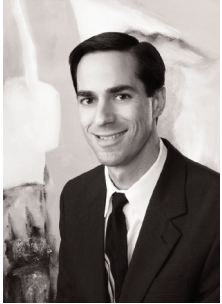


Keep the Lights On: Why What Our Parents Taught Us Still Holds True...In Business

by Justin D. Stets, a Principal with Carlson Capital Management



Darkness is the best friend of the adolescent. We can all look back to our teenage days and recall clandestine meetings with friends, turning off the car headlights for fast drives down unlit country roads and furtively reading adult magazines by flashlight in a tent far from home. When the lights are out, anything can happen. No wonder that parents are the ones who introduce us to the power of light. They immediately switch on the lights whenever teenagers huddle in a darkened family room. They remind us to always drive safely during the day or night always with our headlights on. They are the ones who draw us out of darkness and into the power of the light.

In business terms, the officers of a corporation would do well to always follow a “keep the lights on” policy, wherein all relevant actions amongst board members and management are clearly visible. If management and directors of public companies fail to adhere to this standard, shareholders should cry foul about the resulting lack of transparency.

The recent disclosures of United Health Care’s option program might be a great “keep the lights on” case study. Here’s the background: Companies may grant employees and, at times, board members the right to buy shares in their company at a pre-determined time and price. Such stock option programs are justified in that they are thought to align the interests of shareholders and management. This alignment is theoretically achieved by motivating management to focus on long term growth, economic viability and market strength.

In a typical stock grant program, Joe CEO is granted 1,000 shares of company X on a pre-determined date. The date

could be the annual meeting or a quarterly close. The stock closes on that pre-determined date at \$10.00/share. Joe’s job as CEO is to increase profitability through efficient resource allocation, product development, expense management, and other value-directed techniques. Joe hopes that his efforts will be recognized in the future by stock appreciation. If all goes well, several years later the stock price of company X is now at \$50.00/share. Joe then exercises his options and receives income of \$40.00/share- the difference between the strike price and the current market price.

Let’s now add an uncommon variation to this structure. Without fully disclosing to stockholders, the company decides to retroactively determine when options get priced. Instead of pricing options at the close of the annual meeting, or at the end of a quarter, the company decides to selectively go back over the last 6-9 months of trading activity and pick the lowest ending stock price. They then assign the stock option strike to that lowest-ending stock price date.

So ... what’s the problem with that? By backdating the strike price of the options, you artificially optimize wealth creation for stock option holders. Stated differently, you create wealth without requiring any specific or even general efforts of the option holders. The option recipient comes into the money by virtue of the fact that a low stock price was chosen retrospectively. It is truly a gift worth receiving!

When everyone is playing by one set of rules, but management and the board are playing by another, it is understandable that shareholders are outraged. The outrage is not directed at wealth creation; it is in how wealth is transferred. At its core, risk and wealth creation should be highly correlated to each other. Wealth creation relates to stock appreciation. Risk relates to a whole host of unknown market

forces, one primary factor being time. Transferring wealth to employees should not be optimized through a backdating policy for one very simple reason: if you don't incur the risk, you should not receive any benefit.

Whether or not UNH has, in fact, engaged in this activity will be borne out over time. If the CEO of a company had previously communicated a backdating options program to all stakeholders, then disclosure would be a non-issue for stockholders. Suspicions are aroused, however, when a program is immediately cancelled due to the lights being turned on.

Market-based reforms and other steps may eventually fix the many problems with corporate compensation, but real change is unlikely to occur unless we all demand the kind of transparency that comes from adhering to the kind of "keep the lights on" policy of which our parents would be proud. We must reject actions that occur behind closed doors which have the appearance or the reality of manipulating information to the benefit of one stakeholder group over another. Management works on behalf of the shareholders and not the other way around. Directors and management need to follow the simple advice of our parents: Turn the lights on and behave yourself.



CARLSON CAPITAL MANAGEMENT LOCATIONS

NORTHFIELD

11 Bridge Square
Northfield, Minnesota 55057
507.645.8887

HASTINGS

12181 Margo Ave. South, Suite 250
Hastings, Minnesota 55033
651.437.2360

ROCHESTER

150 South Broadway, Suite A
Rochester, Minnesota 55904
507.288.9797