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Can You Have Your Stock and Sell It, Too?

Critics contend that something is amiss when companies buy back stock at the same time executives are selling.

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Add a new wrinkle to the longstanding debate about the wisdom of share-repurchase programs: claims of a conflict of interest.

Companies cite many good reasons for buying back shares: the practice boosts earnings per share, it sends a signal that the company considers its shares undervalued, and it finds a use for some of that vast cash horde many firms have. Companies could, of course, pay a dividend, but many prefer the flexibility of buybacks because they are occasional events (the issuance of a dividend usually creates an expectation of regular payouts). But what happens when a company buys back its shares at the same time that executives are selling theirs? There are no laws to prohibit officers and directors from selling company stock while the company is buying. But at a time when investors and regulators are hypersensitive to even the appearance of conflicts of interest, some critics are asking whether officers and directors who promote and authorize massive stock-buyback programs should also be taking the other side of those trades.

“In our view, there is an inherent conflict of interest when insiders are using the stockholders’ money to buy back shares on the theory that they are undervalued, and at the same time are unloading their own shares,” argues plaintiff’s attorney William Lerach of Lerach Coughlin Stoia Geller Rudman & Robbins LLP in San Diego. “We believe it to be an inherently bad practice. Certainly, when we evaluate whether to bring suit against insiders for securities fraud, it’s something we look for, and when we see it we view it to be very incriminatory.”

Three years ago, Lerach helped negotiate a settlement of shareholder litigation with Sprint Corp. (now Sprint Nextel Corp.) in which Sprint agreed that it would no longer allow insiders to sell Sprint shares while the company was buying them. A Sprint spokeswoman says the prohibition applies only under “certain limited circumstances,” but declined to elaborate. Lerach says it is a reform other corporations ought to embrace voluntarily.

Few have, at least in part because both buybacks and stock options as a form of compensation are relatively recent phenomena. In 1980, for example, the value of stock buybacks exercised by S&P 500 companies equaled just 10 percent of the value of the dividends issued, according to Scott Weisbenner, a finance professor at the University of Illinois who studied the issue while serving as an economist at the Federal Reserve Board from 1999 to 2000. By the late 1990s, however, companies were spending more on repurchases than on dividends. And the boom continues: in the second quarter of this year, buybacks outpaced the same period a year ago by 43 percent, while dividends accounted for just 32 percent of cash paid out to shareholders, down from 51 percent as recently as the second quarter of 2001. Weisbenner also found that between 1994 and 1998, the use of stock-options programs by S&P 500 companies grew by more than 40 percent.

“The world in which [insider trading] laws were made existed before the world in which there were massive buyback programs,” says Robert Monks, a shareholder activist, attorney, and investment-fund partner. “I don’t think anyone foresaw how these two trends would play out together.”

**Options Play**

Critics contend that potential conflicts of interest take several forms. For starters, options holders aren’t eligible to receive dividends, which may make them turn a blind eye to a practice that would benefit other shareholders. And dividends dilute the value of options because the share price is typically marked down to reflect the value of the dividend issued. In addition, a prime motivator for buybacks — to boost earnings per share — is seen by critics as potentially self-serving because many executives are compensated at least in part based on EPS targets, so using company money to inflate that figure can result in personal gain. Less clear is whether buybacks actually bump up the price of shares, allowing executives to garner more than they would have otherwise (see “More Knocks Against Buybacks” at the end of this article).

But as those recent figures on buyback activity indicate, rumblings from certain quarters seem to be having no effect on the popularity of the practice. “I think there’s a responsibility, if you accumulate too much cash on the balance sheet, to make a decision of some kind to return money to shareholders, unless you have it earmarked for something else,” says USANA executive vice president and CFO Gilbert Fuller. “Over the past five years, we’ve bought back something like 6.5 million shares, and spent $130 million doing so. And we’ve chosen to do that rather than issue a dividend, primarily because it gives us more flexibility.”

The company spent nearly $50 million between 2005 and the first quarter of 2006 alone, a period during which company insiders sold USANA shares worth approximately $64 million. Fuller cites several reasons for that activity, noting that the company’s stock went from less than $1 a share in 2002 to more than $40 per share this year. “First of all, it takes an iron stomach not to sell into that,” says Fuller. “Second, it’s a way for executives to balance out their cash needs. And third, there’s the issue of diversity. If you wake up and see that your stock has gone from under $1 to $44, common sense says you should diversify some of your holdings.”

Because of USANA’s compensation philosophy and its long-term commitment to stock-buyback programs, Fuller says there have been times when insiders were selling stock at the same time the company was buying. “But there hasn’t been an orchestrated effort to link when insiders were selling to times when the company was buying back shares,” he says. The idea that companies *could* connect the two practices has caught the attention not only of academics and attorneys, but even Warren Buffett. In his annual letter to shareholders last year, the chairman and CEO of $82.5 billion Berkshire Hathaway Inc. raked the practice of orchestrating buyback programs with a vignette about a fictitious caretaker executive, Fred Futile, CEO of Stagnant Inc. In Buffett’s example, Futile gets rich on stock options simply by using buybacks to boost his company’s reported EPS — and hence the company’s stock price, which investors calculate as a multiple of EPS — despite being unable to grow the company’s net income. This June, Audit Integrity, a Los Angeles–based accounting and governance analysis firm, sent a note to clients identifying 16 companies with market capitalizations of at least $100 million that it considers at high risk for fraudulent behavior, including USANA, because the companies have high levels of both stock buybacks and insider selling. Meanwhile, attorney Lerach is putting the finishing touches on a lawsuit he plans to file against “one of the most high-profile companies in the United States,” along with its CEO, over issues relating to its buyback programs.

Fuller notes that USANA has simply followed a practice shared by many companies: pay modest salaries that are accompanied by sizable equity-based compensation, and work to make the latter as valuable as possible.

Companies can, of course, arrange for their executives to sell their stock through so-called 10b5-1 plans, named after the Securities and Exchange Commission rule that allows them to transact in company shares at all times, not just during open trading windows, without running afoul of insider-trading rules. Under such plans, the executive must specify in advance the amount, price, and date of any stock purchase or sale, or provide a written formula for determining the amounts, prices, and dates. These decisions must be made at a time when the executive is not aware of any material, nonpublic information. Similarly, many companies seek to conform their buyback programs to SEC Rule 10b-18, which provides them with a safe harbor against charges of manipulating their own stock price. A new “cashless buyback” equity instrument advocated by MG Holdings of Summit, New Jersey, may give companies another option.

**Perceptions vs. Incentives**

Attorney Stephen Riddick, a principal shareholder with law firm Greenberg Traurig in Washington, D.C., says steady selling activity by insiders pursuant to 10b5-1 plans, which are designed to be active in good times and bad, could be skewing the perception that insiders are timing sales to coincide with buybacks. Lerach sees it differently. “Most of the time, we find there aren’t 10b5-1 programs,” he says. “Most of the sales look to be discretionary and a result of insider decisions, not some preexisting program.

But even if there is a 10b5-1 program, I continue to believe there’s an inherent inconsistency in using the stockholders’ money to buy back stock while you’re unloading your stock.”

Jack Zwingli, CEO of Audit Integrity, is similarly skeptical. “Common sense and history suggest that problems arise when management has a short-term financial incentive to behave in a certain way,” he says. “If management benefits more from doing stock buybacks than from paying dividends or reinvesting in the business, it will buy back stock.”

Some may regard that as a cynical view, but if so the cynics appear to be on the ascendancy. Companies may have to look at this issue within the boardroom, lest they find themselves looking at it in the courtroom.

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**More Knocks Against Buybacks**

**Researchers have found virtually no link between buybacks and share-price increases.**

While it is commonly thought that buyback programs foreshadow higher stock prices, substantial research suggests otherwise. Critics also say that firms run the risk of bungling the timing of buybacks, the net effect being a substantial waste of corporate cash. In a 2003 study entitled “Changing Motives for Share Repurchases,” J.F. Weston and Juan Siu, of the Anderson Graduate School of Management at UCLA, surveyed the academic literature from the prior two decades and found that, while buybacks in the 1960s and 1970s tended to precede substantial stock-price gains, that phenomenon has largely disappeared. Part of the reason may be that during that time, most buybacks were accomplished through fixed-price tender offers in which management made it clear what it thought the firm’s stock was worth. Since the 1990s, most buybacks have taken the form of open-market transactions, which are less transparent.

A 1981 study by Larry Dann in the *Journal of Financial Economics* looked at 143 fixed-price tender offers between 1962 and 1976. Dann found that in the three days following the announcement, share prices enjoyed a “cumulative abnormal return” of 23 percent on average. By the expiration of the tender offer, share prices on average were 13 percent above their preannouncement levels.

But the good ol’ days appear to be over. A 1995 study by David Ikenberry, Josef Lakonishok, and Theo Vermaelen in the same publication looked at 1,239 open-market share repurchases from 1980 to 1990 and found that announcement of those buybacks sparked a five-day price jump, on average, of just 3.5 percent. Other research conducted between 2000 and 2002 says the gains are less than half that percentage.

Meanwhile, critics are sounding off on companies’ tendencies to buy high and then see the price track lower. Sometimes much lower. Dell spent more than $7 billion on its stock in 2005, buying shares priced in the mid 30s; as of September the company was trading in the low 20s. “A buyback is bad when shares are overpriced,” says Michael Gumport, a certified financial analyst and founder of consultancy MG Holdings in Summit, New Jersey. “If you don’t know the value of your stock, it’s really simple; you just pay a dividend. I know plenty of companies that bought back shares and found out a year or two later that they would have saved a lot of money by waiting.” *— R.M.*