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Old Options Still Haunt an Insurer

By **ERIC DASH**

When Stephen J. Hemsley joined UnitedHealth Group after 23 years with the accounting firm Arthur Andersen, he was greeted with a grant of 400,000 stock options dated shortly after he started in June 1997.

There was just one thing: the options carried a stock price based on the market price five months earlier, when he did not yet work for UnitedHealth, one of the largest health insurers in the country. The difference in dates effectively created a built-in gain of \$7.26 for every share.

Mr. Hemsley's Pay



Catherine Whipple/St. Paul Pioneer Press

TOTAL BASE SALARY	\$ 7,379,808
BONUSES	13,451,099
PAYOUTS	5,503,135
OPTION EXERCISE GAINS	108,952,054
TOTAL PAY (1997-2005)	135,286,096

Sources: Equilar; S.E.C. filings

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Mr. Hemsley, who was chief financial officer at Andersen, said that he “didn’t recall focusing at the time” that his options carried a discounted price and that there was not enough evidence to determine if the grant was actually backdated.

But the episode, recounted in a 14-page report into UnitedHealth’s option practices, does raise some questions about Mr. Hemsley, who has taken the reins at UnitedHealth from Dr. William W. McGuire, who was forced to resign Sunday amid criticisms of how stock options were awarded.

“That obviously raises credibility issues,” said Patrick McGurn, a corporate governance expert at Institutional Shareholder Services, a proxy advisory firm. “We are seeing a lot of modified Sergeant Schultz defenses here,” he said, referring to a character in the 1960’s television series “Hogan’s Heroes.” “They are not claiming to know nothing, but only part of what went on.”

Mr. Hemsley has not been accused of any wrongdoing.

And the investigation by an outside law firm, Wilmer Cutler Pickering Hale & Dorr, that was commissioned by UnitedHealth largely exonerates Mr. Hemsley, accepting his word that he never focused on his stock option grants and that had “he had little or no role” in the negotiation and authorization of a subsequent stock option megagrant.

UnitedHealth declined to make Mr. Hemsley available for comment. His lawyer did not return calls seeking comment.

In shaking up management, the board of UnitedHealth appeared to opt for a middle way between a clean sweep and retaining top executives who could continue the strong track record of Dr. McGuire. Mr. Hemsley is a skilled operations executive who helped execute Dr. McGuire's strategies. Working together, the two helped take UnitedHealth's stock price up more than 500 percent since mid-1997. And with lavish pay packages, both got very rich. Dr. McGuire banked more than \$500 million during his 15 years as UnitedHealth's chief executive and currently holds more than \$1.1 billion worth of stock options. Mr. Hemsley has taken home more than \$135 million and likely holds more than \$500 million worth of stock options.

As a result of the recent options problems, both voluntarily agreed to re-price all the options they were awarded from 1994 through 2002 to the annual high share price, eliminating any extra financial benefits from the improper grants. That move would take back only a tiny portion of the value of their outstanding options, but not affect the hundreds of millions of options each has already cashed out.

Dr. McGuire's option holdings will be reduced by about \$100 million to a little over \$1 billion, according to Brian Foley, an independent compensation consultant. Mr. Hemsley's options will likely be reduced by an even smaller amount. Shares of UnitedHealth fell 2.5 percent yesterday, to \$47.54. UnitedHealth is among the biggest of the more than 100 companies that have acknowledged possible problems with their options practices. And despite the ouster of Dr. McGuire, United Health's troubles are far from over. The Justice Department, the office of the Minnesota attorney general, the Securities and Exchange Commission and the [Internal Revenue Service](#) all have investigations into the company's stock option practices. The company will also have to restate earnings, lowering past results by potentially hundreds of millions of dollars. The investigation by Wilmer Cutler focused on 29 option grants that accounted for nearly 450 million stock options that the company granted between 1994 and 2002. Most of those grants, their report concluded, "were likely backdated" after investigators found that nearly 80 percent of the total number of options were granted at the second, third, or lowest price of the quarter. The odds of such a finding appear to defy the possibility of pure chance.

The report absolves most of the directors from legal responsibility, but is critical of Dr. McGuire. It contends he "authorized or sought the approval of the compensation committee" for "option grants at opportune times when the company's share price was depressed," including several times to directly benefit himself.

The report indicates that investigators had little evidence to suggest that Mr. Hemsley, who had served as UnitedHealth's president and chief operating officer, had direct knowledge of stock option problems or other improprieties. But the report does raise flags on whether he should have known more.

Of the nine grants Mr. Hemsley was awarded between 1997 and 2002, for example, nearly half were issued when the stock was at or near a trough, according to an analysis of his stock option grants.

Moreover, the report questions the circumstances of a written employment contract that Mr. Hemsley signed when he became UnitedHealth's president. According to the report, UnitedHealth put out a press release stating that "both Hemsley and McGuire had entered into long-term employment agreements" with the company in mid-September 1999 in an effort to ease concerns about Dr. McGuire's plans to remain at the company. In fact, the report said, it was likely that the contracts were not approved by a board committee until an early November meeting and were not signed until a month later in December. The report does not account for Mr. Hemsley's explanation of the discrepancy.

The report also raises questions about his judgment in managing potential conflicts. Investigators detail that Dr. McGuire had extensive financial dealings with William Spears, a longtime director and chairman of UnitedHealth's compensation committee when Dr. McGuire's contract was being negotiated. Mr. Spears managed millions of dollars for Dr. McGuire's family and was a trustee for two family trusts.

Mr. Hemsley did not engage Mr. Spears in 1999, when his contract was being negotiated. But he did hire him to manage his money in 2001. And his former employer, Arthur Andersen, which was hired by UnitedHealth's management as its auditor, also served as the compensation consultant advising the board committee negotiating his contract. In addition, the report found that UnitedHealth had "inadequate internal controls" to prevent option grant manipulation. Investigators suggested poor communication and sloppy paperwork among its accounting, legal and human resources departments led to many of the problems. The report said that new hires and promoted employees were routinely awarded stock options at the lowest closing price between the start and finish of the quarter when an employee began work, and those "practices were followed openly" in the human resources department.

Investigators found that Mr. Hemsley played a "more limited role in the option-granting process." He told investigators "he was unaware of how the grant dates were selected" or other precise terms.

Who did the human resources department ultimately report to? Mr. Hemsley, according to analysts.