3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
Governance: Corporate Governance Issues

Options Behavior Related to "Earnings Management"? Ecolab Inc. (NYSE: ECL)

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Ecolab Inc. is engaged in the development and marketing of products and services for the hospitality, institutional and industrial markets. The Company provides cleaning, sanitizing, pest elimination, maintenance and repair products, systems and services primarily to hotels and restaurants, foodservice, healthcare and educational facilities, quick-service (fast food and other convenience store) units, grocery stores, commercial and institutional laundries, light industry, dairy plants and farms, food and beverage processors, pharmaceutical and cosmetics facilities and the vehicle wash industry.

Summary of 3DAdvisors Findings for ECL

- **Insider Trading:** Performance options provided plenty of incentive to boost stock
- **Accounting:** Management did what it needed to do to "beat the street"

Discussion of 3DAdvisors Findings

Insider Trading: Performance options provided plenty of incentive to boost stock

There have been some interesting intersections of events concerning Ecolab, which have heightened our awareness of the Company. Evidence points to the fact that it was in the best interest of Company executives to see to it that Ecolab shares were trading above $50 (pre two-for-one split) per share in May in order for them to profitably exercise underwater Company options that were due to expire.

The clues start at the May 20th expiration of a big series of "Premium Priced Options". These options were granted back in February of '98. They were issued at a 75% premium to the then market price and they were issued to a group of eight key executives. The strike price was $49/share and the options are all expiring on May 20, 2003. A really interesting sidebar to these options is the limited disclosure of their very existence. Ecolab never revealed the size of the original grant. **Allan Schuman**, Chairman and CEO, received 715,000 of them but the Company fell short of saying what the other seven got. After the cryptic mention of them in the '99 Proxy (covering the '98 year), all reference to the existence of these options dropped out of sight, except for one small footnote reference (in each successive proxy) indicating that the related individual's option compensation (as quantified in the Executive Compensation Chart) included some calculation for them.

A few years back, when these "Premium Priced (or performance) Options" were somewhat in vogue, we used to keep our eyes peeled for them. It would generally seem that, when these options were in play, related company managements would do everything in their power to get the stock price up to, and above, the target price. In Ecolab's case the magic number was $49 per share. Any negative news that could be delayed would wait, and any good news that could be disseminated would be trumpeted prior to the expiration of the options. This all comes at a price however. Once the options no longer are a factor in "management's planning", and if the underlying shares (once exercised for) are sold, there is usually a "News Hangover" effect as all the positive news that could have been thrown at the public has been slung, and undisclosed negative information that was withheld still lurks. Perhaps it's by design the Ecolab shares were split two for one just after the expiration of these performance options.

This behavioral pattern seems to be happening with Ecolab. Now that the expiration date of these options (May 20th) has past, we have seen the program participants clearing out of all the shares they have exercised for. Making matters even more interesting is the fact that the underlying shares, which had been acquired for $49 each, have all been sold for prices in the $51 to $52 range. The selling insiders have thus realized minimal profits in such transactions.

Another behavior that we've seen before: the fact the performance options were expiring provided the Company cover with regards to the reasons for the selling activity at this time. This does not adequately explain the fact that insiders involved chose to sell all the shares optioned for. Another point unexplainable by the "expiration explanation" is the fact that some of the sellers have not only cleared out of their performance options, and underlying shares, but also significant pieces of their long-vested additional options positions (and underlying shares) that were no where near expiration. The way they've unloaded the related shares from long-term options seems to imply that they don't want to hang around long. It is truly unusual to see this type of aggressive insider behavior.

The insider sales represent the majority of the holdings of many of those involved. The following sales occurred between late April and early June. All sales are in pre-split (two-for-one) numbers. All shares were sold in the $50 to $52 range:

Allan Schuman (68) - Schuman cleared out of the original 715,000 performance shares (after exercising the same number of performance options for $49 each) at prices between $50 and $51 each. If that wasn't enough, he cleared out of another long-standing options position as well, exercising options, and selling, 130,000 shares. These options have been exercisable since 1999 and were not set to expire until 2008. In all, Schuman's sales of 845,000 shares represented just over 50% of his actionable holdings.

Douglas Baker (44) - President and CEO. Relatively new to his position, Baker had only 25,000 of the performance options. Nevertheless, like the others, he exercised them and sold the shares. In addition, Baker cleared out of three separate option series, all of which were not set to expire until between August 2005 and August 2007. He sold all the 17,400 shares exercised for. Baker's combined sales of 42,400 shares trimmed 35% from his total actionable holdings.

John Spooner (56) - President, International. Spooner had been CEO of Henkel-Ecolab until November '01. After exercising performance options (at $49) for, and selling, 207,000 shares (in the $51 range), Spooner cleared out of three additional options positions, none of which were set to expire until between August 2005 and August 2007. These additional sales totaled 92,800 shares, which were sold in the $51 range. Consequently, Spooner's sales of 299,800 shares lobbed off 69% of his actionable position.

Steve Fritze (48) – CFO. Fritze exercised for, and sold, his entire stake of 45,000 shares worth of performance options. His sales prices were in the $50 to $51 range. This action trimmed his actionable holdings by about 37%.

Diana Lewis (56) - Sr. V.P., Human Resources. Lewis exercised performance options totaling 105,451 shares. In addition, she exercised options for an additional 10,800 shares, clearing out that particular option series. We have limited data on her holdings, so we hesitate to calculate her reduction as a percentage of total holdings.

Maurizio Nisita (61) - Sr. V.P., Global Operations. Nisita cleared out of his entire position of $49 performance options and sold the 110,000 shares in the $50 to $51 range. This action trimmed his actionable holdings by 39%.

Lawrence Bell (55) - General Counsel. Bell exercised his entire stake of performance options (for 45,000 shares) and sold most of them (44,487) in the same price range as the others. In addition, he cleared out of a separate option position and sold the underlying 6,400 shares.

Make no mistake about it. These represent one of the largest sets of holdings reductions, from key operations management personnel that we've seen in a long time.

Accounting: Management did what it needed to do to "beat the Street"

The Company's latest Quarter was one of their typical "Beat the Street by a penny" reports. Company guidance looked quite back-loaded too, calling for the next quarter (Q2) to come in at the low end of analyst's ranges but being fairly emphatic about showing strong second half performance. They are cutting back on Capex too. Looks like Ecolab made its numbers through cost cutting and positive currency translations. Given that management knew the options were expiring the following month, they may have thrown everything they had into the quarter in order to make those numbers.

We also note that Henkel and related interests continue to hold almost 28% of the shares of the Ecolab (about 36.4 million shares). If Henkel had been looking to raise cash, the performance options may have given them a reason to hold off. Now that these options are history, Ecolab shares may be on the verge of "news of a different color" in their wake. This certainly is what we are inferring from the actions of these insiders. Now it remains to be seen if Ecolab's biggest holder (Henkel) is looking to behave similarly.