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

Comp Plans May Have Led to Earnings Management Union Pacific Corporation (NYSE:UNP)

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Union Pacific Corporation (UPC) operates primarily in the areas of rail transportation through its indirect wholly owned subsidiary, Union Pacific Railroad Company (UPRR), and trucking, which includes Overnite Transportation Company (OTC) and Motor Cargo Industries, Inc. Both companies are operating as separate and distinct subsidiaries of Overnite Corporation, an indirect wholly owned subsidiary of UPC. UPRR is a Class 1 railroad that operates in the United States, OTC is a major interstate trucking company specializing in less-than-truckload (LTL) shipments and Motor Cargo is a western regional LTL carrier that provides comprehensive services throughout 10 western states.

Summary of 3DAdvisors Findings for UNP

- **Governance:** Comp plans may have led to earnings management
- **Accounting:** Making that 2002 EPS number
- **Governance:** Generous comp plans apparently not enough to keep execs
- **Insider Trading:** Significant departure from prior insider behavior

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Discussion of 3DAdvisors Findings

Governance: Comp plans may had led to earnings management

It is always interesting to us when the behaviors of those involved with a long-standing corporate culture begin to show signs of change. With regards to Union Pacific (UNP) the culture we are talking about is one where insiders have been required to build their stock positions to very high levels. Indeed, for years, stock ownership guidelines at the Company have dictated that executives must own between one and seven times their salaries (three and seven times for senior executives). The culture created by these guidelines has, most likely, kept insiders from selling, as evidenced by the fact that their distribution had been non-existent up until late 2002.

One of the perks of UNP's corporate culture has been its more-than-generous compensation plans, rife with stock compensation the likes of which we have rarely seen.

Union Pacific Management is quick to state, ad nauseam, how its executive compensation plans, and stock ownership guidelines “align our interests with those of shareholders”. It’s funny though, how this implied alignment becomes diluted when executives are regularly awarded stock they do not have to pay for. Additionally, these compensation plans have come with targets that provide management with ample incentives to manage earnings to meet short-term financial goals that benefit management, rather than shareholders. Specifically, here is what we are talking about:

The Plans that Keep on Giving:

Union Pacific goes beyond typical stock option grants in its compensation plans. It regularly grants “Retention Shares” to key management individuals. These Retention Shares are simply held in reserve for the individual involved until certain, typically liberal, conditions are met. One of the key conditions requires the individual to remain in the Company’s employ for a period of three years (in some cases, four) before the shares can vest. During that period however, the individual gets all dividends associated with the related Retention Shares as if they have already been vested.

Union Pacific executives have been able to forego cash bonuses and, in their place, receive Retention Shares equal to 150% of the bonus amount earned in the applicable year. As you read on, it will become apparent how fundamental these Retention Shares are to UNP’s compensation scheme and how they are practically risk-free to the insiders who have been made wealthy through their existence.

The Bifurcated Long Term Performance Program (LTPP):

The first of such plans to catch our eye, the LTPP was formed in 1996. Participants were awarded Retention Shares, which vested in three equal installments. If the targets (which were stock price-based) were not hit by November 20,2000, the Retention Shares would be forfeited. These targets were not hit, and the Retention Shares were forfeited, leaving the participants out in the cold. This was not a problem, though, for the four top Company executives (including Chairman and CEO Richard Davidson) as they received a slightly different package. Their package allowed for an extension of the program, until November 20, 2005, should the November 20, 2000 target not be achieved. The self-serving nature of this treatment caused us to dig further into the Company’s Stock Compensation Plans.

The Stock “Loan” Program:

In 1999, Union Pacific loaned about $46.3 million to executives to buy just over 1 million shares of UNP common. Interest on these loans has been accruing since 1999. The principle and interest would be forgiven, in three equal installments, upon the occurrence of following circumstances: 1) the borrower remained an employee of the Company until January 31, 2003; 2) earnings per share of $5.00 or grater are achieved during any calendar year and; 3) either EPS of $6.00 or greater are achieved during any calendar year or a stock price of $85 is achieved and maintained for 20 consecutive days. Either of these last two ($85 target price or $6.00 EPS) would cause all criteria to be considered met under the deal.

This loan program was not insignificant to top officers at the Company. Chairman and CEO Davidson owed $11 million at Y/E, 2002; COO Ivor Evans owed $5.5 million; Overnite Chairman Leo Suggs owed $4.1 million; CFO James Young, Executive V.P – Operations Dennis Duffy, Executive V.P. – Network Design R. Bradley Young, Executive Vice President – Marketing and Sales, John Koraleski and General Counsel, Carl W. von Bernuth all owed $2.2 million each.

All of these individuals fulfilled the first criteria, allowing for 33% of their interest and loan principle to be paid by the Company. As you probably can surmise, the target of $85 per share for 20 consecutive days was never achieved, nor was $6 in EPS in any given year. The $5.00 EPS target is quite a different story though and this was achieved in 2002 with a large amount of contribution from Q4 2002. Thus, the individuals involved had two-thirds of their loans, and associated interest, paid for them by the Company. They must pay the remaining one-third in equal installments beginning on January 31, 2004 and ending on January 31, 2006.

This is the kind of plan that Wall Street salivated over at the time. Indeed, it would seem that UNP shares rallied on the news, moving 22% higher in the month the plan was initiated. This one, however, was flawed. With the EPS “out” clauses, management payout was not necessarily tied to stock price. All they had to do was to manage, to the best of their ability, the EPS side of the equation.

Another plan with similar features:

Above, we described the 1996 Long Term Performance Plan, which, although having fallen short of its performance targets, still allowed the top four Company executives a five-year extension of the performance period, an extension not available to others in the plan. In November of 2000, upon the expiration of the 1996 plan’s performance period, the new plan surfaced. This plan included the award of Retention Shares so commonly utilized in UNP’s compensation practices. The performance period to this 2000 plan covers the years 2001 through 2003. The targets are cumulative EPS targets ranging from $13.50 to $16.00 (for the three-years combined). An alternative condition is attainment of $70 or $85 stock price for twenty consecutive days.

With Union Pacific shares under-performing the stock price target so far into the performance period, they have yet to hit the low-end of the stock price target range dictated by the Plan. It may be that management must once-again, focus on the EPS performance target if they have any hope of reaping rewards from this deal. Through F/Y 2000, cumulative EPS has totaled $9.22 per share. This means that UNP needs an EPS of at least $3.78 for 2003 if the low-end of the target EPS performance is to be achieved and $6.78 for attainment of the high-end.

We think that both the Long Term Performance Plans and the Stock Loan Program represent deals that tend to show that management strategy is heavily geared towards the attainment of targets that inure to their personal benefit. In this regard, the Company would argue that the goals are aligned with shareholders’ interests. To this, we would counter with, what kind of interests? Those who are concerned about this year’s numbers or those with a longer term (read: strategic) picture in mind?

Accounting: Making that 2002 EPS number

There were millions at stake to top Company executives who had borrowed under the stock purchase program. With the performance period for the above program ending in January of 2003, it appears very much as if UNP management did everything it could to enhance its 2002 EPS number.

It wasn't all that subtle. A quick look into the composition of Union Pacific's "Other Income" section for 2002's 10K revealed plenty: During F/Y 2002, the Company recorded gains of $288 million in Non-Operating Asset Dispositions. Gains from these Non-Operating Assets, though existent in every year, had never approached this number previously. In 2001, for instance, these gains amounted to $133 million; these gains totaled $88 million in 2000, $74 million in 1999, $128 million in 1998, $102 million in 1997 and $92 million in 1996.

Union Pacific needed only about $140 million in extra income in order to put its EPS number over the $5.00 performance criteria threshold under the stock loan program. This would release one-third of the loan (and interest) repayment obligations under the deal. It would seem that increases in these Non-Operating Asset Sales (over their levels of previous years) contributed the big boost necessary to hit the numbers.

Another contributing factor to 2002 earnings was the Company's retention of a 10% Expected Rate of Return on Retirement Plan Assets, one of the highest still out there. At Y/E 2002, they finally reduced this to a still-high 9%. And this during a period when even many of the most aggressive plans have trimmed their return assumptions by more.

If Non-Operating Asset Sales weren't enough however, there may have been more subtle measures being utilized at the time as well. To this, we point to the Q1, 2003 Net Income number. In that quarter, UNP's reported net income of $429 million contained $243 million in non-cash items related to an accounting change (FASB Statement 143, Accounting for Asset Retirement Obligations). Without this extra juice, Net Income would have been only $155 million for the quarter. When you take a look at Net Income for previous quarters, the $155 million number really jumps out: Net Income for Q4, 2002=$378 million, Q3, 2002=$437 million, Q2, 2002=$304 million, Q1, 2002=$222 million, Q4, 2001=$275 million, Q3, 2001=$267 million.

To us, it was very interesting to see the jump in Net Income, in Q4 of 2002 and the corresponding (and uncharacteristic) drop in the number in the following quarter. Digging into this a bit revealed an interesting inverse correlation, between Q4, 2002 and Q1, 2003: While Revenues dropped 3.2% (From $3.17 billion to $3.07 billion) sequentially, Cost of Goods Sold actually rose by 5.2% in the same time frame ($2.29 billion to $2.41 billion).

This could indicate that, outside of the asset sale gains, there may have been other factors contributing to that Q4, 2002 net income gain, factors that, in their utilization, penalized revenue and expense numbers in the following quarter.

Governance: Generous comp plans apparently not enough to keep execs

In spite of their more-than-generous compensation packages, it is apparent that certain members of Union Pacific's top management team were thinking about leaving the Company in 2002. In response to this, the board again went to the Retention Share well. A brief disclosure of this situation appears in the most recent Proxy Statement (issued April 18, 2003): **"In May 2002, The [Compensation] Committee became concerned about the retention of certain key executives. As a result of the program subsequently approved by the Committee in July 2002, Mr. Davidson [Chairman and CEO] was granted 95,000 retention units with a four-year employment requirement."**

It would seem that, in order to quell possible defections of key executives, the Union Pacific Board moved to create a new plan that would award even more retention shares to executives at no cost to them. Thus, in 2002, Davidson received (in addition to his $1.2 million base salary), options for 325,000 shares, retention shares, in lieu of bonus (calculated at 150% the value of the cash bonus due him), of 107,182 shares plus an additional 95,000 retention shares to get him to agree to stay four more years.

It is not clear how many other executives may have gotten these Retention Share bonuses under the quickly established July 2002 program. What seems clear however, is that with an economy generally considered far from robust, by any measure, and Company (and stock) performance hardly knocking the cover off the ball, a number of insiders were looking to leave their lucrative Union Pacific compensation deals behind. We find all of this very curious.

Insider Trading: Significant departure from prior insider behavior

As stated earlier, Union Pacific is a company that has created an insider culture that would, for many reasons, cause them to hold on to their shares. And this is exactly what they had been doing during most of Davidson's tenure. Until, that is, late 2002. It was in October and November, and then again through the first half of 2003, that the persistent (but subtle) transition, to insider selling manifested itself. This change in insider behavior caused us to begin monitoring the Company.

The selling is not tantamount to wholesale unloading of positions. With such strict insider ownership guidelines, and the generous use of Retention Shares whose vesting requires extended tenures, we wouldn't expect to see such a thing. The persistency of the selling, coupled with the breadth of insiders involved, were enough for us to suspect that something, in the UNP stock ownership culture, may have been breached. Between October 2002, and early July 2003, a total of sixteen Company insiders have quietly disposed of 371,818 shares between them, all at prices in the $59 to $62 range. To put this in behavior in perspective, in the four-year period beginning in late 1998 and ending in late 2002, insider sales (for the entire period) totaled just 43,000 shares from far fewer individuals.

Then there are the forward sales by director Philip Anschutz. Anschutz is one of UNP's largest shareholders by virtue of the Company's acquisition of Southern Pacific Rail Corp. He has been monetizing his position using forward sales. In 2001, Anschutz (through his entity, The Anschutz Corporation) had a position totaling 12.5 million shares. Through forward sale contracts, and their eventual execution, he has monetized about 9 million shares of this position, but continues to retain the associated voting rights. As recently as July 1, 2003 he entered into yet-another forward sale from his remaining position. In this transaction, he committed another 166,000 shares to forward sales, pocketing $7.8 million in the process.