

Everyone's Winning, Except the Shareholders: Optioning the Long-term Value of a Company

By Andrew M. Kulpa

An Unexpected Boom in Option Use

Stock option grants have been the financial vehicle of choice for a large portion of executive compensation due to an attempt to link executive compensation to the performance of the company. Generally, a stock option is the right to purchase a stated number of shares of the stock of an employer at a specific exercise price over a prescribed period of time in accordance with certain eligibility requirements for vesting.¹

Essentially, it is a right to a future stock gain. Stock options first surfaced in the 1920s² but really garnered attention in the 1990s based on two events. First, the Accounting Principals Board (the predecessor organization to the Financial Accounting Standards Board) issued its Opinion Number 25 in regard to employee stock compensation,³ stating that when a company issues stock options to executives and the number and exercise price per share of stock underlying the options are known on the grant date, the company may recognize a compensation expense on its income statement equal to the difference, if any, between the market price of the stock on its grant date and the option's exercise price.⁴ Therefore, there is no requirement for a change to the company earning for at-the-money options or options with a strike price equal to the current price of the underlying security.⁵ Second, the Clinton administration instituted changes to the corporate tax structure under which companies could not deduct annual compensation in excess of \$1 million for any of their top five officers⁶ but exempted performance pay (e.g., stock options) from this computation.⁷ Therefore, a company could deduct a dollar for every dollar of options gained by the grantee, making it beneficial for the company to pay every possible bill with a stock option.⁸ As a result of these factors, stock option use among Fortune 500 companies increased by 45 percent in 1994, the first year the law was in effect.⁹ While corrected to an extent, there is still fa-

vorable treatment toward stock options and performance based pay under Internal Revenue Code (IRC) 421 and 422.

Optioning the Long-term Value of the Company against the Executive's Near-term Prospects

Stock options can be classified as either incentive stock option plans (ISO) or non-statutory stock option plans (NSO).¹⁰ Options that qualify as an ISO and are granted in connection with employment are granted favorable tax treatment under IRC 421(a).¹¹ However, there are some strict requirements for an ISO. The option (a) must be exercised while the party is employed with the issuing company or within three months of termination,¹² and (b) must be granted under a written plan approved by the shareholders specifying the total number of shares and the employees eligible to receive the options.¹³ Finally, the aggregate fair market value of stock bought by exercising ISOs that are exercisable for the first time cannot exceed \$100,000 in a calendar year.¹⁴ While no income tax is assessed against the executive receiving an ISO in the year of the grant or at the time he or she exercises the option,¹⁵ the company granting the ISO will not be permitted to deduct any amount for the option grant.¹⁶ Due to these restrictions, most stock options for executives are NSOs.¹⁷

An NSO does not have any statutorily defined holding period, term guidelines, or the \$100,000 ceilings on exercise,¹⁸ and it may be granted to non-employee individuals valuable to the corporation, such as outside directors and consultants.¹⁹ The company granting an NSO can also deduct the option gains received by executives as a compensation expense.²⁰ Regardless of the preferred form, stock options tend to misalign executive and company incentives.²¹

Stock options can provide a form of perpetual growth for executives receiving the same number of options each time regardless of the movement of the underlying stock

price.²² In turn, the total compensation package for the executive will provide short-term exponential growth in the case of a rising stock price regardless if that rising stock price is connected to the executive's performance or simply market conditions.²³ To maximize the option value, enhancing the company's value may give way to insider manipulation, including timing the release of positive and negative releases relative to option issues²⁴ or backdating the option to correspond to the release.

Cheaters Kind of, Sort of, Prosper

Backdating is done to identify the lowest price of a company's stock over a given period, providing hindsight to "best" price the option and provide the most future value to the executive.²⁵ An estimated 23 percent of unscheduled, at-the-money, stock option grants to executives between 1996 and August 2002 suffered from some sort of backdating or manipulation.²⁶ The practice of backdating stock options is not illegal per se if none of the documents related to the practice are forged, the backdating is disclosed to the company's shareholders, and the backdating is properly reflected in a company's earnings statement.²⁷ By failing to follow these guidelines, there are tax and securities law implications, including section 10 of the Securities Exchange Act of 1934 covering manipulative and deceptive devices,²⁸ and section 302 of the Sarbanes-Oxley Act of 2002,²⁹ requiring the chief executive officer and the chief financial officer to certify the accuracy of financial statements.³⁰ In addition to backdating, around 40 percent of option awards are non-periodic, or flexible in the offering time during the year, making them ripe for manipulation in regard to information dissemination surrounding the options issuance.³¹ This distorts the original valuation of the compensation package, which was usually done with the Black-Scholes method.³² Although the board may have felt it was presenting a fair deal to the executive on behalf of the shareholders, information imbalance and abuse can cause the Black-Scholes method to break down, with a resulting one-sided boon for the executive.³³ These manipulative practices have garnered legal attention.

Through September 2007, over 200 companies have been investigated,³⁴ thirty class action suits have been filed regarding option backdating,³⁵ and six criminal cases have been brought against executives as of Febru-

ary 2007.³⁶ Companies have had to restate financial results,³⁷ accept the resignation of top executives,³⁸ suffer criminal investigations,³⁹ face shareholder derivative suits,⁴⁰ and in some cases even delist.⁴¹ Monetarily, this is not a zero-sum game, either. The executives committing the backdating of stock options derive an average of about \$2.5 million per firm over a five-year period, but when the issue reaches the public, the shareholders bear damages of about \$400 million per firm.⁴² To curtail the dating issue, the Securities and Exchange Commission (SEC) adopted disclosure requirements, including disclosure of a company's intent to grant options within two business days after the option is granted.⁴³ However, approximately 24 percent of the companies are still late in reporting option grants with 14 percent being reported within one month of the grant date and 10 percent in excess of a month,⁴⁴ providing the aura of, if not any actual, wrongdoing. All this excess compensation does not even purport to enhance company performance.

Excessive Compensation Negates Performance

There is a continued disconnect between the boom in executive compensation and the bust in executive performance. In 1992, the average CEO of an S&P 500 firm earned \$2.7 million, which grew more than 400 percent to over \$14 million by 2000.⁴⁵ However, this increase in pay does not correlate to improved company performance.⁴⁶ In some sectors, the companies with the best performance had the lowest levels of long-term incentives and lowest total direct compensation for executives.⁴⁷ In addition, high levels of total executive compensation are inversely correlated to company performance.⁴⁸ Beyond the lack of positive correlation between performance and compensation, there appears to be little punishment, per se, for poor performing executives. Fifty-three percent of CEO's who resigned or were asked to resign from companies due to poor performance remained as members of the board of directors of the company from which they departed, and 40 percent retained the chairman position on the board.⁴⁹ Therefore, not only is there apparently little incentive to perform, there is no disincentive to fail to perform either.

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Realigning Competing Interests— Use of Restricted Stock

The ultimate goal of incentive-based pay is to encourage an executive to perform at a level that will increase the value of the company and ultimately the value of his or her compensation,⁵⁰ while also permitting the company to have more cash on hand for investment and to pay its liabilities as they come due.⁵¹ These goals must be kept in perspective when awarding compensation packages. These factors, coupled with the desire to remove inside factors like information control from the equation, have led some companies to utilize restricted stock as the mechanical answer to the performance pay problem.

Restricted stock is a grant of shares that restricts the right to transfer or sell the shares until after a defined vesting period or pre-defined metrics are achieved.⁵² It has increased in use from 10 percent of total executive compensation in 2004 to 15 percent in 2005.⁵³ Restricted stock, like stock options, has two primary classifications, qualified employee stock purchase plans⁵⁴ and non-qualified employee restricted stock plans, both with differing tax treatment. When restricted stock is issued, the executive is not entitled to the stock until he or she actually performs; therefore, the stock is subject to a substantial risk of loss and will not be immediately taxed.⁵⁵ The restricted stock will be taxed when earned and when there is an ascertainable value,⁵⁶ requiring the executive to pay tax immediately on the gain even though the executive has not actually received cash for the stock.⁵⁷ To help the executive, the taxes may be paid when the restricted stock is first issued based on the implicit value, which is often very low, and additional taxation does not occur until the stock is sold.⁵⁸ While tax-wise and structurally, restricted stock may fill in the stock option gaps, to avoid revisiting similar problems, oversight by the board to protect the long-term value for the company is still necessary, and a process of continuous evaluation and improvement regarding major expenditures like executive compensation is required to ensure the continued increase in the value of the company for the sake of the shareholders.

NOTES

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