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## Even Last Year, Option Spigot Was Wide Open

By STEPHANIE STROM

**SURPRISE, surprise. Early reports suggest that top executives across America got a bigger dollop of stock options last year as part of their pay.**

**As corporate earnings and cash flow have ebbed and stock prices have fallen, boards have been doling out options as a cheap, balance-sheet-friendly way of compensating managers.**

**The annual proxy season, when companies reveal compensation, is just starting. If the disclosures show the trend toward larger option grants holding after a year that most companies would like to forget, it would seem to make a mockery of the concept of pay for performance. That was the reason options grew so popular in the first place. Yet while some companies are trying to make options better reflect their fortunes, most others simply contend that options are primarily a motivational tool and have never been a reward for performance.**

**With stock prices stalled, options may not seem attractive now. But executives who receive them can usually count on rich rewards eventually, even if a company does only marginally better. The increase in options, however, imposes additional costs on shareholders; the more options granted, the lower the return for investors, since their holdings are, one way or the other, diluted.**

**But the options keep coming. Chief executives who received more of them last year, even as their companies suffered, include Daniel A. Carp of Eastman Kodak ([news/quote](#)), John T. Chambers of Cisco Systems ([news/quote](#)), Scott G. McNealy of Sun Microsystems ([news/quote](#)) and Harvey R. Blau of Aeroflex ([news/quote](#)).**

**And Henry B. Schacht, returning to the helm of troubled Lucent ([news/quote](#)), received annual options grants almost five times the size of those his predecessor received — and more than 17 times the size of the last grant he received the year he retired. "Fiscal 2001 was rather challenging for Lucent, so the grants were made to ensure Henry had management stability through the turnaround," said Mary Lou Ambrus, a Lucent spokeswoman, in explanation.**

**Chances are, many chief executives received bigger options awards, as proxy statements, filed each March and April by most companies, are expected to show, experts say. Some were no doubt issued to make up for previous grants that had been rendered worthless by tumbling stock prices.**

**At the same time, the market's recovery has revived hopes that old option grants will not be worthless. "Options typically run for 10 years, and already many of the ones issued in the last year are back in the money," said John N. Lauer, chief executive of Oglebay Norton, a shipping company. "If the economy recovers, those issued in previous years will also regain value."**

**MR. LAUER has gained notoriety in corporate circles for his insistence on being paid entirely in options priced well above Oglebay's stock price. Though Oglebay's performance has improved somewhat, options he received five years ago are still worth nothing.**

**"In a social setting where I'm in a room with other C.E.O.'s, someone will teasingly suggest that they pass the hat for me because I'm not making any money," he said. "I think they figure I'm loony or something."**

**Mr. Lauer is not the only executive to have high performance goals, but it is safe to say that most executives keep drawing large salaries, plus more and more options. According to a survey done in the third quarter of last year by Pearl Meyer & Partners, a human resources consulting firm in New York, the number of options granted by 50 major companies that will report their 2001 compensation this spring was up an average of 12 percent from 2000.**

Consultants expect that trend to continue as companies report 2001 compensation practices this spring. "It's a great time to give options," said Pearl Meyer, president of the firm. "They're cheap because they involve no charge to earnings, and that's important at a time when profits are down and boards are trying to make up for the fact that salaries and bonuses are both down."

But Ms. Meyer and many others in the field — as well as, they say, the members of corporate compensation committees — are not happy to see the increase in options grants. Their expressions of concern are striking because compensation consultants have been among the biggest champions of the use of options as performance incentives.

The consultants are worried, in part, about the option "overhang" — options outstanding, plus those shares that investors have authorized but that have yet to be granted. More fundamentally, they suggest that the links between a manager's pay and a company's performance — as measured by, say, profitability, market-share growth and smart acquisition strategies — have become more tenuous.

Ms. Meyer suggests that the at-risk components of executive pay be viewed as the legs of a stool; the leg reflecting stock performance has grown longer and longer, while those reflecting business and financial performance have become shorter.

"We have overdosed on options and the stock market," she said. "We're dependent on the stock market for executive compensation, pension payments, directors' compensation, 401(k) plans — our whole economy, practically, is dependent on the market's performance."

That reliance has produced an overhang that dangles like a sword of Damocles over investors. Eventually, their stakes will be diluted — either when companies issue vast quantities of new shares to make good on options grants, or when they undertake share-repurchase programs that eat up cash they might use for operations.

According to a study by Watson Wyatt Worldwide, a human resources consulting company, the average options overhang of the companies in the Standard & Poor's 500- stock index was 14.6 percent of outstanding shares in 2000, up from 13 percent a year earlier.

This spring's numbers will probably show another rise. The overhang "is definitely going to be up" by a percentage point or more in 2001, said Ira T. Kay, a consultant at Watson Wyatt Worldwide, "because people aren't exercising their options the way they were when the stock market was booming."

Mr. Kay predicted that the slowdown in the exercising of options would work to curb the issuing of new ones this year and next, although he anticipates a slow increase over the long term. "I've been in meetings of five boards that were very reluctant to go to shareholders to ask for more shares to underwrite options grants," he said. "They don't think they can justify it."

Companies are losing out on another salutary benefit of options compensation as well — their ability to reduce corporate taxes. Employers get a deduction when employees exercise options, but as Mr. Kay and other compensation consultants note, these days few are cashing them in.

Oddly, shareholder advocates and institutional investors, who stand to lose the most from an option glut, seem sanguine thus far. Some note that while option awards have increased, the value of the awards has collapsed. Pearl Meyer's research shows that the value of option grants fell 7 percent in the first eight months of 2001 after rising steadily for several years.

Some shareholder advocates say that will also help curb future grants, as long as stocks are sluggish.

"We've had a 20 percent drop in the Standard & Poor's index," said Patrick S. McGurn, of Institutional Shareholder Services, a consulting business in Rockville, Md. "And the standard valuation method for options would tell you that you'd have to double or triple grants just to get to the level where you were the previous year. Most boards are going to balk at those numbers, particularly when corporate performance has been so poor."

**But that may be wishful thinking. Last year, Eastman Kodak took \$659 million in restructuring charges that, combined with falling sales and market share, pushed its earnings down 95 percent. In November it awarded its chief executive, Mr. Carp, options for 250,000 shares at an exercise price of \$29.31, Kodak's stock price at the time. All Mr. Carp must do to gain is keep Kodak's stock level.**

**That grant came on top of the 100,000 options he received in January 2001 at a strike price of \$40.97. So Mr. Carp received three and a half times as many options in 2001 as he did in 2000 — at markedly lower strike prices. Sandra R. Feil, director for worldwide total compensation at Kodak, said Mr. Carp received two awards last year because the company had changed the timing of its grants, to November from January.**

**As for the increase, Ms. Feil said Kodak had worked with Frederic W. Cook & Company, a compensation consultant, which found that Mr. Carp was in the lowest 25 percent of executives receiving options. "What we've done," she said, "is taken a step, and even a conservative step at that, in getting him out of that lowest quartile."**

**But what about Kodak's dismal performance last year? "We look at stock options as a long-term incentive that's forward-looking," Ms. Feil said. "We don't look at them as a reward for past performance."**

**To understand just how easy it is to get richer and richer on options, consider the case of Lawrence J. Ellison, chairman, chief executive and co-founder of the Oracle Corporation ([news/quote](#)), the software maker. In January, with Oracle's stock trading just above \$30, near its yearly high of \$34, Mr. Ellison exercised option grants for about 23 million shares at an average price of 23 cents, for a paper profit of more than \$700 million.**

**It was the biggest options bonanza on record — and Mr. Ellison holds options to buy an additional 47.9 million shares. "He could end up taking \$3 billion out of the company," said Judith Fischer, managing director of Executive Compensation Advisory Services, a consulting firm.**

**Investors are often forgiving of founders like Mr. Ellison, many of whom staked personal assets and invested buckets of sweat equity to get companies off the ground. His paper profit has shrunk to \$378 million as Oracle's stock has sagged.**

**But investors were still piqued by Mr. Ellison's timing. He exercised his options a month before Oracle issued an earnings warning. The options expired on Aug. 1; he was under no pressure to sell them in January.**

**To protect shareholders from dilutions from options, Oracle routinely buys shares in the market. Other big corporate users of options, like Microsoft ([news/quote](#)) and Dell Computer ([news/quote](#)), do, too, contending that it not only protects shareholders, but offers them tax advantages.**

**But repurchase programs can also have a huge impact on a company's cash flow. Oracle started the fiscal year that began June 1, 2000, with \$7.4 billion in cash, then spent \$4.3 billion to repurchase shares largely for use in its options program.**

**At the end of the fiscal year, the company's overhang stood at 28 percent of total outstanding shares. Microsoft has a similarly large overhang, but it also has more cash.**

**For years, shareholders have pushed companies to make chief executives earn their keep, and they initially applauded the use of options to accomplish that goal. But companies found ways to make sure the options were worth something regardless of performance, by repricing worthless options or replacing them with fistfuls of new ones.**

**The outcry over those practices, however, may be pushing some companies to make changes.**

**In the spring of 1999, the LongView Collective Investment Fund, which manages some A.F.L.-C.I.O. pension money, submitted a shareholder proposal to the Chubb Corporation ([news/quote](#)), the insurer, asking it to grant options that would more closely align compensation with performance.**

**The proposal was defeated. But when Beth W. Young, an independent consultant who advises the A.F.L.-C.I.O. and other pension fund managers, called Chubb the next spring to resubmit the proposal, she was told**

that Chubb had already incorporated into its incentive plan options that could be exercised only if the stock price rose significantly.

Roughly half the options handed out to Chubb's senior management in 2000 and 2001 have an exercise price 25 percent higher than the stock price on the day they were granted. But only 2 percent to 4 percent of large companies use such "premium priced" options, consultants say.

"The executives who were granted these options will, at least in theory, have a much stronger incentive to take steps to increase the stock price," said Donald B. Lawson, the Chubb senior vice president who manages compensation and benefits.

Chubb also uses "performance shares," which can typically be redeemed only after three years and only if the company clears specific hurdles. In 2000, for example, the performance shares it handed out in 1998 were worthless because the company did not hit those targets.

For Dean R. O'Hare, Chubb's chief executive, that meant his total compensation fell by \$448,508 from the previous year. He did get more options, but those largely replaced restricted shares — those that cannot be sold right away — after the company decided not to use them to reward executives, Mr. Lawson said.

Performance shares held by C. Michael Armstrong, the chief executive of AT&T ([news/quote](#)), have proved to be worthless for three years, as the company has fallen short of the board's goals for increases in total return to shareholders.

An options award for 419,200 shares granted to Mr. Armstrong at the end of 2000 was also tied to better performance. The options can be exercised only if AT&T produces a \$145 billion pretax gain for shareholders in the year that started March 31. On the other hand, another twist on options accelerates the vesting period if a company's shares reach a certain target. In 2000, the Williams Companies ([news/quote](#)) granted options with the condition that if, on certain days, the stock traded at 1.4 times the price at the beginning of the year, the options could be exercised immediately rather than over three years.

Other companies are working to get more plain-vanilla stock, not options, into executives' hands — stock they must buy. When Beazer Homes USA ([news/quote](#)), a home builder, went public in 1994, it adopted a management stock purchase program to increase managers' stakes. At the beginning of each year, some 80 executives can choose to give up a percentage of their bonuses to buy stock at a 20 percent discount on the year-end closing price. The stock cannot be sold for three years.

Executives now own roughly 8 percent of the company, said David S. Weiss, Beazer's chief financial officer. "We think it's a good idea to have them put real money at risk, as opposed to just receiving a reward," he said. "Options feel like a gift from the company that the market, through its whims, will reward or not. Shares reflect the company's performance, whether good or bad."

Mr. Kay, at Watson Wyatt, said such pure stock subsidies were gaining popularity. More companies, he said, plan to use contingent options like those at Chubb and AT&T, which try to reflect financial and business performance.

Investors expect the BellSouth Corporation ([news/quote](#)) and the Eaton Corporation ([news/quote](#)), for example, to disclose such adjustments in their new proxy statements. A spokesman for Eaton said he was unaware of such a move, and a spokesman for BellSouth declined to comment until the proxy is released in March.

But other boards are already finding ways to limit the risks that performance shares, premium-priced options, performance-accelerated options and other performance-linked tools pose.

Until last April, Archie W. Dunham, chief executive of Conoco ([news/quote](#)), had options giving him the right to buy 700,000 shares. But he could exercise them only if Conoco's shares traded above \$35 on each of the five days before Aug. 17 of this year.

**Before Conoco bought Gulf Canada Resources in July, however, its board granted a two-year extension to Mr. Dunham and at least six other executives holding those options. "The board thought the climate was right this year for some kind of an acquisition but that it could have an adverse effect on the stock price," John McLemore, a Conoco spokesman, said. "They thought it wouldn't be really fair for those people who held these options to be punished for something that might make it harder for them to meet the conditions."**

**That means the board rewarded Mr. Dunham and his colleagues for an acquisition that it knew was likely to hurt Conoco's shares, at least temporarily — a courtesy not extended to shareholders.**