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Option Math: Why So Many to So Few?

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Among corporate executives, there are wealth spreaders and wealth hoarders.

The spreaders disperse millions of stock options among their employees, not just to top executives, allowing many to benefit when the company's stock rises. Spreaders remain very much in the minority, but their ranks include management at Walt Disney, many large technology companies like [I.B.M.](#) and [Microsoft](#) and drug makers like [Johnson & Johnson](#).

The hoarders, meanwhile, concentrate option grants among a tiny group, sometimes even keeping 50 percent or more of all options in the hands of five senior executives. [Circuit City Stores](#), [Citigroup](#), [Target](#) and [United States Steel](#) are hoarders, according to an analysis done for Money & Business of filings by the country's 250 largest companies that award options.

This may well be a year of reckoning for stock options, and the way they are distributed is driving much of the debate. The tax scandal that recently forced the resignations of Sprint's top two executives had its roots in their gains from an enormous pile of options, which towered over the holdings of most Sprint workers.

Last week, Ernst & Young became the first major accounting firm to lobby regulators in favor of requiring companies to take a charge against earnings for awarding options, as they must do for other forms of pay. Many executives aggressively oppose a rule change and are threatening to stop giving options to rank-and-file workers if the grants would reduce reported earnings.

But the actual distribution of options has received relatively little scrutiny. In reality, the use of options is far less democratic than many opponents of an earnings charge have claimed, and their concentration appears to be damaging many companies' performance, according to the analysis of company filings, which was done by Joseph R. Blasi and Douglas L. Kruse, management professors at Rutgers.

"The enormous variation in what boards of directors have done with their top five executives," Mr. Blasi said, "raises serious questions about corporate governance and the process that's used to divide the stock

option pie."

The 250 biggest options-granting companies, which employ an average of 69,000 people, gave an average of 18.1 percent of options to just the top five executives during their 1999 through 2001 fiscal years. Many of the remaining options went to executives on the next few rungs of the corporate ladder, according to compensation consultants and other surveys. In 1999, about 1.7 percent of private-sector workers received options, according to the most recent government study.

"Broad-based employee options are not the norm," said Jannice M. Koors, a vice president at Pearl Meyer & Partners, a compensation consulting firm in New York.

Yet, defying some traditional management theory — which holds that options are best used to motivate only people with clear control over a company's stock price — the spreaders have outperformed the hoarders over the last decade, posting an annual return that is almost nine percentage points better. (Options, which have become the dominant form of executive pay over the last decade largely because of the favorable accounting treatment, give their holders the right to buy shares at a fixed price, regardless of the current market price.)

Even a glance at the list of companies that have recently given more than 20 percent of their options to their top five executives in a single year makes the point. Beside Sprint, it includes two targets of Securities and Exchange Commission investigations ([Tyco International](#) and [Qwest Communications International](#)), a company that agreed to reimburse its customers \$400 million for improper billing ([Providian Financial](#)) and one subject of a Federal Bureau of Investigation raid late last year ([Tenet Healthcare](#)).

Broad-based plans, while rare, do lie at the core of a management credo shared by most big companies in the technology and pharmaceutical industries, as well as a few others.

"There's a management philosophy that leadership can be exhibited everywhere in the company," said David L. Shedlarz, the chief financial officer of [Pfizer](#), which makes Roloids, Sudafed and Viagra, among other products. "The stock-option program is meant to exhibit exactly that culture."

Individually, senior Pfizer executives still receive many times the number of options that other employees do. Together, though, the top five received about 4 percent of options from 1999 to 2001, according to Professors Blasi and Kruse, who are the authors, with Aaron Bernstein, a Business Week writer, of "In the Company of Owners: The Truth About Stock Options" (Basic Books, 2003, \$27.50).

In a typical year, Pfizer gives options to about 15 percent of its employees, most of whom are managers and the rest of whom are rewarded for specific accomplishments. Robert W. Norton, the senior vice president for human resources, said he thought the grants had helped keep Pfizer's turnover "always in

the single digits."

Many technology companies go further in spreading around their equity. At [Cisco Systems](#), 80 percent of options go to employees below the level of vice president, said Robyn Jenkins, a spokeswoman. Since 1994, Cisco employees outside of the top five executives have made an astonishing \$19 billion exercising stock options — or roughly \$97,000 annually per employee, Professors Blasi and Kruse said.

Of course, the spreading of wealth could not insulate Cisco or any other company from the sharp downturn in technology spending. At the close of trading on Friday, Cisco's stock was more than 83 percent below its peak in 2000.

And there is a flip side to the company loyalty that option grants can promote: riches created by the stock market's technology bubble raised employee turnover by allowing many workers at Cisco and other Silicon Valley companies to retire early.

As for the top five Cisco executives, they were taken care of. Each has made about \$18 million annually, not including shares that were granted to them outright, rather than in the form of a stock option.

[Intel](#), widely respected over the years as a well-managed company, is the most aggressive distributor of options on the Rutgers list. It was the only company to have awarded less than 1 percent of its option grants to the top five executives between 1999 and 2001.

(Most companies have not yet filed their annual proxy statements, which contain option information, for 2002.)

At the other end of the spectrum are many energy companies and old-line manufacturers. [Baker Hughes](#), an oil and gas company based in Houston, ranked first, giving more than half of all options to its top five executives in 2001 and more than 90 percent in 1999, according to Professors Blasi and Kruse.

[Conoco](#), another energy company based in Houston, offered a window into the way a management team that seems to be a generous spreader of options can in fact keep them concentrated. Early in 2001, Conoco gave 100 options to every one of its employees, the second time it had made such a grant in three years. The company, which has since become ConocoPhillips, made the announcement on its annual "Pie Day," a celebration of its commitment to sharing a piece of its financial pie with workers.

But compared with the 700,000 options that Archie W. Dunham, the chief executive, received in 2001, the employees' awards were crumbs. Conoco, eighth on the list, granted almost a quarter of all options to its top executives that year.

Mr. Dunham has said that Conoco gave options to employees primarily to make them interested in the stock price and that the options were not meant to serve as a significant portion of their pay.

Some management experts call the hoarding of options a perfectly rational strategy for executives. Workers tend to view a stock option as less valuable than an outside investor would because they are usually prevented from trading it freely and because they are rightly wary of tying too much of their money to their employer. Many employees also have trouble seeing the connection between their own job and their company's stock price.

"The most effective incentives are those that reward people for things over which they have control," said Ms. Koors, the compensation consultant. "When you really get down to the number of people who have the ability to influence stock prices, it's not a big group."

In fact, there are many companies that have spread equity throughout their ranks and failed. [WorldCom](#) sits near Cisco and Intel on the Rutgers list, having given just 3 percent of options to its top five executives, while the unions at [UAL](#), the parent of United Airlines, received more half of the company's stock in the 1990's. Both WorldCom and UAL filed for bankruptcy protection last year.

THE list of 250 options-granting companies appears to confirm these anecdotes. The stocks of the 50 companies that have spread their options most widely fell 29.9 percent from Jan. 1, 1999 through Thursday, according to the RiskMetrics Group, a financial analysis company in New York. Stocks of the 50 that have concentrated them at the top fell 11.8 percent in the period.

The reason may well have little to do with compensation practices — and much more to do with bigger economic trends, however. The last three years have been kind to energy companies and harsh to technology concerns. In fact, over long periods, companies that distribute options or stock to many workers tend to do better than those that do not, according to a number of academic studies.

From 1993 to 2001, the one-quarter of companies that gave the smallest shares of options to top management gave their investors a 31.3 percent annual return, according to a study of 1,500 companies by Professors Blasi and Kruse. Shareholders of the one-quarter of companies that gave top executives the biggest slices of the options pie received only a 22.5 percent return.

Controlling for industry trends — so that the rise and fall of technology stocks do not account for differences, for example — a study by Professors Blasi, Kruse and James Sesil of Rutgers and Maya Kroumova of the New York Institute of Technology found that companies with broad-based equity plans were 7 percent more productive than those without them.

Simply handing out options is not enough to make a difference, say many executives who do distribute options widely; companies must also treat employees as people with a stake in the business.

[Southwest Airlines](#), the only large carrier that is profitable today, gives less than 7 percent of options to the top five executives and roughly an additional 18 percent to other managers. The remainder go to

customer service agents, dispatchers, flight instructors, mechanics and pilots, among other employees. The company also asks these workers to help shape its strategy, from its overhaul of boarding procedures after the Sept. 11 attacks to its recent switch of onboard coffee brands.

"Our approach is real simple: if it applies to management, we want it to apply to everyone," said Gary C. Kelly, Southwest's chief financial officer. "We want all 35,000 Southwest employees acting in the best interest of Southwest as a whole. We think tying your wealth to Southwest's stock is the way to do that."