

February 2004

## Pay without Performance, The Unfulfilled Promise of Executive Compensation, Part III: The Decoupling of Pay from Performance

Lucian Arye Bebchuk<sup>\*</sup> and Jesse M. Fried<sup>\*\*</sup>

This paper contains a draft of Part III of our forthcoming book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, September 2004). The book provides a detailed account of how structural flaws in corporate governance have enabled managers to influence their own pay and produced widespread distortions in pay arrangements. The book also examines how these flaws and distortions can best be addressed.

Part III of the book examines how managerial influence has operated to reduce the performance-sensitivity of executive pay. Among other things, we examine the structure of non-equity compensation, the design of conventional option plans, the use of restricted stock grants, and managers' freedom to unload options and shares.

Keywords: Corporate governance, managers, shareholders, boards, directors, executive compensation, stock options, principal-agent problem, pay for performance, agency costs, rent extraction, stealth compensation, camouflage.

JEL classification: D23, G32, G34, G38, J33, J44, K22, M14.

---

<sup>\*</sup> William J. Friedman Professor of Law, Economics, and Finance, Harvard Law School, and Research Associate, National Bureau of Economic Research.

<sup>\*\*</sup> Professor of Law, Boalt Hall School of Law, University of California at Berkeley.

In the course of writing our book manuscript we have incurred debts to many individuals whom we will thank in the published version of the book. For financial support, we are grateful to the John M. Olin Center for Law, Economics, and Business (Bebchuk) and the Boalt Hall Fund and U.C. Berkeley Committee on Research (Fried). Comments are most welcome and could be directed to [bebchuk@law.harvard.edu](mailto:bebchuk@law.harvard.edu) or [friedj@law.berkeley.edu](mailto:friedj@law.berkeley.edu).

© 2004 Lucian Bebchuk and Jesse Fried. All rights reserved.

# Pay without Performance: The Unfulfilled Promise of Executive Compensation

Lucian Bebchuk and Jesse Fried

## TABLE OF CONTENTS

Introduction

### Part I: The Official View and its Shortcomings

- Chapter 1: The Official Story
- Chapter 2: Have Boards Been Bargaining at Arm's Length ?
- Chapter 3: Shareholders' Limited Power to Intervene
- Chapter 4: The Limits of Market Forces

### Part II: Power and Pay

- Chapter 5: The Managerial Power Perspective
- Chapter 6: The Relationship Between Power and Pay
- Chapter 7: Managerial Influence on the Way Out
- Chapter 8: Retirement Benefits
- Chapter 9: Executive Loans

### Part III: The Decoupling of Pay from Performance

- Chapter 10: Non-Equity Compensation
- Chapter 11: Windfalls in Conventional Options
- Chapter 12: Excuses for Conventional Options
- Chapter 13: More on Windfalls in Equity-Based Compensation
- Chapter 14: Freedom to Unwind Equity Incentives

— *Included in  
this paper*

### Part V: Going Forward

- Chapter 15: Improving Executive Compensation
- Chapter 16: Improving Corporate Governance

TABLE OF CONTENTS OF PART III (THIS PAPER)

CHAPTER 10: NON-EQUITY COMPENSATION ..... 1

    Windfalls in Salary and Bonus ..... 2

    Do Bonus Plans Reward Performance?..... 4

    Bonuses for Acquisitions ..... 9

    Golden Hellos ..... 12

    Split-Dollar Life Insurance Policies ..... 14

    Soft Landing in Cases of Utter Failure ..... 15

    The Myth of Limited Non-Performance Pay ..... 18

CHAPTER 11: WINDFALLS IN CONVENTIONAL OPTIONS..... 20

    Option Plan Design: The Devil is in the Details ..... 20

    The Benefits of Reducing Windfalls ..... 22

    The Many Ways of Reducing Windfalls ..... 24

    The Puzzling Avoidance of Reduced-Windfall Options ..... 27

    The Managerial Power Explanation ..... 29

CHAPTER 12: EXCUSES FOR CONVENTIONAL OPTIONS..... 32

    Accounting Excuses ..... 32

    The Battle Over Options Accounting ..... 35

    Efficient After All?..... 39

Chapter 13: More on Windfalls in Equity-Based Compensation..... 48

    At-the-Money Options..... 48

    Re-pricing and Backdoor Re-pricing ..... 55

    Reload Options ..... 61

CHAPTER 14: FREEDOM TO UNWIND EQUITY INCENTIVES..... 68

    Benefits of Restricting Early Unwinding ..... 68

    Managers’ Widespread Freedom to Unwind Early ..... 70

    Managers’ Freedom to Time Their Sales..... 74

    Perverse Incentives..... 80

## CHAPTER 10: NON-EQUITY COMPENSATION

“Eighty percent of success is showing up.”

- Woody Allen

Managers’ influence over the own pay has enabled them to obtain a larger amount of compensation than they would receive under arm’s length bargaining. Perhaps more important, managers’ influence leads to pay without performance -- arrangements that weaken the link between compensation and performance and that sometimes even create counter-productive incentives. The failure of compensation arrangements to provide desirable incentives is the focus of this part of the book.

Arm’s length contracting might conceivably call for sizable compensation packages for executives, but it would demand that such arrangements provide strong incentives to enhance shareholder value.<sup>1</sup> Paying large sums to managers can benefit shareholders if it induces managers to increase the size of the corporate pie by an even larger amount. Indeed, the justification often offered when executives receive substantial packages is that generous compensation aligns managers’ and shareholders’ interests.

The problem, however, is that the high price shareholders have been paying for executive compensation has bought too little incentive. Much of both equity-based and non-equity compensation is substantially disconnected from, or only weakly linked to, managerial performance. This pay/performance disconnect, which is puzzling from an arm’s length contracting view, is very costly to shareholders.

In subsequent chapters, we will show that executives’ stock- and option-based compensation has been much less performance-sensitive than widely believed. We begin, however, with the large part of compensation that is not equity-based -- that is, not tied to changes in stock price. Although the equity-based fraction of managers’ compensation has

---

<sup>1</sup> A well-known, forceful appeal for large compensation comprised of high-powered incentives was made by economists Michael Jensen and Kevin Murphy in 1990. Michael Jensen and Kevin J. Murphy, “Performance, Pay, and Top-Management Incentives,” *Journal of Political Economy* 98 (1990): 225-264.

increased considerably during the past decade and has therefore received the most critical attention, non-equity compensation continues to be substantial. In 2002, for example, CEOs of S&P 500 firms received over \$2 million in salary and bonus.<sup>2</sup>

As we discuss below, there are several reasons why much of the non-equity compensation that managers have been enjoying delivers weak performance incentives. Executives hired from outside the firm often receive hefty “golden hellos” even before they walk in the door. Once in office, they may enjoy increases in salary, and even bonuses, when the firm profits for reasons that have little or nothing to do with their own performance. Although bonuses’ *raison d’être* is to reward good performance, they often have been given even to poorly performing managers.

In addition to performance-decoupled bonuses, managers have also benefited from various hidden forms of compensation (such as retirement benefits and loans, discussed in chapters eight and nine) that are largely decoupled from their own performance. Generous severance arrangements for fired managers have further boosted pay without performance. In sum, although tax rules make it more costly for firms to provide non-performance-based compensation in excess of \$1 million per year, companies have been finding ample ways to circumvent the spirit of this limitation. The widely held belief that firms can deduct only \$1 million per year of non-performance-based compensation is, in fact, mistaken.

### **Windfalls in Salary and Bonus**

From the perspective of efficient incentives, it is desirable to reward executives for good performance. To determine whether a manager has performed well, however, we must assess his or her performance relative to that of peers. There is no incentive value to rewarding managers for increases in stock price or accounting earnings that have nothing to do with their efforts or decision-making, but rather reflect general market or sector changes, or simply pure luck.

If salary and bonuses are to create desirable incentives, their amounts must depend on the executive’s own performance. Salary increases should correlate strongly with executive performance relative to that of other

---

<sup>2</sup> Paul Hodgson, “What Really Happened to CEO Pay in 2002,” *The Corporate Library* (June 2003), p.8.

managers in the industry during the preceding period. Likewise, bonus plans should be designed to reward an executive only for his or her own contribution to the firm's bottom line.

It is striking that empirical work has failed to find any strong, persistent correlation between cash compensation, i.e., salary and bonuses, and managers' performance relative to their respective industries.<sup>3</sup> Although some correlation may have existed during the 1980s, there was none in the 1970s or 1990s. These findings indicate that managers' cash compensation has been at most weakly linked to their performance.

Rewarding executives for unrelated stock price gains or earnings increases makes little sense if creating incentives is the board's goal. Such pay arrangements, however, are just what one would expect from a system shaped by managerial influence. A CEO with power over the board can use unrelated gains as a pretext for increasing compensation. When the firm's stock price goes up or its earnings increase, the board has a convenient excuse to increase executive compensation. Additionally, due to the rise in the stock price, shareholders are less inclined to resent or even notice the pay raise. Indeed, the evidence indicates that CEO cash compensation is strongly correlated with market-wide stock price increases.<sup>4</sup>

In addition, two studies show that cash compensation increases in response to sector-wide and firm-specific windfalls. The first study, by Olivier Jean Blanchard, Florencio Lopez-de-Silanes, and Andrei Shleifer,<sup>5</sup> examines what eleven firms did with recoveries they received in connection with settled or victorious lawsuits. Most of the suits had nothing to do with the firms' current business activities, and thus the legal victories were most likely unrelated to the efforts of current executives. The study found that the

---

<sup>3</sup> See Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, vol. 3, bk. 2, ed. Orley Ashenfelter and David Card (New York: Elsevier, 1999), p. 2535. Some correlation between cash compensation and managerial performance was found in the 1980s (see Robert Gibbons and Kevin J. Murphy, "Relative Performance Evaluation for Chief Executive Officers," *Industrial and Labor Relations Review* 43 (1990): 36), but not in the 1970s and 1990s.

<sup>4</sup> See Charles P. Himmelberg and R.G. Hubbard, "Incentive Pay and the Market for CEO's: An Analysis of Pay-for-Performance Sensitivity," working paper, Columbia University and the National Bureau of Economic Research, 1999, pp. 17, 24.

<sup>5</sup> See Olivier Jean Blanchard, Florencio Lopez-de-Silanes, and Andrei Shleifer, "What Do Firms Do with Cash Windfalls?" *Journal of Financial Economics* 36 (1994): 358-359.

firms retained the bulk of the windfalls. Those firms distributing cash either gave a significant dividend to a large controlling shareholder or repurchased the shares of large outside shareholders that could pose a threat to managers. On average, 16 percent of the net award was given to the top three executives in each firm during the three years following the award, boosting median cash compensation to these executives by 84 percent.

The second study, by Marianne Bertrand and Sendhil Mullainathan, found that managers are rewarded for sector-related “luck.”<sup>6</sup> The authors examined the compensation of managers when their respective sectors did exceptionally well for reasons beyond their control. They studied three such situations: (1) when oil price increases boosted the performance of the oil industry; (2) when a change in exchange rates benefited import-affected industries; and (3) when, for some other reason, all other firms in the industry performed well. They found that, in all three situations, managers were paid the same for a “lucky” dollar as for a “general” dollar (a dollar that does not appear to be generated by “luck”).

As the authors of the above studies recognized, arm’s length contracting would be unlikely to produce results of this kind. Rewarding managers for “luck,” or for improvements in the business environment that are beyond their control, does not provide them with useful incentives. The managerial power approach, however, predicts that managers will take advantage of such windfalls to increase their pay when such an increase is less likely to generate outrage.

### **Do Bonus Plans Reward Performance?**

We now take a closer look at the structure of bonuses. The term “bonus” suggests a payment for particularly good performance. It may then come as a surprise that the total salary and bonus paid to an executive does not correlate strongly with the executive’s performance as compared to that of his or her peers. After one sees how bonus plans have been designed, this finding is less surprising. Bonus design commonly provides executives with value even when their relative performance is not particularly good.

---

<sup>6</sup> See Marianne Bertrand and Sendhil Mullainathan, “Are CEOs Rewarded for Luck?: The Ones without Principals Are.” *Quarterly Journal of Economics* 116 (2001).

Firms use both objective and subjective criteria for determining an executive's bonus eligibility and amounts. The objective measures are goals whose attainment can be readily determined. This ostensible performance link allows the firm to deduct the bonus under Section 162 of the tax code. In truth, however, the measures are designed to enable the executive to benefit even after mediocre performance.

In some cases, for example, bonuses are tied to whether the executive meets the budget. Attainment of this goal is hardly a clear indication that the executive has increased shareholder value. In other cases, bonuses are awarded if profits exceed those of the preceding year. This use of past accounting results readily enables some executives to "earn" bonuses even when they perform poorly, because a firm's profits can be the worst in the industry and still beat the prior year's numbers. Interestingly, but in our view not surprisingly, a large majority of companies with bonus plans based on objective measures do not base bonuses on the firm's performance relative to its peer group.<sup>7</sup>

Awarding the CEO for surpassing the preceding year's performance may not only fail to provide beneficial incentives, but also distort managers' existing incentives. Such a scheme reduces the penalty for performing poorly: doing badly in any given year negatively affects that year's bonus, but positively affects the next year's bonus. The same scheme also lessens the reward for performing well: achieving in any given year, though perhaps increasing one's bonus, raises the bar and makes it harder to get a bonus the next year.

There are other ways in which firms provide performance-insensitive bonuses. For example, companies have based bonuses on accounting earnings not adjusted for the appreciation of pension fund investments and earnings derived from restating the "expected return" of such investments. The difference between filtered and unfiltered earnings can be significant.<sup>8</sup> For example, in 2000 and 2001, General Electric reported within its accounting earnings pension income of \$1.3 billion and \$2.1 billion respectively, about 10 percent and 11 percent of its pre-tax earnings. The

---

<sup>7</sup> Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, vol. 3, bk. 2, ed. Orley Ashenfelter and David Card (New York: Elsevier, 1999), p. 2537.

<sup>8</sup> Bethany McLean, "That Old Financial Magic; How Do You Grow Earnings Five Times Faster Than Revenues? Just Watch," *Fortune*, 18 February 2002, p. 70.



## *Non-Equity Compensation*

company used this pension income in the calculation of bonuses. In 2000 and 2001, IBM reported pension income of \$1.2 billion and \$904 million respectively, 10 percent and 13.2 percent of its pre-tax earnings for those years. Like GE, IBM considered the pension income in determining managers' compensation.

In 2001, Verizon Communications reported a net income of \$389 million and awarded its executives bonuses based on that amount. Net income would have been negative, however, had the company not included \$1.8 billion of pension income. Thus, Verizon Communications was able to use pension earnings - which generally depend on stock market performance and not on the efforts of the firm's executives -- to convert net income to profits, giving the firm cover to provide managers higher bonuses.

It gets worse. It turns out that Verizon's pension funds did not generate any real income in 2001; they had negative investment returns, losing \$3.1 billion in value. How then could Verizon report income of \$1.8 billion from its pension assets? The company merely increased its projection of future returns on pension assets to 9.25 percent, a move allowed under the accounting rules then in effect.<sup>9</sup> Thus, the \$1.8 billion in pension income used to move Verizon into the black did not even reflect actual returns generated by the pension funds. The pension income was simply the result of a change in the accounting assumptions. This certainly did not create any value for the firm or its shareholders.

To be sure, pension fund "losses" can reduce accounting earnings. Therefore, in theory, including pension results in earnings will sometimes reduce executive bonuses. But there were no such losses in most years during the bull market of the last two decades.

Excluding pension income for bonus purposes is hardly difficult. In some firms, such as McDermott, shareholder pressure has led the firm to remove pension income from earnings for purposes of bonus calculation.<sup>10</sup> Indeed, after the bull market ended, and pension fund performance did reduce accounting earnings, General Electric, Verizon, and other firms

---

<sup>9</sup> Floyd Norris, "Pension Folly: How Losses Become Profits," *New York Times*, 26 April 2002. p. C1.

<sup>10</sup> Ellen E. Shultz, "McDermott Alters Its Pay Formulas for Top Executives," *Wall Street Journal*, 25 February 2002, p. A2.

rushed to remove pension effects from bonus calculations in order to boost executive compensation. In some cases, firms have presented these modifications as corporate-governance reforms.<sup>11</sup>

The preceding discussion suggests that bonus plan design is likely to reflect managerial influence and managers' predictable desire to be well-paid regardless of performance. One insider put this point bluntly in a media interview:

"They now use performance formulas – based, say on return to equity – that determine the size of the bonus pool. Most of the formulas are b.s. When you've got a formula, you've got to have goals – and it's the people who are the recipients of the money who are setting these. It's in their interests to keep the goals low so that they will succeed in meeting them."<sup>12</sup>

In addition to objective measures -- which, as we have seen, often fail to link bonus pay to managerial performance -- many firms' bonus plans rely wholly or in part on subjective, discretionary measures. For example, boards consider factors such as strategic decisions and effective leadership. Observers might reasonably disagree on whether the executive meets the goal. The decision to provide the bonus depends on the judgment of the board or of its compensation committee.

Some economists justify the use of discretionary measures on the grounds that objective measures cannot fully reflect executive performance.<sup>13</sup> According to this view, the addition of subjective measures enables the board to base bonus pay on a more complete and accurate picture of the executive's performance. We agree that if a board is genuinely seeking to link pay tightly to performance, supplementing objective measures of performance with subjective ones can serve this purpose.

Discretionary measures, however, are not likely to improve the link between pay and performance unless the relationship between the board

---

<sup>11</sup> Jesse Drucker and Theo Francis, "Pensions Fall – Not CEO's Bonus," *Wall Street Journal*, 18 June 2003, p. C1.

<sup>12</sup> Carol J. Loomis, "This Stuff Is Wrong," *Fortune*, 25 June 2002, pp. 73-84.

<sup>13</sup> Kevin J. Murphy and Paul Oyer, "Discretion in Executive Incentive Contracts: Theory and Evidence," working paper, USC Marshall School of Business and Stanford University Graduate School of Business, 2002.

and the executive is arm's length. Otherwise, such measures provide another way for the board to compensate poorly performing managers and still pay lip service to the importance of incentives and shareholder value. In fact, the use of subjective performance measures may well contribute to the *absence* of a strong correlation between cash compensation and performance.

Besides using objective (but undemanding) targets and purely discretionary measures, boards engage in yet another practice that enables managers who perform poorly to obtain bonuses nonetheless. Boards often lower the goal posts when it appears that CEOs are unlikely to achieve their designated targets, or indeed have already missed them. As we'll see in chapterthirteen, a similar practice arises in option compensation when boards replenish or reset existing options after the stock price declines significantly below their exercise price.

One recent illustration is Coca Cola's lowering of a key target in its CEO's bonus plan.<sup>14</sup> When Douglas Daft became CEO in 2001, the board promised him a bonus increase if the firm's earnings increased by more than 15 percent annually over the five-year period beginning on January 1, 2001. The bonus was supposed to be between \$30 million and \$60 million, depending on the amount by which earnings growth passed the 15 percent threshold. In Coca Cola's public filings, the compensation committee reported that "the award allows Mr. Daft to achieve significant wealth only in the presence of significant performance." In April 2001, the company cut its earnings expectations. In May 2001, just a few months after the board put the incentive plan into effect, the board cut the bonus threshold from an earnings growth rate of 15 percent annually to an earnings growth rate of 11 percent annually. AT&T Wireless reset *its* bonus targets in the middle of 2002, after it became clear that its managers' performance would fall short. This maneuver enabled the top five executives to collect \$2.9 million in bonuses.<sup>15</sup> Other firms have set financial targets for bonuses, while adding a

---

<sup>14</sup> Richard Trigauz, "Great Disconnect," *St. Petersburg Times*, 26 May 2002, p. 1H; Louis Lavelle, "Executive Pay," *Business Week*, 15 April 2002, p. 84; David Leonhardt, "Coke Rewrote Rules, Aiding Its Boss," *New York Times*, 7 April 2002, sec. 3, p. 6.

<sup>15</sup> Jesse Drucker, "AT&T Wireless Eases Bonus Rules," *Wall Street Journal*, 15 April 2003, p. B3.

caveat that executives who fail to meet the targets can still receive bonuses if that is in “the best interests” of the company.<sup>16</sup>

### **Bonuses for Acquisitions**

We have seen how contractually promised bonuses do not correlate with managerial performance as strongly as one would expect under the arm’s length contracting model. This de-linking of pay and performance is also found in the practice of awarding “gratuitous” bonuses that are not required by existing contracts. A good example is the awarding of bonuses to executives whose firms have acquired other firms. During the last decade, in about 40 percent of large acquisitions, the CEO of the acquiring firm received a gratuitous multimillion-dollar bonus for completing the deal. In most cases, the award was in the form of cash.<sup>17</sup>

For example, in September 2000, the chairman of Chase Manhattan Corporation, William Harrison, signed a deal to buy J.P. Morgan & Company for \$30.9 billion.<sup>18</sup> As a “reward” for overseeing the acquisition, which took him three weeks to negotiate, the board paid Harrison a bonus worth \$20 million (half in restricted stock), to be spread over 2001 and 2002. Harrison’s three lieutenants, including Geoffrey T. Boisi, a vice chairman who had joined Chase only four months earlier, received special bonuses of \$10 million each, in addition to their regular salaries and bonuses. NationsBank paid its CEO, Hugh McColl Jr., almost \$45 million in restricted stock after the firm bought Bank of America. William Wise, the chairman of El Paso Natural Gas, received almost \$29 million for his company’s acquisition of Sonat.<sup>19</sup> Edward Whiteacre, the CEO of SBC, received a \$3.3 million bonus for completing a merger with Pacific Telesis Group and for his work in connection with the acquisition of another company.<sup>20</sup>

---

<sup>16</sup> Gretchen Morgenson, “The Rules on Bosses’ Pay Seem Written with Pencil,” *New York Times*, 25 May 2003, sec. 3, p. 1.

<sup>17</sup> Yaniv Grinstein and Paul Hribar, “CEO Compensation and Incentives – Evidence from M&A Bonuses.” *Journal of Financial Economics*, Forthcoming.

<sup>18</sup> Andrew Ross Sorkin, “Those Sweet Trips to the Merger Mall,” *New York Times*, 7 April 2002, Section 3, p.1.

<sup>19</sup> El Paso’s 2002 proxy statement.

<sup>20</sup> SBC 1998 proxy statement.

Even though acquisitions tend to benefit the shareholders of the target company considerably by providing them with substantial premia over the current stock price, they do not provide similar benefits to the shareholders of the acquiring company.<sup>21</sup> Share prices of acquiring firms do not generally increase around the time an acquisition is announced; instead, the stock price declines, on average, by 1 to 2 percent.<sup>22</sup> A recent study estimates that between 1980 and 2001, public shareholders of acquiring firms lost a total of \$218 billion from acquisitions.<sup>23</sup> And it is not because a few very bad deals drag down the average. A 2002 BusinessWeek study examining large acquisitions made in Spring 1998 found 61percent of the buyers “destroyed their own shareholders’ wealth” in the process by overpaying for their targets.<sup>24</sup>

Why do some managers engage in acquisitions that do not benefit their shareholders? One commonly offered explanation is that such executives wish to expand the size of their empire and thereby enhance their private benefits and prestige. Another explanation is managerial hubris: executives may be overconfident in believing that they can increase the value of the target firm.

In any event, there is no reason to expect managers to make fewer acquisitions than is desirable for shareholders. If anything, the concern is that executives may engage in too many acquisitions. Thus, there is little reason for an efficient contract to provide managers with additional rewards for acquiring other firms. Indeed, the promise -- or even the expectation -- of an acquisition bonus could exacerbate managers’ excessive acquisition tendencies.

In fact, during the eighteen months following Chase’s acquisition of J.P. Morgan, for which Chase executives received a gratuitous bonus of \$50 million, Chase Manhattan stock lost more than 30 percent of its value. To be

---

<sup>21</sup> See Bernard S. Black, “Bidder Overpayment in Takeovers,” *Stanford Law Review* 41 (1989): 597.

<sup>22</sup> Fred J. Weston, Juan A. Siu, and Brian A. Johnson, *Takeovers, Restructuring, and Corporate Governance*, 3d ed. (Upper Saddle River, N.J.: Prentice Hall, 2001), 200, 221.

<sup>23</sup> Sara B. Moeller, Frederik P. Schlingemann, and Rene M Stulz, “Do Shareholders of Acquiring Firms Gain from Acquisitions?,” working paper no. 2003-4, Dice Center (2003), p.9.

<sup>24</sup> David Henry, “Mergers: Why Most Big Deals Don’t Pay Off,” *Businessweek*, 14 October 2002, pp. 60, 62.

sure, this decline may have been due to other factors. But Chase was not an isolated case. A recent study by Yaniv Grinstein and Paul Hribar found that, on average, acquiring firm shareholders lost money in transactions where the CEO received a completion bonus. Moreover, the higher the acquisition bonus, the worse the deal tended to be for shareholders.<sup>25</sup>

Even if (hypothetically) acquisitions tended to increase the value of the acquiring firm's shares, there would still be little reason, from the perspective of incentives, to make acquisitions a special bonus event. After all, compensation packages already have a mechanism -- large option grants -- that provides incentives for executives to pursue opportunities that increase share value.<sup>26</sup> Because of managers' private interest in maintaining and building its empire, there might be a need to provide an additional award for value-increasing *downsizing*. But there certainly would be no need to give a special bonus for acquisitions. Indeed, special bonuses would only strengthen managers' personal incentives to make acquisitions rather than pursue other business strategies that make shareholders even better off.

As chapter seven discussed, managers of target firms often receive large acquisition-related benefits. Some compensation consultants "blame" large payments to target firm managers for the practice of giving gratuitous bonuses to acquirer executives. Alan M. Johnson, president of a New York City compensation consulting firm, explained: "And then there's a bit of envy. The executives are going to be sitting two doors down from guys whose options just vested. They're asking: what happened to me?"<sup>27</sup> The reasons usually given for the large payments made to the executives of target companies, however, do not apply to acquirer executives.

An acquisition causes target executives to lose much of the power and prestige associated with their former jobs, if not the jobs themselves. Payments may thus be required to induce them or their director friends to assent to the acquisition, or perhaps to remain with the company during the

---

<sup>25</sup> Yaniv Grinstein and Paul Hribar, "CEO Compensation and Incentives - Evidence from M&A Bonuses." *Journal of Financial Economics*, Forthcoming.

<sup>26</sup> One compensation consultant said that it is only fair to "award CEO's willing to take the risk to make bet your company, bet your career transactions." See Andrew Ross Sorkin, "Those Sweet Trips to the Merger Mall," *New York Times*, 7 April 2002, Section 3, p.1. But isn't that what running the firm is all about?

<sup>27</sup> Andrew Ross Sorkin, "Those Sweet Trips to the Merger Mall," *New York Times*, 7 April 2002.

transition. The acquirer's executives, however, do not face a loss of positions or benefits. On the contrary, they experience an expansion of empire that is likely to boost their pay, perks, and prestige. Thus, acquisition-related bonuses given to the acquirer's executives, unlike those given to the target's managers, are not necessary to facilitate a value enhancing acquisition.

Although acquisition bonuses cannot be explained by arm's length contracting, they are easily understood under the managerial power approach. Executives naturally wish to boost their compensation and boards are generally eager to accommodate them, as long as the increase can be explained to shareholders. Arbitrarily paying \$50 million bonuses to executives may create considerable outrage, however, so managers must look for excuses. Because acquisitions occasionally increase value for acquirer shareholders, boards of acquiring firms can give bonuses to their executives and plausibly claim they are rewarding managers for boosting shareholder value. In any given case, such a claim would be difficult to disprove.

Moreover, as the managerial approach predicts, managers with more power get bigger acquisition bonuses, all else being equal. Thus Yaniv Grinstein and Paul Hribar found that CEOs who were on a board's nominating committee received an additional \$1.4 million for completing a deal, and CEOs who chaired their boards received an additional \$1.4 million. This is yet another example of the strong relationship between power and pay, a subject we explored in chaptersix.

### **Golden Hellos**

Pay without performance often starts with a "golden hello" -- a large initial payment on top of the annual compensation package. These golden hellos have become larger and more common in the last ten years. Among the more infamous examples from the late 1990s were the \$45 million paid by Conesco when Gary Wendt joined the firm as CEO, and the over \$20 million that Kmart promised to pay incoming CEO Thomas Conaway during his first five years in office.<sup>28</sup>

---

<sup>28</sup> This section draws on a report by Paul Hodgson of The Corporate Library. See Paul Hodgson, "Golden Hellos," The Corporate Library, 2002.

Although golden hellos often have an equity component, almost all of them contain a substantial cash component. The cash takes a number of forms, such as “make-whole payments,” signing bonuses, salary, guaranteed bonuses, and forgivable loans. Whatever its form, the cash component of a golden hello is completely detached from managerial performance, because a manager gets the full benefit even if his or her performance in the new job is mediocre.

Kmart’s Conaway, for example, was offered a package whose cash component was \$10 million to be paid over five years, plus a \$5 million loan that would be forgiven if he stayed until July 31, 2003. The latter part of the golden hello turned into a golden goodbye when the loan was later gratuitously forgiven and “grossed up” -- the company paid the taxes triggered by the loan forgiveness -- even though the CEO did not stay until the specified date. In 1999, Global Crossing hired Robert Annunziata and paid him a signing bonus of \$10 million. When he resigned about a year later, he was not required to return any of the bonus. He also received several million dollars in severance.<sup>29</sup> Robert Nardelli, who became CEO of Home Depot in 2001, received a \$10 million loan, with 20 percent to be forgiven each year, including tax gross-up payments. In addition, he was guaranteed at least \$4.5 million annually in salary and bonus, plus grants of at least 450,000 options per year.<sup>30</sup> Richard Roscitt of ADC Communications was offered \$5.5 million over four years, plus a \$1.5 million “hiring bonus.” Aetna’s John Rowe was granted a \$2 million “signing bonus” and a \$1.4 million “retention bonus.”

Companies frequently justify golden hellos as necessary to attract star CEOs who are reluctant to forfeit the substantial income they expect to earn in their current positions. To attract such a CEO, a firm must offer a compensation package with an expected value exceeding his or her outside opportunities. Our focus here, however, is not on the magnitude of expected compensation but rather on its structure. Even very sizable golden hellos could be structured to be performance-dependent. In addition to attracting the executive, such compensation would also provide incentives.

---

<sup>29</sup> Al Lewis, “Global Crossing’s Revolving Door Pure Platinum,” *Denver Post*, 17 February 2002, p. K-01.

<sup>30</sup> Patrick McGeehan, “Top Executives’ Lucrative Deals Tie the Hands That Pay Them,” *New York Times*, 28 June 2003, p. C1.



Nevertheless, firms generally include substantial performance-insensitive components in their golden hellos. Thus, the practice of granting golden hellos contributes to the decoupling of compensation from performance.

### **Split-Dollar Life Insurance Policies**

In the past, many firms took out split-dollar life insurance policies for their executives, purchasing billions of dollars' worth of insurance. It is unclear whether split-dollar life insurance will be considered a company loan, and therefore prohibited, under the Sarbanes-Oxley Act.<sup>31</sup> In any case, their widespread use prior to 2003 provided another source of performance-insensitive compensation for executives.

Under one common form of split-dollar life insurance, the executive owns the policy and the firm pays the premium. In some cases, the executive also pays part of the premium, but usually only a small fraction. A small part of the premium pays for the death benefit; the rest is invested tax free to build up the "cash value" of the policy. The executive, meanwhile, assigns the employer a portion of his or her interest in the proceeds of, or the cash surrender value of, the policy. This portion equals the premiums paid by the employer. This split-dollar insurance arrangement is equivalent to a transaction in which (1) the firm lends the executive, interest free, the funds needed to make premium payments for the term of the policy; (2) the executive purchases an equivalent insurance policy for him- or herself; and (3) the executive receives the cash value of the policy when it matures, and uses part of the money to repay the principal on the loan.

The accruing premium payments -- the value transferred to executives -- have often been quite substantial. Comcast paid nearly \$20 million in executive split-dollar life insurance premia during the years 1999-2001.<sup>32</sup> In 2000, Estee Lauder promised to pay \$26 million in premiums over five years for its CEO, Frank Langhammer. Cendant has made premium

---

<sup>31</sup> Jeremy Kahn, "Suddenly Some Perks Aren't Worth the Pain," *Fortune*, 11 November 2002.

<sup>32</sup> Paul Hodgson, "My Big Fat Corporate Loan," Study by The Corporate Library, December 2002, p. 5.

payments of a similar magnitude on a \$100 million split-dollar policy for CEO Henry Silverman.<sup>33</sup>

It is possible to defend split-dollar insurance policies as consistent with arm's length contracting on tax grounds: a tax loophole, only recently closed by the IRS, enabled firms to use split-dollar policies to provide value to executives tax-free.<sup>34</sup> But because split-dollar policies involve a third party – the insurance company – they create transaction costs, and there is reason to believe these transaction costs outweighed any tax benefits. Notably, firms did not offer such policies to lower level executives, though one would expect them to do so if split-dollar policies were overall an efficient way to deliver compensation. Whether or not the tax benefits outweighed the transaction costs, firms used split-dollar policies to provide executives with a significant amount of pay without performance.

### **Soft Landing in Cases of Utter Failure**

The extent to which pay is tied to performance depends not only on how much managers are rewarded for relatively good performance, but also how much they are “punished” for poor performance. Therefore, in examining the relationship between compensation and performance, we must consider the cost to executives of poor performance. Currently, most compensation contracts ensure that executives receive generous treatment even in cases of spectacular failure.

As discussed in chapter seven, in the unusual cases when executives are forced out because of poor performance, boards generally provide large gratuitous severance payments in addition to the already substantial, contractually mandated, severance payments. These generous severance benefits distort CEOs' incentives by dramatically reducing the cost of failure.

Among the better-known soft landings in recent years is that of Mattel CEO Jill Barad. She received \$50 million in severance pay after being employed for only two years, during which time Mattel's stock price fell by 50 percent, eliminating \$2.5 billion in shareholder value. In another example, Consec provided \$49.3 million to departing CEO Stephen Hilbert, who left

---

<sup>33</sup> Liz Pulliam Weston, “Despite Recession, Perks for Top Executives Grow,” *Los Angeles Times*, 1 February 2002, p. A1.

<sup>34</sup> See IRS Notice 2002-8.

the company in a precarious financial situation.<sup>35</sup> The Conseco board then gave incoming CEO Gary Wendt a package that guaranteed more than \$60 million in compensation, even if he failed. George Shaheen, who ran Webvan before it filed for Chapter 11, will be paid \$375,000 annually for life. Procter & Gamble gave ousted CEO Durk Jager a \$9.5 million bonus, even though he lasted only 17 months on the job and oversaw a 50 percent drop in the value of P&G stock, a loss of \$70 billion in shareholder value.

Promises of such comfortable landings are not unusual. Henry Silverman, the CEO of Cendant, received a contract guaranteeing \$140 million in cash if he were fired in 2003 or 2004 for any reason other than a small number of specified causes. Home Depot CEO Robert Nardelli, whose golden hello we described earlier, was promised that if he quit or was fired under a broad range of circumstances during his first three-year contract, Home Depot would still pay the full compensation promised under the three-year contract, forgive the balance of a \$10 million loan, and provide \$20 million in cash. Disney CEO Michael D. Eisner was guaranteed “post-termination annual bonuses” that would be paid if he were fired or quit under certain circumstances. The bonuses were to continue for two years after the expiration of the original contract and pay at least \$6 million annually.<sup>36</sup>

These generous severance packages are often guaranteed as long as the executives are not removed “for cause” – usually defined rather narrowly as felony, fraud, malfeasance, gross negligence, moral turpitude, and, in some cases, willful refusal to follow the direction of the board. As long as they are not deliberately negligent or clearly acting in bad faith, then, CEOs are virtually guaranteed a “soft landing,” no matter how dismal their own performance may be.<sup>37</sup>

It might be argued that such provisions are necessary – and justified – to provide risk-averse executives with insurance against termination. We find this insurance rationale unpersuasive. For one thing, these packages

---

<sup>35</sup> Dean Foust and Louis Lavelle, “CEO Pay: Nothing Succeeds Like Failure,” *Business Week*, 11 September 2000, p. 46.

<sup>36</sup> Patrick McGeehan, “Top Executives’ Lucrative Deals Tie the Hands That Pay Them,” *New York Times*, 28 June 2003, pp. B1-B2.

<sup>37</sup> Paul Hodgson, “Golden Parachutes and Cushion Landings,” *The Corporate Library*, February 2003, p. 7.

typically provide the ousted CEO with severance equal to three or more years' total annual compensation.<sup>38</sup> Because the duration of the typical executive compensation contract, is only three years, in many cases a CEO who began working under a three-year contract would earn more for being fired than for completing the contract.

Moreover, severance arrangements designed with insurance in mind would cease providing value to the CEO once he or she found other employment. In practice, only 2 percent of firms in the Standard & Poor 500 would reduce any part of a severance package once the executive finds new work. The vast majority of such firms indicate that officers are under no obligation to seek further employment during the severance period, and if the managers do find such employment, their benefits will not be reduced.<sup>39</sup> Thus, severance arrangements not only insulate executives from the costs of termination, they may even make executives who take another job better off overall.

Note also that the insurance rationale is, if anything, more applicable to other employees, who generally are more likely to be terminated than executives, but who rarely receive severance provisions that insulate them from the costs of termination. Given executives' accumulated wealth and the generous retirement benefits they commonly receive after leaving the firm, they are likely to be, if anything, less risk-averse and better able to insure themselves than most other employees. In addition, executives' large compensation packages are commonly premised on the importance of providing them with incentives. Thus, we should expect executive pay to be more sensitive to performance, not less. Consequently, we should expect executives to receive less protection, not more, in the event of dismal failure.

To be sure, one could argue that executives' severance payments are intended to protect them if they are forced out even though their performance is not poor. However, given the reluctance of boards to dismiss even mediocre CEOs, it is highly unlikely that a board will dump a CEO who is performing satisfactorily. Indeed, executives are much less likely to be fired for non-performance reasons than are most employees.

---

<sup>38</sup> Paul Hodgson, "Golden Parachutes and Cushion Landings," The Corporate Library, February 2003, p. 2.

<sup>39</sup> Paul Hodgson, "Paying CEO's to Stay at Home," The Corporate Library, February 2003, p. 1.

Furthermore, even if dismissal for non-performance reasons were a realistic possibility for executives, incentives would be improved by the specter of a substantial financial penalty, as long as termination is strongly correlated with poor performance.

In any event, it is possible (if desired) both (1) to deny large severance payments to an executive who has performed very poorly, and (2) to protect an executive from the unlikely event of being fired by the board while performing adequately. Compensation contracts could specify that a departing CEO would receive no severance pay, or substantially curtailed pay, should the departure occur under certain objective conditions that reflect a high likelihood of extremely poor performance. For example, a contract could stipulate a reduction in departure benefits when the firm's performance (in terms of stock price or earnings) is sufficiently below that of most of its industry peers. Yet we do not find such provisions. Thus, the practice of providing generous severance packages, however weak the company's performance at the time of severance, is another way in which current practices make pay less sensitive to performance than arm's length contracting would predict.

### **The Myth of Limited Non-Performance Pay**

During the 1990s, while executives received vast and ever-increasing levels of compensation, it was widely believed that this compensation was largely based on performance. The passage of section 162(m) of the Internal Revenue Code in 1992 reinforced this general perception. Because 162(m) limits the deductibility of non-performance-based pay to \$1 million, one might reasonably believe that such pay had been capped and that any given executive's generous compensation must therefore be tightly linked to performance. This, however, has not been the case.

To begin with, managers in many companies have been paid salaries exceeding \$1 million, even though the excess is not deductible.<sup>40</sup> In such cases, the use of non-performance pay not only fails to produce incentives but also imposes substantial tax costs. Interestingly, only 22 percent of corporations paying more than \$1 million in non-performance compensation

---

<sup>40</sup> Steven Balsam, *An Introduction to Executive Compensation* (San Diego: Academic Press, 2002), pp. 86-87.

defer some or all of that excess in order to preserve the deductibility of the compensation.<sup>41</sup>

In addition, although most bonus payments are regarded as performance-based for purposes of section 162(m), they often are only weakly tied to performance. As we have discussed, bonuses are often conditioned on easily attained performance targets that do not reflect good performance relative to peer firms; also they often reward executives for improvements in the firm's earnings or stock price that clearly have nothing to do with managerial performance.

Furthermore, as discussed in the two preceding chapters, managers obtain substantial value from loan arrangements, pensions, deferred compensation, and post-retirement perks and consulting fees -- value that is largely decoupled from performance. Much of this income is never reported in the compensation tables filed with the SEC, and none of it appears in the pay statistics that financial economists use in their studies. This substantial "stealth" compensation further disconnects non-equity pay from performance.

In sum, the sizeable fraction of managerial compensation not based on equity is linked only tenuously to performance. Firms continue to fail to harness this major element of executive compensation to increase performance incentives. Needless to say, the weak connection between non-equity pay and performance is not inherent in non-equity compensation. Bonuses and salaries can easily be designed to reward managers for prior performance. Firms have failed to do so because those who design compensation arrangements have chosen *not* to do so.

Those defending current executive compensation practices may still try to downplay the significance of this pattern by arguing that the weak link between non-equity pay and performance is excusable because equity-based compensation is tightly tied to performance. As we shall see in the next several chapters, however, this is not the case. A significant amount of the option compensation that executives receive is also decoupled from their own performance. As with non-equity compensation, option plans are designed to provide substantial value for managers even when they perform poorly relative to their industry peers and the rest of the market.

---

<sup>41</sup> Steven Balsam, *An Introduction to Executive Compensation* (San Diego: Academic Press, 2002), p. 110.

## CHAPTER 11: WINDFALLS IN CONVENTIONAL OPTIONS

“The huge gains from options for below-average performers should give pause to even the most ardent defender of current corporate pay systems.”

-- Alfred Rappaport, *Harvard Business Review*, 1999

Historically, there has been a weak link between managers' performance and their non-equity compensation. As a result, shareholders and policy makers have increasingly looked to equity-based compensation to provide the desired link between pay and performance. As we have discussed, institutional investors and federal regulators, with the support of financial economists, began encouraging the use of such compensation in the early 1990s. Stock options became an increasingly important component of executive compensation during that decade.<sup>42</sup>

The use of equity-based compensation, however, has hardly lived up to its promise. Managers have been able to use their influence to grab the reins of the options bandwagon and steer it in a direction that serves their interests. As a result, they have received option plans that deviate substantially from the arrangements that arm's length contracting would likely produce. These option plans have provided executives with ever-increasing amounts of compensation while failing to efficiently provide powerful incentives to generate shareholder value.

### Option Plan Design: The Devil is in the Details

We should emphasize at the outset our strong support for the general idea of equity-based compensation. Because option compensation can provide pay for performance and thereby incentivize managers to create shareholder value, a well-designed option plan can substantially benefit shareholders.

---

<sup>42</sup> See Kevin J. Murphy, “Executive Compensation,” in *Handbook of Labor Economics*, vol. 3, bk. 2, ed. Orley Ashenfelter and David Card (New York: Elsevier, 1999), p. 2490; David Yermack, “Do Corporations Award CEO Stock Options Effectively?” *Journal of Financial Economics* 39 (1995): 238.

## *Windfalls in Conventional Options*

The devil, however, is in the details. The question is not whether a particular option plan is better than no option plan at all. Rather, the question is whether the features of that plan – the number and, perhaps more importantly, the terms of the options – are designed to create cost-effective incentives, or whether they are intended instead to favor managers. An option plan designed to make managers better off is likely to produce significantly less value for shareholders than a plan created with shareholders' interests in mind.

It is worth noting that the only recent academic study to consider the effect of options on shareholder value suggests that option plans designed by boards are not structured to serve shareholders. Michel Habib and Alexander Ljungqvist examined the effect on shareholders of option grants to CEOs of publicly traded U.S. firms between 1992 and 1997.<sup>43</sup> They found that boards give CEOs too many options: the marginal incentive benefit of the last option is less than the cost to shareholders. In other words, all else being equal, shareholder value would increase if the number of options held by CEOs were reduced. Consistent with Habib's and Ljungqvist's results, a study by Salomon Smith Barney found that firms in the S&P 500 that heavily used options to compensate both executives and employees underperformed the index.<sup>44</sup> Thus, the most relevant empirical data suggest that the design of option programs is consistent with the presence of managerial power and rent-taking.<sup>45</sup>

In the present and following chapters, we show that the option plans that have been used by the overwhelming majority of public firms are skewed in managers' favor. While options hold out the promise of linking

---

<sup>43</sup> Michel A. Habib and Alexander P. Ljungqvist, "Firm Value and Managerial Incentives: A Stochastic Frontier Approach." *The Journal of Business*, Forthcoming.

<sup>44</sup> David Leonhardt, "Report on Executive Pay: Will Today's Huge Rewards Devour Tomorrow's Earnings?" *New York Times*, 2 April 2000, sec. 3, p. 1.

<sup>45</sup> The only other study focusing exclusively on options also suggests that option plans may not be designed efficiently. An analysis of companies that adopted executive stock option plans between 1978 and 1982 determined that cumulative abnormal returns declined subsequently for two-thirds of the sample, that ROA declined absolutely and adjusted for industry, that R&D expenditure decreased, and that perquisite consumption increased. See Richard A. DeFusco, Robert R. Johnson, and Thomas S. Zorn, "The Association between Executive Stock Option Plan Changes and Managerial Decision Making," *Financial Management* 20 (1991): 40.



pay to the managers' own performance, the option plans actually used by firms have delivered a considerable amount of pay without performance. The plans also package the compensation so that it seems defensible and legitimate. We discuss below several important features of option pay practices that, although difficult to justify from an arm's length contracting perspective, can be readily explained by the managerial power approach. The feature on which we focus in this chapter is the persistent failure of option plans to filter out windfalls – substantial gains for managers that are not due to their own performance.

### **The Benefits of Reducing Windfalls**

From the perspective of incentives, it is desirable to base pay on the measure that is the most “informative,” i.e., that best reflects the manager's own actions.<sup>46</sup> Managerial actions are not directly observable and verifiable. Accounting results are noisy and fail to reflect the current value of growth opportunities. Therefore, the share price of a firm may seem a useful tool for evaluating executive performance.

Changes in share price, however, are not the best proxy for a manager's performance. A company's stock price can increase for reasons that have nothing to do with its managers' own efforts and decision-making. Falling interest rates, for example, cause stock prices to increase without managers lifting a finger. Indeed, one study of U.S. stock prices over a recent ten-year period reported that only 30 percent of share price movement reflects corporate performance; the remaining 70 percent is driven by general market conditions.<sup>47</sup> If performance is measured by changes in share price, managers who perform poorly relative to their peers are rewarded when the market or sector is rising on the whole. Compensation would be better targeted if it were based on firm-specific changes in the share price, i.e., on relative stock performance rather than on absolute price changes.

---

<sup>46</sup> The “informativeness principle” was introduced by economist Bengt Holmstrom in Bengt Holmstrom, “Moral Hazard and Observability,” *Bell Journal of Economics* 10 (Spring 1979): 74-91.

<sup>47</sup> The study by SCA Consulting is reported in Simon Patterson and Peter Smith, “How to Make Top People's Pay Reflect Performance,” *Sunday Times & Business*, 9 August 1998, Business Section, p.12.

## *Windfalls in Conventional Options*

To be sure, when managerial compensation is linked to absolute changes in the share price, managers incur losses equally unrelated to their own performance if the market or the firm's sector declines on the whole. But such negative shocks are unlikely to hurt managers as much as positive shocks benefit them. At worst, negative shocks would make the managers' options worthless (although, as we discuss in chapter thirteen, when falling stock prices drag options "underwater," boards usually provide managers with new or repriced options). On the other hand, positive shocks can boost the value of options by an unlimited amount. Thus, the expected value of changes in the value of options due to market or sector forces is always positive.

From the shareholders' perspective, an option plan should be designed either to maximize incentives for the dollars spent or to achieve a certain level of incentives at the lowest possible cost. When managers are rewarded for market- and sector-wide price movements unrelated to their efforts, shareholders' money is poorly spent. A firm could either create the same incentives for less money or use the same amount of money to create even more powerful incentives.

The latter possibility is worth exploring. If a firm gives its managers 1,000 options to buy stock at the current market price of \$100, some of the expected value of the options – and therefore some of the expected cost of the options to other shareholders – comes from the fact that the stock price may increase independent of the managers' efforts. If industry- and market-wide effects boost the stock price, the managers will be "rewarded" for these increases when they exercise the options. Shareholders will pay for this reward even though it has no effect on the managers' incentives for good performance.

Compensation would be more efficient in creating incentives if movements in the stock price that are clearly unrelated to managers' actions were excluded from the compensation calculus. Identifying all these elements, however, is sometimes difficult. Adjusting changes in the stock market price to account for general market or sector movements, however, is a more straightforward exercise, because these fluctuations are easily determined. Thus the firm's performance relative to these benchmarks can easily be calculated.

Removing or reducing the undeserved reward component of an option's value – that is, moving from conventional options to reduced-

windfall options – could substantially reduce the expected cost of option compensation. One study, by James Angel and Douglas McCabe, estimates that the cost of providing conventional options to executives at the 100 largest NYSE-listed firms is 41 percent greater than the cost of providing options that screen out market effects.<sup>48</sup> The costs eliminated by using reduced-windfall options could be saved or used to provide managers with more incentive-strengthening compensation.

### **The Many Ways of Reducing Windfalls**

A wide range of methods is available for reducing managers' windfalls from stock price increases that are unrelated to the managers' own performance. Some of these methods involve "indexing" the exercise price of options. Others involve making the vesting of at least some options contingent upon share price appreciation exceeding a certain benchmark (say, exceeding the appreciation of the shares of the bottom 20 percent of firms in the company's sector). Plan designers could create windfall-reducing schemes that are gentle, moderate, or severe, tailoring them to each situation. All of this makes the widespread failure of plans to filter out *any* windfalls especially puzzling.

#### **Indexing**

The most familiar way to reduce windfalls is by indexing – setting an exercise price that rises and falls either with sector or broader market movements, thereby screening out the effects of those fluctuations on a firm's stock price. Options that are indexed to the market prevent managers from benefiting from stock price increases that are due to general market movements. Options that are indexed to the average performance of a particular industry screen out not only broad market effects, but also effects associated with the firm's sector.<sup>49</sup> Alfred Rappaport discussed this

---

<sup>48</sup> James J. Angel and Douglas M. McCabe, "Market-Adjusted Options for Executive Compensation," *Global Business and Economics Review* 4 (2002): 14

<sup>49</sup> For an analysis suggesting that indexed options could not screen out *all* market or industry effects, see Lisa K. Meulbroeck, "Executive Compensation Using Relative-Performance-Based Options: Evaluating the Structure and Costs of Indexed Options," working paper, Harvard Business School, 2001, pp. 1-3. Meulbroeck shows that an

approach in a well-known *Harvard Business Review* article, attracting much attention from management researchers and practitioners but little interest from firms.<sup>50</sup>

By tightening the link between compensation and performance, indexed options generate more incentive per dollar. A firm can therefore reduce costs without weakening incentives. Or, for the same cost, the firm could grant more options and thereby improve managers' incentives.

Take a firm that now grants managers 1,000 conventional options with an exercise price equal to the current market price of \$100. Suppose the company could, at the same cost, provide managers with 1,500 options whose strike price is \$100 multiplied by a market index. Under such a scheme, if the market has risen 30 percent since the options were granted, the exercise price would be  $\$100 \times (1.30)$ , or \$130. This alternative scheme would provide managers with more high-powered incentives by tying their rewards to gains that are more likely to be the result of their actions.<sup>51</sup>

Standard indexing, either to the market average or to the average of a basket of peer firms, is not the only possibility. Suppose one opposes indexing options to the average performance of peer firms because of concern that half the managers will not make any money on their options.<sup>52</sup> Such odds, one may believe, impose excessive risk-bearing costs on managers, who may, as a result, demand higher fixed compensation. Someone with these concerns may prefer a more "moderate" form of

---

option with an exercise price tied to a market or industry index does not completely filter out market or industry effects, and she offers an alternative mechanism designed to do so.

<sup>50</sup> See Alfred Rappaport, "New Thinking on How to Link Executive Pay with Performance," *Harvard Business Review* (March-April 1999): 91-101; See also Mark A. Clawson and Thomas C. Klein, "Indexed Stock Options: A Proposal for Compensation Commensurate with Performance," *Stanford Journal of Law, Business & Finance* 3 (1997): 31-50.

<sup>51</sup> See Shane A. Johnson and Yisong S. Tian, "The Value and Incentive Effects of Non-Traditional Executive Stock Option Plans," *Journal of Financial Economics* 57 (2000): 25-26. For a detailed analysis of the incentive effects and valuation of indexed options, see Shane A. Johnson and Yisong S. Tian, "Indexed Executive Stock Options," *Journal of Financial Economics* 57 (2000): 35.

<sup>52</sup> Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options." *University of Chicago Law Review* 69 (2002): 863.

indexing in which the exercise price is increased by a certain fraction of the increase in sector stock prices. Alternatively, the exercise price can be tied to the performance of the companies in, say, the bottom quartile of the market or the industry.

Note that indexing may result not only in increasing the exercise price but also, when the market or sector declines, in reducing the price. Although this involves a cost to the firm, it provides rewards for managers who outperform their peers. As we will discuss in the next chapter, firms with conventional option plans often react to market or sector declines by providing new options or by re-pricing existing ones. Indexing provides much of the needed adjustment automatically.

### **Other Methods of Reducing Windfalls**

Although tying the exercise price of options to market or sector indexes is the best known and perhaps the most effective way of reducing windfalls, other approaches can be used. One is performance-conditioned vesting. Under this approach, managers who do not meet certain performance targets forfeit their options. The exercise price is usually set to the grant-date market price. If performance targets are met, the executive may exercise the options and profit to the full extent of the stock's appreciation.

These performance targets may involve an index. For example, the executives may be required to generate share price increases that beat the market or a basket of similar stocks over a certain period. This approach is like an indexed option, in that there is no payout unless the share price exceeds a certain benchmark. Thus, to the extent that the increase of a firm's stock price merely reflects market- or sector-wide changes, its managers do not receive a reward. It is unlike an indexed option in that the payout, if made, corresponds to the absolute share price increase, not to the amount by which the stock price exceeds some benchmark.

The performance targets can use benchmarks other than indexes. For example, vesting can be conditional on the firm's earnings per share, net asset value, return on capital, and/or cash generation. Such measures may not screen out *sector-wide* effects (such as the effect of an increase in oil prices on an oil drilling firm), but they may screen out some *market-wide* effects (such as a general rise in stock prices due to a change in interest rates).

Performance-conditioned options should be distinguished from another type of performance-based option, which might be called a “performance-accelerated” option. A performance-accelerated option enables executives to accelerate the vesting of their options if they meet specified performance targets. Arguably, performance-accelerated options provide stronger incentives than conventional options because they increase the rewards that managers receive for performances exceeding the specified targets. However, if the performance target is not met, performance-accelerated options provide the same payout as conventional options with the same exercise price and maturity. Thus, accelerated-vesting options do not remove the windfalls executives enjoy from conventional options.

Although we have discussed various ways to reduce windfalls, our present intention is not to determine the most efficient form of reduced-windfall option. Indeed, it is highly unlikely that one size would fit all. The efficient design might well vary from industry to industry and perhaps even from firm to firm. Our main point is that using some form of windfall-reduction is likely to be efficient for at least some significant fraction of companies, if not for all companies.<sup>53</sup>

### **The Puzzling Avoidance of Reduced-Windfall Options**

Firms have in the past largely avoided any version, however moderate, of “reduced-windfall” options. This widespread failure to adopt mechanisms that filter out windfalls has led prominent scholars of executive compensation to conclude that “the near complete absence [of such mechanisms] seems to be a puzzle.”<sup>54</sup> Only after the corporate governance

---

<sup>53</sup> There are other possible benefits to indexing that we have not discussed. For example, it has been argued that indexing the exercise price of options could reduce the executive’s exposure to market risk. See Bengt Holmstrom, “Moral Hazard in Teams,” *Bell Journal of Economics* 13 (1982): 328-330. In any event, our focus is not on the riskiness of conventional options but rather on the fact that the random noise associated with them has significant positive value for executives.

<sup>54</sup> Brian J. Hall and Jeffrey B. Liebman, “Are CEO’s Really Paid Like Bureaucrats?” *Quarterly Journal of Economics* 113 (1998): 683; Brian J. Hall, “A Better Way to Pay CEO’s?” in *Executive Compensation and Shareholder Value*, ed. Jennifer Carpenter and David Yermack (Boston: Kluwer, Academic Publishers, 1999), p. 43.

### *Windfalls in Conventional Options*

scandals broke has there been some movement – under pressure from shareholders -- toward adoption of reduced-windfall arrangements.

Firms have not only generally failed to use standard indexing, i.e. linking the exercise price to market or sector movements, but have even avoided using the partial or moderate forms of indexing we discussed above. Before the corporate governance scandals, only a small number of firms, including Monsanto and Citigroup, reduced option windfalls to executives by conditioning the vesting of options on the firm's meeting certain performance targets. Monsanto, for example, has not allowed its CEO's options to vest unless he or she generates shareholder returns of at least 10.5 percent per annum over a five-year period.<sup>55</sup> These policies were widely praised by the business press and by prominent market personalities such as Warren Buffett, but the use of performance-conditioned vesting failed to spread.<sup>56</sup> In 2001, only 5 percent of the 250 largest publicly traded firms condition option vesting on performance.<sup>57</sup>

The overwhelming majority of executives have therefore been rewarded for absolute share price increases, even those that are purely a function of broad market or sector rises that lift all boats. Indeed, during the big market boom of the 1990s, even executives with sub-par performance reaped vast gains from options. Under these schemes, if the market goes up 300 percent, an executive whose firm lags the market by 50 percent will still make very large profits on his or her options – larger profits, indeed, than an executive whose firm beats the market by 50 percent during a period when the market is flat. Remarking on the situation, Warren Buffett has said: “There is no question in my mind that mediocre CEOs are getting incredibly overpaid. And the way it's being done is through stock options.”<sup>58</sup>

---

<sup>55</sup> See Shawn Tully, “Raising the Bar,” *Fortune*, 8 June 1998, p. 272.

<sup>56</sup> *Ibid.*

<sup>57</sup> See Alan Levinsohn, “A Garden of Stock Options Helps Harvest Talent,” *Strategic Finance* 82 (February 1, 2001): 81-82.

<sup>58</sup> Shawn Tully, “Raising the Bar,” *Fortune*, 8 June 1998, p. 272.

### **The Managerial Power Explanation**

The managerial power approach can explain the almost complete absence of windfall-reducing mechanisms. Options whose value is more sensitive to managerial performance are less favorable to managers for the very same reasons that they are better for shareholders: reduced-windfall options provide managers with less money or require them to cut managerial slack, or both. As long as managers can get away with the use of conventional options, they will do so.

The expected value of a conventional option to an executive – and its expected cost to shareholders – is substantially greater than that of a reduced-windfall option. Specifically, the return on a conventional option is equal to the windfall-reduced return plus the expected value of the market or sector movements not filtered out by the reduced-windfall option. Because the market is expected to increase over time, the expected value of future market changes is positive. Conventional options enable managers to enjoy this expected value, but do not provide them with any incentives.

Recall the two ways in which using reduced-windfall options can benefit shareholders. First, by decoupling the options from market or sector performance, the firm can create the same incentives at lower cost, saving shareholders money. In such a scenario, the managers would earn less. Alternatively, the firm could use the same amount of money to grant managers a larger number of reduced-windfall options, thereby creating more powerful incentives. In this case, the managers would not earn less, but they would be forced to reduce slack more than under conventional options. They would have to take steps that would increase shareholder value but be personally costly,, such as downsizing their empires or firing loyal but unproductive subordinates. Thus, for the same reasons that shareholders should favor reduced-windfall options, managers balk at adopting them.

Furthermore, managers may oppose indexing the exercise price or conditioning vesting on performance because these arrangements can shine an unwelcome spotlight on their performance relative to their peers. By withholding rewards for below-par performance, reduced-windfall options make relatively poor performance more salient to outsiders, thus embarrassing managers. The fear of being exposed as relatively mediocre is distinct from the risk of nonpayment under an indexing regime. That is, the



## *Windfalls in Conventional Options*

fear of embarrassment arises even if the firm adopts a soft form of indexing that provides an even greater likelihood of payout than conventional options provide.

Of course, in certain situations, one type of reduced-windfall option – indexed options – makes executives better off. In particular, if the index declines during the period between the grant date and the exercise date of the options, the exercise price is adjusted downwards, increasing the holder's profits on exercise. Under conventional option plans, managers capture the benefits of general market or sector rises but have to bear the costs of general market or sector declines. These costs, however, are outweighed by the benefits of conventional option plans. Because the market is expected to rise over time, the expected value of increases in market value is likely to be substantially higher than the expected value of declines. Furthermore, as we shall discuss in chapter thirteen, managers have found ways to escape some of the costs of market declines. When such declines occur, dragging down the firm's stock price, managers are often given new options at a lower strike price. Thus, conventional options place managers in the enviable position of "heads I win, tails I don't lose."

Because conventional options do not link pay and performance as tightly as reduced-windfall options do, they have made it possible for managers to reap significant pay without performance during the last decade in a way that appears completely legitimate and defensible. Because the theory behind equity-based compensation is sound, and because conventional options are the dominant form of equity-based compensation, executives and boards can use such options without incurring "outrage costs" for failing to use reduced-windfall options.

We are not claiming that the use of conventional rather than reduced-windfall options arose because managers consciously preferred and pushed for the former type. Those who initially advocated the use of options – whether academics, compensation consultants, institutional investors, or even managers themselves – may not have thought much about the benefits of indexed and other types of reduced-windfall options. However, for some years now, academics, leading investors, and business commentators at least have understood the advantages of reduced-windfall options and a small fraction of existing firms have even adopted them. The managerial power approach helps solve the puzzle of why, even as general

### *Windfalls in Conventional Options*

awareness of the efficiency of these arrangements has increased, their adoption has remained rare.

Some may think that the use of conventional options persists not because of managerial power but simply because of inertia. Recall that in chapter five we discussed boards' desire to conform to "the norm" and the resulting "stickiness" in compensation arrangements. Despite this tendency, it is unlikely that inertia can explain the almost universal use of conventional options. First, stickiness has not stopped compensation consultants from rapidly introducing and "selling" new option features, such as reloading (discussed in chapter thirteen) and accelerated vesting, that make managers better off. These management-favoring innovations are hardly more complex or difficult to adopt than indexing or performance-conditioned vesting would be.

Furthermore, Monstanto, Citigroup, and a number of other large and prestigious firms in the United States have already adopted windfall-reducing features such as performance-conditioned option vesting. Although conventional options still enjoy legitimacy and acceptability, the benefits of reduced-windfall options are now sufficiently recognized that a move in this direction would likely generate praise rather than criticism of management. Inertia thus cannot explain the persistent dominance of conventional option plans. A more likely explanation is that managers prefer the pay without performance provided by conventional options and are making their preferences felt.

## CHAPTER 12: EXCUSES FOR CONVENTIONAL OPTIONS

“[D]espite the obvious attractive features of relative performance evaluation, it is surprisingly absent from U.S. executive compensation practices. Why shareholders allow CEOs to ride bull markets to huge increases in their wealth is an open question.”

John Abood and David Kaplan (1999)

Defenders of current compensation practices have attempted to explain why companies have been spending their compensation dollars rewarding managers for stock price increases due entirely to market- or industry-wide trends. Managers and compensation practitioners have focused on accounting considerations, and financial economists and economically oriented legal scholars have labored to come up with theories to explain why such pay without performance might reflect arm’s-length contracting after all.

### Accounting Excuses

The most common explanation given for the widespread failure of companies to adopt reduced-windfall options -- whether indexed options or performance-conditioned options -- has been the unfavorable accounting treatment these options have received.<sup>59</sup> Under current FASB rules, a company that grants employees stock options with a fixed expiration date and a predetermined exercise price equal to or exceeding the grant-date market value of the stock need not take a charge against earnings either when it issues the options or when executives exercise the options, which is when the firm gets a tax deduction equal to the gains received by the executives.<sup>60</sup> Accordingly, conventional at-the-money (or out-of-the-money)

---

<sup>59</sup> See, for example, Kevin J. Murphy, “Executive Compensation,” in *Handbook of Labor Economics*, vol. 3, bk. 2 (New York: Elsevier, 1999), p. 21; Brian J. Hall and Jeffrey B. Liebman, “The Taxation of Executive Compensation.” *Tax Policy and the Economy*. Edited by James Poterba. Vol. 14. Cambridge, Mass.: MIT Press, 2000.

<sup>60</sup> See APB Opinion No 25. See also Ronald L. Groves, *Executive Compensation* ¶ 214.04 at 498 (CCH Tax Transactions Library 1992).

stock options have not produced a corporate earnings charge in firms' financial statements.

Indexed options, however, lack a fixed exercise price and therefore fall outside this charge-free zone. Companies issuing indexed options must mark these options against the market on a regular basis and accrue an earnings charge reflecting the appreciation in the value of the options over the indexed exercise price. So, it is argued, conventional options are preferred over indexed options because the former result in higher reported earnings, which could in turn enhance share value.<sup>61</sup> Options that do not vest unless performance conditions are met are subject to the same unfavorable accounting treatment as indexed options.

Accounting considerations, however, cannot adequately explain why reduced-windfall options have been so rarely used. We accept the possibility that market pricing is not perfectly efficient and thus the way in which option use is reported might affect a company's stock price.<sup>62</sup> Yet even if this is the case, it does not follow that the lack of reduced-windfall options reflects arm's-length contracting.

Unfavorable accounting treatment could make reduced-windfall options undesirable only if two conditions were met: (1) the market would have to be sufficiently inefficient that moving to indexed or performance-conditioned options would cause a substantial short-term decline in the price (in the long run, the stock price presumably would reflect the fundamental value of the firm); and (2) the cost of the short-term decline in share price to shareholders (who might sell in the interim for liquidity reasons) would have to be greater than the benefit to them of using reduced-windfall options. There is little reason to expect these conditions to be met by firms in general. It thus seems unlikely that accounting considerations

---

<sup>61</sup> To the extent that managers' bonuses are based on reported earnings, higher earnings also are rewarded with increased bonuses. But presumably if the board were sophisticated enough to use indexed options, it would understand that the bonus formula would need to be adjusted to reflect the accounting effect of these options.

<sup>62</sup> Indeed, there is evidence that stock prices are affected slightly by whether option expenses are recognized or merely disclosed. See Hassan Espahbodi, Pouran Espahbodi, Zabihollah Rezaee, and Hassan Tehranian, "Stock Price Reaction and Value Relevance of Recognition versus Disclosure: The Case of Stock Based Compensation," *Journal of Accounting and Economics* 33 (2002): 343-373.

can adequately explain the almost complete absence of reduced-windfall options.

It is worth noting at the outset that sophisticated institutional investors and their advisers do not share managers' negative view of indexed options. Institutional Shareholder Services, whose advice is followed by a large number of institutional investors, and the Council of Institutional Investors, which represents more than 130 pension funds, have called for the use of indexed options, even though this step would reduce reported earnings.<sup>63</sup> Institutional investors have also supported the indexing of options.<sup>64</sup> Interestingly, while managers argue that expensing options would hurt shareholders, institutional investors disagree. Indeed, these investors see expensing options as desirable for shareholders, whether or not reduced-windfall options are adopted. TIAA-CREF has announced a campaign to lobby 1,750 major public corporations in which it owns shares to begin expensing options. The Council of Institutional Investors has also indicated its support for expensing.

In the wake of the corporate governance scandals of 2001 and 2002, and in response to pressure from institutional investors such as TIAA-CREF, hundreds of firms, including Coca-Cola, Bank One, and the *Washington Post* decided to expense options in an attempt to placate shareholders. This number is expected to keep growing.<sup>65</sup> Interestingly, even though these firms have bowed to pressure to switch to expensing, they have not switched from conventional to reduced-windfall options, despite the fact that the accounting excuse for avoiding the latter has been eliminated. Because managers are likely to continue to have influence over their pay, we predict that, as long as there is little pressure to adopt reduced-windfall options, most of these firms will continue to use conventional options. Behavior consistent with this prediction would further confirm that accounting considerations have been an excuse, rather than a real impediment to the use of reduced-windfall options.

---

<sup>63</sup> Jennifer Reingold, "Commentary: An Option Plan Your CEO Hates," *Business Week*, 28 February 2000, p. 82; James P. Miller, "Indexing Concept Aims at Fairness," *Chicago Tribune*, 4 May 2003, p. C1.

<sup>64</sup> "Update on Stock Option Accounting Debate," memo from Fred W. Cook & Co., Inc., July 30, 2002.

<sup>65</sup> Bear Stearns Study, June 17, 2003.

## *Excuses for Conventional Options*

Whether or not accounting considerations explains the widespread failure of firms thus far to use reduced-windfall options, that explanation may well collapse in the future. In the summer of 2002, the London-based International Accounting Standards Board (IASB), whose accounting rules are followed by most major European countries, decided to require the expensing of all equity compensation awards at the grant-date value. In 2003, FASB announced its tentative decision to require companies to expense stock options for fiscal years beginning after December 15, 2004. Despite heavy lobbying by certain firms, it appears likely that this time FASB will not be prevented from adopting this requirement. Congress is also considering legislation that would require expensing options given to the CEO and the four other highest paid executives. Assuming option expensing is adopted, it will provide an additional test of whether accounting can explain the widespread lack of reduced-windfall options. Continued insistence by firms on using conventional options, despite the lack of an accounting advantage, will indicate that accounting rationales were merely a cover that afforded managers option compensation on terms most favorable to them.

### **The Battle Over Options Accounting**

If FASB's tentative decision to require option expensing becomes final, or if Congress passes legislation requiring such expensing for options given to the CEO and other highly paid executives, publicly traded firms will soon be forced to expense managers' options. Nevertheless, the history of FASB's attempts to require such expensing nicely illustrates the importance managers place on equity-based pay that provides them with substantial compensation not strongly tied to their own performance.

Under current accounting rules, if a firm buys plane tickets by giving an airline options, the value of those options is entered as an expense on the firm's income statement. Expensing the options makes sense because the firm has given up something of value in exchange for the tickets. The transaction is equivalent to a two-step process in which the firm first sells the options to a third party and then uses the proceeds to buy the tickets.

However, firms have until now been permitted *not* to expense certain employee options. Options provided as compensation for employee services have not had to be expensed if (1) the strike price was fixed and equal to or

higher than the grant-date market price, and (2) the expiration date was fixed in advance. Given these rules, firms have not had to expense conventional, as opposed to indexed or performance-conditioned options. As we explained above, this unequal accounting treatment has frequently been used to justify firms' failure to filter out windfalls due to market or sector rises.

During the last decade, reformers have attempted to require firms to expense all employee options, but managers have played a major role in blocking those attempts. In the mid-1990s, the FASB sought to require that all stock-based compensation be accounted for on a rational and consistent basis -- that it be expensed in line with the current treatment of indexed and performance-conditioned options.<sup>66</sup> Heated resistance forced the FASB to stop short of requiring firms to adopt this method.<sup>67</sup> Instead, the FASB required companies that fail to expense options (almost all firms) to disclose the cost of granted options in footnotes to the firm's financial statements.<sup>68</sup> Following the corporate governance scandals of 2001-2002, reformers renewed their efforts; although it now appears that reforms will ultimately prevail, managers have displayed considerable resolve to fight any move toward expensing of options, investing a considerable amount of time, effort, and political capital to avoid such an outcome.

Executives claim to have fought so vehemently because expensing options will reduce reported earnings, lead to a decline in share prices, and thus hurt shareholders. Because option pay now involves substantial sums of money, the effect of expensing on bottom line earnings would be quite significant. In 1992, expensing options would have reduced earnings by approximately 2 to 3 percent.<sup>69</sup> In 2001, expensing would have reduced the earnings of the S&P 500 by 21 percent.<sup>70</sup> In the case of some firms, such as

---

<sup>66</sup> See Financial Accounting Standards Board, Statement of Financial Accounting Standards no. 123 (October 1995), 23-25.

<sup>67</sup> See Graef S. Crystal, *In Search of Excess: The Overcompensation of American Executives* (New York: Norton, 1991), p. 234.

<sup>68</sup> See Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123 (October 1995), p. 14.

<sup>69</sup> Linda Barris, "The Overcompensation Problem: A Collective Approach to Controlling Executive Pay," *Indiana Law Journal* 68 (1992): 73.

<sup>70</sup> Justin Fox, "The Only Option (for Stock Options, That Is): Pretending They Are Free

## *Excuses for Conventional Options*

Cisco, expensing options would in fact have converted reported profits into losses.

As noted, the value of employee options must already be reported in the footnotes to firms' financial statements, and thus is already available to the market. Managers have argued, however, that the market pays little attention to these footnotes, focusing instead on reported earnings. Thus, they claim that moving the information from the footnotes to the income statement itself will alter investors' perception of the company's earnings and reduce the value of the stock.

If expensing options would indeed hurt shareholders, it is puzzling, as we noted earlier, that large institutional investors and their advisors, such as TIAA-CREF and the Council of Institutional Investors, support such expensing. We do not wish to resolve here the question of whether expensing will affect share prices and thereby hurt shareholders. We do, however, wish to note that, whether or not expensing is adverse to shareholder interests, managers' campaign against expensing certainly serves their own interests in obscuring favorable compensation arrangements.

First, expensing options will make the magnitude of option-based pay more salient. If, as executives claim, shareholders pay more attention to items expensed on the financial statement than to those detailed in the footnotes, shareholders will pay more attention to the cost of employee options, including executive options, if they are expensed. Options granted to senior executive constitute a significant fraction of overall employee options.<sup>71</sup> By using conventional options and burying their costs in footnotes, managers can mask their considerable option pay. Expensing options will make such costs more manifest. This, in turn, may put pressure on compensation plan designers to reduce the use of options and perhaps even decrease managerial pay.

Indeed, a study by three financial economists also suggests that camouflage considerations partly explain managers' resistance to

---

Didn't Work. Expensing Them May Be the Silver Bullet We're Looking For," *Fortune*, 12 August 2002, p.110.

<sup>71</sup> According to a study by compensation consultant Pearl Meyers & Partners, 6.9 percent of the options firms grant to employees are given to the CEO, and another 8.6 percent are given to other top executives. See Pearl Meyer & Partners, "Equity Stake: Study of Management Equity Participation in the Top 200 Corporations," 2001. p.14.



expensing.<sup>72</sup> Patricia Dechow, Amy Hutton, and Richard Sloan report that the likelihood of a firm opposing FASB's attempt in the mid 1990s to require expensing was positively correlated with managers' total compensation and with the portion of executive compensation paid in options. They found no evidence that expensing options would increase the cost of raising new capital. They concluded that executives were advancing the cost-of-capital argument to disguise concerns that expensing would draw attention to their pay.

Second, expensing conventional options will deprive managers of their main justification for not shifting to indexed or performance-conditioned options, i.e. that such a move would reduce reported earnings. If *all* employee options were expensed, reduced-windfall options would have the same accounting consequences as conventional options and the accounting argument against reduced-windfall options would disappear, leaving managers' personal interests in conventional options uncomfortably exposed.

If the managerial campaign against expensing were truly driven by concerns for shareholder interests, managers might be expected to lobby against the expensing of indexed and performance-conditioned options. No plausible financial justification requires the expensing of a performance-conditioned option when a conventional option, identical in every other respect, need not be expensed. Indeed, the performance-conditioned option represents less of a cost to shareholders than the corresponding conventional option does because there is a greater chance that it will never be exercised. Yet, managers who have fiercely opposed the expensing of conventional options have shown no interest in seeking similar treatment for reduced-windfall options. There is nothing surprising about this fact. Leveling the accounting playing field for *all* options would have eliminated any accounting argument against reduced-windfall options. That may have been advantageous to shareholders, but would only have made managers worse off.

---

<sup>72</sup> See Patricia M. Dechow, Amy P. Hutton, and Richard G. Sloan, "Economic Consequences of Accounting for Stock-Based Compensation," *Journal of Accounting Research* 34 (1996): 1-20.

### **Efficient After All?**

Financial economists often assume the impact that disclosure has on stock prices does not depend on how the information is presented in publicly available financial statements: that it does not matter whether an expense is revealed in a footnote or on the balance sheet itself. They therefore have sought non-accounting explanations for the use of conventional options that fail to filter out windfalls. As we note below, however, none of their explanations adequately explains the absence of reduced-windfall options.

(a) *Design Costs*: Some economists have suggested that schemes that filter out industry or market noise are too costly to design and administer.<sup>73</sup> This explanation can be dismissed at the outset; the administrative costs involved are tiny compared to the stakes. A wide variety of sector and market indices appear daily in the *Wall Street Journal* and are available online from numerous sources. Moreover, SEC regulations already require public corporations to calculate and report stock performance data relative to their industry, line-of-business, or peer group.<sup>74</sup> In short, all the requisite information is readily available. Incorporating this information into option plans would involve a trivial cost.

(b) *Avoiding Distortions in Managers' Decisions to Enter Other Industries*: Some economists have argued that rewarding managers for stock price rises caused by general sector movements actually provides desirable incentives. The sector to which a firm belongs, so the argument goes, is not fixed; it might be affected by managers' decisions. It is therefore desirable to offer managers incentives to adapt to poor industry conditions by shifting company resources into more profitable sectors.<sup>75</sup> Providing such incentives requires rewarding managers not only for the firm's performance relative to its sector, but also for sector-related price increases. Moreover, sector-indexed options not only fail to provide managers with incentives to enter

---

<sup>73</sup> See Surya N. Janakiraman, Richard A. Lambert, and David F. Larcker, "An Empirical Investigation of the Relative Performance Evaluation Hypothesis," *Journal of Accounting Research* 30 (1992): 66.

<sup>74</sup> See 17 CFR § 229.402 (2001).

<sup>75</sup> See Surya N. Janakiraman, Richard A. Lambert, and David F. Larcker, "An Empirical Investigation of the Relative Performance Evaluation Hypothesis," *Journal of Accounting Research* 30 (1992): 66-67.

high-profit industries, they also give managers a perverse incentive to remain in a declining sector if their relative performance in that sector is better than it would be in a new, more profitable sector.<sup>76</sup>

The sector-shifting hypothesis cannot explain the lack of reduced-windfall options. First, it assumes that managers can easily shift themselves and their businesses from one sector to another. Although some firms and executives are undoubtedly flexible enough to do this, most are unlikely to be capable of such change. General Motors, for example, is highly unlikely to abandon automobiles and go into the pharmaceuticals, software, or energy industries. Yet industry-wide indexing is almost never used. Second, and more importantly, even if it were desirable to provide managers with an incentive to make good sector choices by rewarding them for sector performance, there would still be no reason to reward managers for market-wide increases. Firms that wish to encourage managers to shift into more profitable sectors could filter out market-wide increases exclusively by using options linked to a broad market index rather than to an industry-specific index. Thus, sector-shifting considerations cannot fully explain the rarity of all forms of reduced-windfall options.

(c) *Softening Industry Competition*: Strategic considerations about competition underlie another explanation offered for the near-absence of reduced-windfall options. By rewarding managers for industry-related stock price movements, conventional options in essence link executive compensation to the performance of rival firms. Some economists have suggested that implicitly linking pay to rival firms' performance serves shareholders by softening competition and allowing all firms in the industry to make more profits.<sup>77</sup>

Not all firms, however, operate in markets where this type of implicit collusion is possible. Indeed, the evidence concerning the (limited) use of explicit relative performance evaluation (RPE) in annual incentive plans is not consistent with these strategic explanations. In those plans using RPE, industry peer group comparison is overwhelmingly favored over broad-

---

<sup>76</sup> Ronald A. Dye, "Relative Performance Evaluation and Project Selection," *Journal of Accounting Research* 30 (1992): 28.

<sup>77</sup> See Rajesh K. Aggarwal and Andrew A. Samwick, "Executive Compensation, Strategic Competition, and Relative Performance Evaluation: Theory and Evidence," *Journal of Finance* 54 (December 1999): 2000.

based comparison.<sup>78</sup> Although the possible advantages of softening competition may make it desirable for some firms to tie their managers' pay to the returns of industry rivals, it cannot explain the almost complete absence of sector-indexed options. Furthermore, even if it were generally desirable to tie executive compensation to industry returns, this would not explain the widespread failure to filter out broader market increases. Therefore, the implicit collusion theory, too, fails to explain firms' almost complete failure to filter out windfalls.

(d) *Discouraging Excessive Risk Alteration*: Saul Levmore has offered a "super-risk alteration" explanation for conventional options. According to Levmore, indexed options would encourage managers to differentiate the prospects of their firm from the index in order to increase the likelihood that their options would be in-the-money.<sup>79</sup> This could cause managers to forgo the best projects and strategies in favor of those that have higher volatility relative to the index.

Even if indexing did lead managers to take more risks, it is far from clear that it would worsen their decision-making overall. In the absence of options, risk-averse managers might prefer low volatility projects, even when higher volatility projects would make the firm's well-diversified shareholders better off. Options, which reward managers for riskier projects, counter this distortion. There is no reason to assume that indexed options would have the net effect of worsening rather than improving managers' choices among projects with different risk profiles. There is even less basis for assuming that, compared with indexed options, the benefits of conventional options are so large as to justify large windfall-based rewards. Finally, even if the effect suggested by Levmore were adverse and sufficiently large to make indexed options undesirable for some firms, it would not likely be so across the board. Thus, the risk-alteration effects of indexed options cannot adequately explain the almost complete absence of reduced-windfall options.

---

<sup>78</sup> See Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, vol. 3, bk. 2 (New York: Elsevier, 1999), p. 74, table 9.

<sup>79</sup> Saul Levmore, "Puzzling Stock Options and Compensation Norms," *University of Pennsylvania Law Review* 149 (2001): 1922-1923, 1930. Options with performance-conditioned vesting could have similar effects.

## *Excuses for Conventional Options*

(e) *Retaining CEOs During Market Booms*: Charles Himmelberg and Glenn Hubbard have argued that conventional options provide a convenient way to retain talented managers during market booms.<sup>80</sup> They find evidence that CEO compensation is positively correlated with market returns, a correlation which results, they argue, from the inelasticity in the supply of individuals qualified to run public firms.<sup>81</sup> In their view, the better the market does, the higher the demand for executives, and the more companies must pay CEOs to retain them. Because conventional options capture market-driven stock price increases, they have a built-in mechanism for increasing pay as the market rises.

This theory again fails to explain the dearth of reduced-windfall options. To begin with, the market boom theory appears to rest on the assumption that the CEO and the firm cannot renegotiate compensation when the executive's outside opportunities improve. In an arm's length world, such an ex-post adjustment should be possible.

Even if an automatic mechanism that provided more pay to retain executives during market booms were desirable, conventional options would not fit the bill. Conventional options do confer additional value on executives during booms, but that increase likely fails to strengthen managers' incentives to remain at their current firms.

Consider a company that signs a compensation agreement providing the CEO with options vesting gradually over a three-year period. Suppose also that the company seeks to address a possible scenario in which, after the first two years, the stock market rises considerably, tempting the executive to switch to a higher-paying firm. By that time, two-thirds of the options will have vested but many may still be unexercised. Increasing the value of those vested options will benefit the executive without increasing the opportunity cost of departing. Because the options are already vested, the executive can

---

<sup>80</sup> See Charles P. Himmelberg and R. Glenn Hubbard, "Incentive Pay and the Market for CEO's: An Analysis of Pay-for-Performance Sensitivity," working paper, Columbia University and the National Bureau of Economics Research, 1999, pp. 1-3. See also Paul Oyer, "Why Do Firms Use Incentives That Have No Incentive Effects?" *The Journal of Finance*, Forthcoming.

<sup>81</sup> See Charles P. Himmelberg and R. Glenn Hubbard, "Incentive Pay and the Market for CEO's: An Analysis of Pay-for-Performance Sensitivity," working paper, Columbia University and the National Bureau of Economics Research, 1999, pp. 1-3.

exercise those options and sell the shares for a large profit while walking out the door.

The increase in value of those options still unvested at the end of the second year might provide some incentive to stay, but only for at most another year, at which time the remaining options vest. Interestingly, however, C. Edward Fee and Charles Hadlock have found that under current compensation practices there is no relationship between the amount an executive forfeits by leaving for another company and the likelihood of jumping ship.<sup>82</sup> The reason they offer: new employers are willing to fully compensate the executives for what they leave behind. Moreover, Fee and Hadlock found that the amount an executive must be compensated does not affect the willingness of new employers to hire the executive.

Finally, even if conventional options were useful in retaining executives during market booms, one could achieve the same result, with better incentives, providing reduced-windfall options. While conventional options do provide more compensation to executives during booms relative to reduced-windfall options, all the increase comes in the form of performance-decoupled value. Thus, conventional options do nothing to strengthen executives' incentives to produce value. A more effective automatic mechanism for retention incentives would award reduced-windfall options at intervals throughout an executive's tenure. Depending on how much the market rose, the executive would get a certain number of additional reduced-windfall options that would vest only after a certain period following their issuance.

(f) *Reducing Managerial Risk-bearing Costs:* It has been argued that standard indexed options (options whose exercise price is indexed to the sector or market average) would impose too much additional risk of nonpayment on risk-averse executives. Kevin Murphy reports that the probability that a given stock will earn returns in excess of a value-weighted index is below 50 percent. In contrast, a typical ten-year conventional option that is, like most conventional options, granted at the money has an 80 percent probability of expiring in the money.<sup>83</sup> Presumably, risk-averse

---

<sup>82</sup> See C. Edward Fee and Charles J. Hadlock, "Raids, Rewards, and Reputations in the Market for CEO Talent," *Review of Financial Studies* 16 (2003): 1347.

<sup>83</sup> See Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options," *University of Chicago Law Review* 69 (2002): 863.

## *Excuses for Conventional Options*

executives would demand indexed options that have a higher expected value than the conventional options they would be replacing. The same claim could be made with respect to options subject to performance-conditioned vesting.

There are at least two problems with this argument. First, and most importantly, a reduced probability of payout is not an inevitable consequence of indexing. To be sure, indexing to sector or market averages would generally reduce the probability of a payout. But as we have emphasized, standard indexing is not the only possible form of indexing. One could instead implement a more moderate form of indexing that would put a CEO in the money even if he or she outperforms fewer than 50 percent of the competition. In fact, one could easily design an indexed option that has the same probability of payout as a conventional option.

Suppose, for example, that conventional ten-year options have an 80 percent likelihood of payout, and one wishes to design a ten-year sector-indexed option for ABC's CEO with the same payout probability. In addition, suppose there are ten firms in ABC's sector. One could simply tie the exercise price of the CEO's options to the stock price performance of the second worst performing firm in the sector. Thus ABC's CEO will get a positive payout as long as ABC is one of the eight best performers in the ten-firm sector. (Of course, the better ABC performs, the higher the payout). This kind of indexed option provides much better incentives than a conventional option with the same payout probability by screening out market- and sector-wide effects, thereby tying the CEO's compensation more closely to the firm-specific value he or she creates.

Second, even if standard indexed options are considered the only reduced-windfall options available, risk aversion is unlikely to explain why almost no public companies have used them. To be sure, a CEO who is given standard indexed options rather than conventional options may demand options with a higher expected value to compensate for the increased risk. But in at least some cases, shareholders will likely prefer such a tradeoff: specifically, whenever the extra value generated by improving the CEO's incentives exceeds the additional compensation paid the CEO for bearing the risk of nonpayment. It is highly unlikely that, in almost every publicly traded firm, the CEO is so risk-averse as to require additional compensation for the extra risk of indexed options that exceeds the additional value created by improving his or her incentives.

### *Excuses for Conventional Options*

g) *Managers' Ability to Index Their Own Compensation*: As explained above, conventional options have a firm-specific component and a sector or market component. The problem we have focused on is that a substantial amount of the compensation delivered through conventional options has nothing to do with an executive's own performance. Economists have been puzzled by the use of conventional options for another reason: the lack of indexing unnecessarily exposes executives to market risk. Given that managers are risk averse, and therefore value risky compensation less, it would be cheaper for firms – at least in a taxless world -- to give managers indexed options and cash equal to the value of the market component of their options.

Some economists, however, have argued that indexing may be unnecessary because managers can make offsetting adjustments in their portfolios to eliminate the market risk from their conventional options.<sup>84</sup> Consider, for example, an executive who would normally wish to invest \$3 million of savings in the stock market. If conventional options expose the manager to \$2 million of stock market risk, he or she can simply reduce the amount of his savings invested in the market from \$3 million to \$1 million in order to maintain the desired exposure to the market. The \$2 million in savings that is no longer invested in the market can be kept as cash or used for other (non-market) investments. Therefore, giving executives conventional options is really no different from giving them indexed options plus cash.

We have no quarrel with this analysis. Conventional options may well be no more risky for managers than a combination of indexed options and cash. For our purposes, however, it is irrelevant whether conventional options are best viewed as a combination of indexed options plus cash or as a combination of indexed options plus a market investment. Our point, simply, is that a large portion of the value of conventional options – which are widely considered to be “performance-based pay” – is in fact pay without performance.

---

<sup>84</sup> See John E. Core, Wayne Guay, and David F. Larcker, “Executive Equity Compensation and Incentives: A Survey.” *Economic Policy Review* 9 (April 2003); Gerald Garvey and Todd Milbourn, “Incentive Compensation When Executives Can Hedge the Market: Evidence of Relative Performance Evaluation in the Cross Section,” *The Journal of Finance*, 58, no. 4 (August 2003): 1557-1581; Li Jin, “CEO Compensation, Diversification, and Incentives,” *Journal of Financial Economics* 66 (October 2002): 29-63.



## *Excuses for Conventional Options*

(h) *Saving Taxes*: David Schizer has suggested that conventional options have a potential tax advantage over indexed options.<sup>85</sup> Recall that, since 1994, firms have not been permitted to deduct executive compensation in excess of \$1 million if it is not performance-based.<sup>86</sup> Both conventional and indexed options qualify as performance-based.<sup>87</sup> However, a conventional option does not screen out market or industry effects. Therefore, such an option provides managers with some non-performance-based value. A conventional option could be useful to a tax-paying firm that wishes to (a) give a manager pay that is not based on his or her performance and (b) give that pay in the form of a call option on the market.

Schizer's argument acknowledges that a substantial portion of the compensation delivered by conventional options isn't performance-linked. He is simply pointing out that, if such performance-decoupled pay is desirable, using conventional options at least enables firms to take a deduction. But he does not offer any justification for providing managers with vast amounts of non-incentivizing compensation.

Furthermore, as Schizer observes, firms have largely avoided indexed options even when there was no tax advantage to delivering performance-decoupled pay through conventional options, as was the case prior to 1994, when there was no limit on the deductibility of such pay. Moreover, for the many firms that do not pay income taxes, the deductibility of executive compensation is largely irrelevant. Thus, Schizer's tax theory cannot explain the exclusive use of conventional options by all but a few firms after 1994.

It is also important to note that the provision of compensation tied to the market's general performance is less efficient than cash compensation of equivalent cost. If both forms of compensation -- a call on the market and

---

<sup>85</sup> See David M. Schizer, "Tax Constraints on Indexed Options," *University of Pennsylvania Law Review* 149 (2001): 1942-1943. As the discussion should make clear, one could also argue that the tax advantage of conventional options is a partial explanation for the lack of options with performance-conditioned vesting.

<sup>86</sup> See 26 USC § 162m (1994).

<sup>87</sup> See David M. Schizer, "Tax Constraints on Indexed Options," *University of Pennsylvania Law Review* 149 (2001): 1942-1943. Although there are technical grounds to deny a deduction for indexed options under Section 162(m), there is a good chance that a taxpayer could get a favorable ruling from the government on this issue. For a discussion, see David M. Schizer, "Reducing the Tax Costs of Indexed Options," *Tax Notes* 96 (September 2002): 1375.

### *Excuses for Conventional Options*

cash -- have the same cost to the firm and do not provide incentives, cash at least is risk-free to managers. The only reason to provide conventional option pay in such circumstances is to make the large amounts of performance-independent pay less noticeable to outsiders.

## CHAPTER 13: MORE ON WINDFALLS IN EQUITY-BASED COMPENSATION

“ [At-the-money] plans are a royalty for the passage of time.”  
-- Warren Buffett

In this chapter, we continue to examine the surprising insensitivity to performance produced by conventional practices concerning equity-based compensation. We discuss three practices that have also benefited managers by providing pay without performance: the near-uniform use of at-the-money options, the re-pricing and “backdoor re-pricing” of options when the firm’s stock price falls, and “reload” features that enable managers to lock in and profit from temporary spikes in the stock price. We conclude by discussing how the increasing use of restricted stock in place of options will tend to increase rather than reduce executives’ windfalls.

### At-the-Money Options

#### The Puzzle of One-Size-Fits-All Options

Options are supposed to provide executives with financial incentives not only to exert effort, but also to make the right decisions for the firm.<sup>88</sup> Because managers are under-diversified and risk averse, they may hesitate to take risks that would be desirable for shareholders. Options are believed to counteract this tendency by providing executives with a financial incentive to take risks. The extent to which an option encourages managers to accept additional risk depends, in part, on the exercise (“strike”) price. Setting the strike price too high or too low may cause executives to take on too much or too little risk. Similarly, the cost-effectiveness of options may depend on their exercise price.

---

<sup>88</sup> Kevin J. Murphy, “Performance Standards in Incentive Contracts,” *Journal of Accounting and Economics* 30 (2001): 273. Richard A. DeFusco, Robert R. Johnson, and Thomas S. Zorn, “The Effect of Executive Stock Option Plans on Stockholders and Bondholders,” *Journal of Finance* 45 (1990): 617.

Not surprisingly, the optimal exercise price in any given case is likely to depend on several factors.<sup>89</sup> Analyses in the finance literature indicate that it is highly unlikely that the same option design would be efficient in all cases. The incentives created by options depend on a variety of grantee-specific factors, including the executive's portfolio and risk preferences.<sup>90</sup> At the same time, a variety of firm-specific factors, such as growth opportunities and debt load, determine which incentives will be desirable.<sup>91</sup> Besides differing from firm to firm, these factors may vary within a single firm over time. Clearly, there is no reason to expect the efficient exercise price to be the same for almost all executives, at all companies, and at all times.

Yet an analysis of options granted to the CEOs of one thousand large companies in 1992 determined that more than 95 percent were granted at the money -- that is, with an exercise price equal to the company's stock price on the date of the grant.<sup>92</sup> This pattern has persisted, leading Brian Hall and Kevin Murphy to refer to this phenomenon as "striking."<sup>93</sup> There has been

---

<sup>89</sup> See, for example, Tom Nohel and Steven Todd, "Stock Options and Managerial Incentives to Invest." *Journal of Derivatives Accounting* 1 (2004).

<sup>90</sup> Tom Nohel and Steven Todd, "Stock Options and Managerial Incentives to Invest." *Journal of Derivatives Accounting* 1 (2004).

<sup>91</sup> Chongwoo Choe, "Executive Stock Options and Investment Choice," *Journal of Corporate Finance* (April 2001), 3 (forthcoming).

<sup>92</sup> See Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, vol. 3, bk. 2, ed. Orley Ashenfelter and David Card, (New York: Elsevier, 1999), p. 70, table 5.

<sup>93</sup> Brian J. Hall and Kevin J. Murphy, "Stock Options for Undiversified Executives," *Journal of Accounting and Economics* 33 (2002): 23. Other economists have also acknowledged that this pattern is inconsistent with arm's length contracting. Yisong S. Tian, "Optimal Contracting, Incentive Effects, and the Valuation of Executive Stock Options," working paper, York University, 2001, p. 40. Hall and Murphy do try to come up with an advantage that at-the-money options have. They conduct numerical simulations in an attempt to derive optimal exercise prices under various assumptions about the shape of managerial utility functions, managerial wealth, stock market returns, and the volatility of the firm's stock. Under a range of parameters, they show that the exercise price that maximizes pay-for-performance sensitivity is usually in a range that includes the current market price. See Brian J. Hall and Kevin J. Murphy, "Optimal Exercise Prices for Executive Stock Options," *American Economic Association Proceedings* 90 (2000): 213; Brian J. Hall and Kevin J. Murphy, "Stock Options for

some movement in the last few years to out-of-the-money options, but it has been slow and grudging. In early 2004, for example, IBM attracted considerable attention when it announced that it would begin providing options to top executives that they could cash in only if IBM's stock rose by at least 10 percent.<sup>94</sup> However, only a handful of firms use such premium options.<sup>95</sup>

Tax and accounting rules might be sufficient to account for the almost complete absence of *in-the-money* options (options with an exercise price below the grant-date stock price). In-the-money options are not considered "performance-based compensation" under Section 162(m) of the Internal Revenue Code and therefore are not deductible if an executive's total non-performance-based compensation exceeds \$1 million per year. Additionally, options that are granted in the money must be charged against earnings, unlike at-the-money and out-of-the-money options.

However, neither the tax nor the accounting explanation can explain why fewer than 5 percent of firms use *out-of-the-money* options.<sup>96</sup> There is little reason to believe that out-of-the-money options are almost never efficient. Indeed, there is a substantial likelihood that what were originally out-of-the-money options will become in-the-money if the firm does well relative to its peers. Even if the firm does relatively poorly, there is also a good chance that, with time and in a rising market, at-the-money options will turn into in-the-money options.

For these reasons, as Hall and others have observed, out-of-the-money options often generate much higher pay-for-performance sensitivity

---

Undiversified Executives," *Journal of Accounting and Economics* 33 (2002): 3-42. However, their analysis cannot explain why, as they report, 94 percent of option grants are at the money. First, there is no evidence that the utility functions they use—which are designed to make their calculations tractable—correspond to those of actual managers. Second, the analysis does not take into account the incentive effects of the options on managerial behavior. Third, even if their parameters corresponded to the situations of actual CEOs and incentive effects could be ignored, their parameters generate a range of optimal exercise prices, some of which, under certain conditions, are out-of-the-money. Yet, almost all option grants are at-the-money.

<sup>94</sup> Gretchen Morgenson, "After I.B.M.'s Option Overhaul," *New York Times*, 29 February 2004, Section 3, p.1.

<sup>95</sup> *Ibid.*

<sup>96</sup> Paul L. Gilles, "Alternatives for Stock Options", *HR Magazine*, January 1999, pp. 40-48.

per dollar of expected value than do conventional options.<sup>97</sup> Moreover, empirical evidence suggests that giving managers out-of-the-money options rather than at-the-money options does, on average, boost firm value.<sup>98</sup> Thus, it is extremely unlikely that out-of-the-money options are almost never efficient. According to Hall, the “almost complete absence of [out-of-the-money] options seems puzzling given their striking advantages in terms of pay to performance.”<sup>99</sup>

There are actually two dimensions along which the uniformity of exercise prices currently occurs: (1) firms use the same exercise price for options regardless of their vesting period and expiration date; and (2) almost all firms use the same formula for determining this exercise price, namely, the current market price. While the second pattern has been widely discussed, few analysts have devoted attention to the odd uniformity across vesting periods.

Because stock prices rise on average over time, an option issued at the current market price is likely to become progressively more in-the-money as time passes, and, correspondingly, to produce incentives progressively more like those that an option issued in-the-money would have created. Furthermore, as time progresses, the fact that the stock price exceeds the exercise price will be less and less indicative that shareholders have gained since the option was issued. Managers who received options issued at-the-money and exercisable over a ten-year period will make money as long as the stock price goes up nominally over the ten-year period. As a result, the

---

<sup>97</sup> See Brian J. Hall, “A Better Way to Pay CEOs?” in *Executive Compensation and Shareholder Value*, ed. Jennifer Carpenter and David Yermack (Boston: Kluwer Academic Publishers, 1999): 43; Tom Nohel and Steven Todd, “Stock Options and Managerial Incentives to Invest.” *Journal of Derivatives Accounting* 1 (2004); Shane A. Johnson and Yisong S. Tian, “The Value and Incentive Effects of Non-Traditional Executive Stock Option Plans,” *Journal of Financial Economics* 57 (2000): 3-34; Richard A. Lambert, David F. Larcker, and Robert E. Verrecchia, “Portfolio Considerations in Valuing Executive Compensation,” *Journal of Accounting Research* 29 (1991): 129-149.

<sup>98</sup> See Michel A. Habib and Alexander P. Ljungqvist, “Firm Value and Managerial Incentives: A Stochastic Frontier Approach.” *The Journal of Business*, Forthcoming.

<sup>99</sup> Brian J. Hall, “A Better Way to Pay CEOs?” in *Executive Compensation and Shareholder Value*, ed. Jennifer Carpenter and David Yermack (Boston: Kluwer Academic Publishers, 1999): 43.

managers can benefit even if shareholders' real returns were tiny or even negative.

For example, Apple Computer reported in a March 2001 SEC filing that in the preceding year it had granted its CEO, Steven Jobs, 20 million options. Apple estimated that if its share price increased at a rate of 5 percent per year (a rate below the historical market average and below the rate of return on long-term corporate bonds at the time), Jobs's options would be worth \$548,317,503 by the time the options expired.<sup>100</sup>

One of many possible approaches to reducing this royalty is to have a strike price that increases over time at a pre-determined rate. An option exercisable at the current market price that vests in five years will have in real terms an exercise price much lower than the current market price. A solution might be, for example, to set the exercise price initially to the grant-date stock price, and then adjust it for inflation. Alternatively, the exercise price could be increased by the T-bill rate from year to year. Indeed, a number of firms in Australia and New Zealand have already employed options with an exercise price that increases over time.<sup>101</sup> U.S. boards, on the other hand, have shown little interest in tying the exercise price to the length of time between the grant date of the option and its exercise date.

We do not attempt here to determine the best strike price for options that will be exercised in the future, nor can such a general determination be made. The efficient price would vary from case to case according to multiple factors, including the time value of money and the rate of inflation. The important point is that there is little reason to think that the exercise price that maximizes value for shareholders would be uniform across almost all firms, executives, times, and exercise dates.

### **The Managerial Power Explanation**

Because there is reason to believe that the value-maximizing exercise price would differ across vesting periods and across firms, the current uniformity along both dimensions poses a puzzle under the arm's length contracting approach. This uniformity, however, is not puzzling under the

---

<sup>100</sup> This example is presented by Steven Balsam in *An Introduction to Executive Compensation* (San Diego: Academic Press 2002), p. 151.

<sup>101</sup> See Joe Cheung, "Valuation of 'Razorback' Executive Stock Options: A Simulation Approach," working paper, The University of Auckland, 2002.

managerial power approach. That approach recognizes that managers do not seek exercise prices that maximize shareholder value. On the contrary, they seek prices that make managers best off -- namely, the lowest exercise price possible in each case, consistent with other constraints.

At-the-money options may well provide the best combination of high rents and low outrage. For a given number of options, executives prefer the lowest possible exercise price. Each dollar of strike price reduction is a dollar gained once the option is in the money. Thus, executives prefer an option that bears the lowest possible strike price without causing too much outrage.

Granting in-the-money options may create outrage for several reasons. Though even at-the-money options may reward executives despite poor performance, it is much more obvious that this is the case when the executive receives in-the-money options. Furthermore, as discussed above, in-the-money options are not considered "performance-based" and are thus at a tax disadvantage.<sup>102</sup> Finally, in-the-money options would force the firm to take a charge against earnings. A firm using such options would no longer be able to use one of the traditional excuses for not adopting reduced-windfall options: that they generate adverse accounting effects.

The above discussion explains why plan designers may be reluctant to use in-the-money options. However, this leaves a range of possible exercise prices at or above the grant-date market price. Within this range, the lowest possible exercise price is the grant-date market price. Setting the strike price here has a superficially plausible justification: managers profit only if the stock price rises, and at-the-money options may be efficient under some circumstances. Managers' desire to have the most favorable exercise price, subject to the constraint that it not be below the grant-date price, can explain why exercise prices are almost uniformly set to the grant-date price, regardless of the vesting period, the expiration date, economic conditions, individual firm characteristics, and the identities of the executives.

As we have explained, even if the grant-date price represents the "true" value of the company at that time, at-the-money options can be expected to provide substantial windfalls—a potential that can be further increased through strategic timing. Managers have influence over both the timing of corporate disclosures and the timing of option grants. They can use their power to release information in such a way that the stock price is

---

<sup>102</sup> See Internal Revenue Code, sec. 162(m).



depressed at the grant date. A lower grant-date price, of course, reduces the exercise price of the options and boosts the managers' profits when the options are later exercised. Thus, managers can obtain options with exercise prices that are, on average, below the "true" value of the company at the grant date.

A number of studies find a systematic connection between option grants and corporate disclosures.<sup>103</sup> Specifically, companies are more likely to release bad news and less likely to release good news just before options are granted. A study by David Yermack focuses on earnings announcements, which tend to occur at certain scheduled times throughout the year. He finds that managers are more likely to be awarded options in advance of the release of favorable earnings results that boost the stock price than in advance of unfavorable announcements. Yermack concludes that managers are able to influence the compensation committee to give them options when they know that the next earnings announcement will be favorable and therefore likely to boost the stock price. Executives effectively award themselves in-the-money options camouflaged as at-the-money options. Yermack's study also finds, consistent with the prediction of the managerial power approach, that more powerful CEOs are able to obtain larger "discounts" on their options.

David Aboody and Ron Kasznik examine companies that have scheduled option grant dates – that is, companies where managers do not appear to have control over the timing of their option grants. They find that managers time voluntary disclosures both to reduce the stock price before getting their at-the-money options and to boost the stock price afterwards.<sup>104</sup> According to the findings of a study by Steven Balsam, Huajing Chen, and

---

<sup>103</sup> David Aboody and Ron Kasznik, "CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures," *Journal of Accounting and Economics* 29 (2000): Steven Balsam, Huajing Chen, and Srinivasan Sankaraguruswamy, "Earnings Management Prior to Stock Option Grants," working paper, Temple University Department of Accounting (2003), pp. 73-100; David Yermack, "Good Timing: CEO Stock Option Awards and Company News Announcements," *Journal of Finance* 52 (1997): 449-477.

<sup>104</sup> This finding is consistent with evidence that there are abnormal price declines shortly before options are awarded. See Keith Chauvin and Cathy Shenoy, "Stock Price Decreases Prior to Executive Stock Option Grants," *Journal of Corporate Finance: Contracting, Governance, and Organization* 7 (2001): 53-76.

Srinivasan Sankaraguruswamy, another approach is to manage earnings around the grant date.<sup>105</sup> They find that managers boost income-decreasing accruals prior to stock option grants.

Aboddy and Kasznik also report that managers delay the release of good news until after the grant-date. Like managers with control over the timing of their option grants, managers with control over the timing of disclosure receive at-the-money options that would actually be in-the-money options if the stock price reflected the good news whose release has been delayed. In either case, managerial influence increases the extent to which at-the-money options provide pay without performance.

### **Re-pricing and Backdoor Re-pricing**

Thus far, we have discussed how an at-the-money exercise price allows managers to benefit from stock price gains unrelated to their performance. We now examine what happens when the stock price falls below the exercise price. Contrary to what one might expect, current practices do not leave executives empty-handed in such situations. Firms either re-price the executive's options or engage in "backdoor re-pricing" by issuing new options at a lower exercise price. The prospect of receiving some value from the firm in such circumstances further weakens the link between option pay and performance.

### **Rewarding Managers when Stock Prices Fall**

Until the late 1990s, the main way in which firms "made up" for options that had fallen out of the money was to reduce the exercise price. Examining the S&P ExecuComp database for 1992-1995, Menachem Brenner, Rangarajan Sundaram, and David Yermack found that, in each of those years, an average of 1.3 percent of executives had their options re-priced.<sup>106</sup> Of 806 individual option re-pricings, they found that the strike

---

<sup>105</sup> Steven Balsam, Huajing Chen, and Srinivasan Sankaraguruswamy, "Earnings Management Prior to Stock Option Grants," working paper, Temple University Department of Accounting (2003), pp. 73-100

<sup>106</sup> Menachem Brenner, Rangarajan K. Sundaram, and David Yermack, "Altering the Terms of Executive Stock Options," *Journal of Financial Economics* 57 (2000): 110. According to the Investor Responsibility Research Center, 3 percent of 1,189 firms

price was increased in only two cases, and they calculated an average reduction in exercise price of 39 percent.<sup>107</sup> The S&P 500 Index rose by about 50 percent during the period studied by the authors, with no significant downturns. The frequency of re-pricing would presumably have been even higher if the markets had not risen as quickly and as consistently as they did in the 1990s.

Since the FASB has required firms that re-price options after December 15, 1998, to expense them, firms have become more reluctant to re-price.<sup>108</sup> However, they have found other ways – methods Brian Hall and Thomas Knox of Harvard Business School call “backdoor re-pricing” -- to achieve the same result without adverse accounting consequences.<sup>109</sup>

When executives are left holding options that are out of the money, firms often carry out a backdoor re-pricing by replenishing the executive with extra options that have a lower exercise price. In some cases, the new option grants are preceded by cancellation of the old, out-of-the-money options.<sup>110</sup> In other cases, the old options remain. The latter, of course, is better for the executives. Though the old options are “under water” (i.e., out-of-the-money) at the moment, they may still have value, especially if the option expiration date is far in the future. Although the various forms of backdoor re-pricing differ somewhat from each other and from standard re-pricing, for simplicity we will use the term “re-pricing” to refer to all the ways in which additional value is given to executives whose options have fallen under water.

The problem with any form of re-pricing is that it weakens the link between pay and performance. Indeed, re-pricing does not simply provide pay independent of performance; it rewards poor stock performance. Re-

---

surveyed by the IRRC repriced options in 1998. Kathy B. Ruxton, “Executive Pay, 1998: Chief Executive Officer Compensation at S&P Super 1,500 Companies as Reported in 1998” (Investor Responsibility Research Center 1999): 2.

<sup>107</sup> Menachem Brenner, Rangarajan K. Sundaram, and David Yermack, “Altering the Terms of Executive Stock Options,” *Journal of Financial Economics* 57 (2000): 112.

<sup>108</sup> Thomas A. Ratcliffe, “New Guidance in Accounting for Stock-Based Compensation: FASBIN No. 44,” *National Public Accountant* 46 (2001): 28.

<sup>109</sup> Brian J. Hall and Thomas Knox, “Managing Option Fragility,” working paper no. 02-19, Harvard Business School, Negotiations, Organizations and Markets Unit (May 2002), p.3.

<sup>110</sup> See \_\_\_\_\_ *Fortune*, 25 June 2001, p. 84.

pricing thus has troubling incentive implications. Clearly, the expectation that firms will engage in re-pricing to offset the consequences of adverse stock price movements undermines ex-ante incentives. Conceivably, if executives anticipate a re-pricing if the stock price falls, they may have an incentive to create a short-run decline in stock price in order to get the benefits of re-pricing. Thus, re-pricing undermines the incentive justification for the use of stock option plans in the first place.<sup>111</sup>

Defenders of re-pricing argue that these adjustments are necessary to retain and motivate executives when prices fall to levels that make existing options far out of the money. Although ex-post re-pricing undermines ex-ante incentives, companies might, it is argued, determine that the ex-post retention and incentive benefits outweigh the ex-ante costs. However, this argument ignores the fact that under-water options may still retain significant value if they have a long maturity and the stock is highly volatile.<sup>112</sup> Thus, the retention and incentive justifications do not apply in the many cases where firms hurry to re-price following a sharp stock decline.

The retention and incentive justifications do apply in some cases, however. It may be necessary to provide additional option value in order to provide an executive with incentive to move forward after a setback. Yet even when re-pricing is on balance warranted, it is important to recognize that the beneficial incentive effects going forward come at a cost to ex-ante incentives by paying for poor stock performance. This recognition must be part of the assessment of any option plan.

Defenders of re-pricing can argue that it is especially justified in situations where the firm's stock decline is due to a general market or sector downturn, an event that is outside the executives' control. Because such a downturn is not the product of managers' actions, protecting them from its consequences does not dilute their ex-ante incentives to perform.<sup>113</sup> But re-pricing conventional options in the wake of a market downturn seems inferior to indexing the options against market movements in the first place.

---

<sup>111</sup> Viral V. Acharya, Kose John, and Rangarajan K. Sundaram, "On the Optimality of Resetting Executive Stock Options," *Journal of Financial Economics* 57 (2000): 67.

<sup>112</sup> Li Jin and Lisa Meulbroek, "Do Underwater Executive Stock Options Still Align Incentives?: The Effect of Stock Price Movements on Managerial Incentive-Alignment," working paper, Harvard Business School, 2001, pp. 39-40.

<sup>113</sup> P. Jane Saly, "Repricing Executive Stock Options in a Down Market," *Journal of Accounting and Economics* 16 (1994): 326.

Using indexed options that automatically correct for market-wide and sector-wide shocks in both directions will generally ensure that the options remain valuable and that managers continue to have incentives to perform. Moreover, the protection will come more cheaply and with fewer complications than if conventional options are coupled with ex-post re-pricing.

Consider executives holding standard indexed options whose exercise price is tied to the sector or market average. The executives are insulated from sector or broad market swings. As a result, there is never a need to engage in re-pricing to protect them from a general market or sector slide. The options will automatically “correct” for such a slide. Executives who perform adequately relative to their peers are thus always rewarded.

Under current arrangements, executives receive conventional options and fall back on re-pricing when the market moves against them. As a result, managers reap the gains of a sector- or market-wide rally, while being protected from sector- or market-wide downturns. For executives, it’s “heads I win, tails I don’t lose.” Indeed, when a market slide is accompanied by re-pricing and is followed by a market rise, executives enjoy the best of both worlds, reaping a windfall from a rally that begins at the bottom of the market and ends at the top. Thus, the re-pricing arrangement is much more costly to the firm and provides no additional incentive for managers to boost shareholder value.

### **The Managerial Power Explanation**

Because the anticipation of re-pricing can dilute ex-ante incentives, re-pricing is, at the minimum, troubling from an arm’s length contracting perspective. Re-pricing can be justified as protection against general market or sector downturns if the use of conventional options is taken as given. But this justification simply underscores the potential value of using indexed options, making the persistent failure of firms to use them all the more puzzling. Not surprisingly, shareholder groups have expressed concern about re-pricing and have sometimes opposed the practice directly.<sup>114</sup>

---

<sup>114</sup> A. Martinez, “Moving the Goal Posts: Options Re-pricing Gives Companies a Powerful Tool to Retain Workers; Critics See It as Rewarding Failure,” *Wall Street Journal*, 9 April 1998, p. R4; J. A. Byrne, “How to Reward Failure: Reprice Stock Options,” *Business Week*, 12 October 1998, p. 50; James E. Heard, “Executive

### *More on Windfalls*

Seen from the managerial power perspective, the practice of re-pricing is easy to explain. Although indexed options could accomplish at lower cost what is currently achieved through a combination of conventional options and re-pricing, executives clearly have a substantial preference for the latter. Executives benefit from conventional at-the-money options and from re-pricing. Thus far they have been able to enjoy both.

It is worth noting that standard re-pricing has met increasing resistance from shareholders,<sup>115</sup> but back-door re-pricing has escaped this scrutiny. Firms are therefore able to engage in re-pricing without much outside attention. When executives benefit from large option gains due to market-wide stock price increases, their windfalls can be easily justified to outside observers. After all, the firm and its executives had a contract that provided incentives; all parties to the contract, including shareholders, enjoyed gains; and the firm adheres to its contracts. When stock prices decline, the replenishing of options can be justified by referring to the need to retain and motivate executives as the firm moves forward. The absence of formal re-pricing also helps, of course.

The empirical evidence supports the managerial power explanation. For example, Donald Chance, Raman Kumar, and Rebecca Todd have found that re-pricing is more common among smaller firms with boards dominated by insiders and otherwise suffering from greater agency problems.<sup>116</sup> Brenner, Sundaram, and Yermack found that re-pricing does not in fact occur as a result of industry-wide shocks, despite firms' claims that

---

Compensation: Perspective of the Institutional Investor," *University of Cincinnati Law Review* 63 (1995): 749. The Council of Institutional Investors, Corporate Governance Policies lists as a core principle that underwater options should not be re-priced or replaced without shareholder approval. See [http://www.cii.org/dcwascii/web.nsf/doc/policies\\_iv.cm](http://www.cii.org/dcwascii/web.nsf/doc/policies_iv.cm) (last visited March 17, 2004).

<sup>115</sup> In one study, the strike price was reduced but remained above the repricing-date market price in about 20 percent of the re-pricing cases examined. See Menachem Brenner, Rangarajan K. Sundaram, and David Yermack, "Altering the Terms of Executive Stock Options," *Journal of Financial Economics* 57 (2000): 112.

<sup>116</sup> Perhaps nervous about public outrage, some executives and boards have limited the benefit from re-pricing by using an exercise price slightly higher than the repricing-date stock price. See Donald M. Chance, Raman Kumar, and Rebecca B. Todd, "The 'Repricing' of Executive Stock Options," *Journal of Financial Economics* 57 (2000): 148.

the practice is used to avoid penalizing executives for trends beyond their control. On the contrary, the authors found that re-pricing is associated with poor stock price performance specific to the firm, thus rewarding managers for poor performance.<sup>117</sup> Two other studies, one by Chance, Kumar, and Todd and the other by Mary Ellen Carter and Luann Lynch, also found that re-pricing decisions are not driven by market or industry factors, but rather are generated in reaction to poor firm-specific performance.<sup>118</sup>

Yet another study, by Sandra Callaghan, Jane Saly, and Chandra Subramaniam, found that re-pricing frequently occurs after the release of bad news or just prior to the release of good news.<sup>119</sup> This suggests that managers opportunistically time either the release of information or re-pricing (or both) in order to depress the stock price prior to the re-pricing and boost it afterwards. This is similar to the findings described in our earlier discussion of at-the-money options— that managers time the release of information or the option grant-date in order to lower the stock price before receiving new at-the-money options, and increase it afterwards.

Interestingly, Chance, Kumar, and Todd found that half of the re-priced options in their study would have been in the money even if they had not been re-priced. This finding casts doubt on the claim that re-pricing is needed to motivate and retain executives. Even more to the point, the authors found no evidence that lowering the exercise price leads to an increase in future stock prices. In other studies, Timothy Pollock, Harold Fischer, and James Wade found that the presence of institutional investors

---

<sup>117</sup> Menachem Brenner, Rangarajan K. Sundaram, and David Yermack, "Altering the Terms of Executive Stock Options," *Journal of Financial Economics* 57 (2000): 121.

<sup>118</sup> Don M. Chance, Raman Kumar, and Rebecca B. Todd, "The 'Repricing' of Executive Stock Options," *Journal of Financial Economics* 57 (2000): 131; Mary Ellen Carter and Luann J. Lynch, "An Examination of Executive Stock Option Re-pricing," *Journal of Financial Economics* 61 (2001): 209. Another study reports that re-pricing firms are likely to have enjoyed rapid, above-industry growth rates and profitability two years before re-pricing and to have suffered a drop to below-industry growth rates and profitability during the year of re-pricing. Nemmara K. Chidambaran and Nagpurnanand R. Prabhala, "Executive Stock Option Repricing, Internal Governance Mechanisms, and Management Turnover," *Journal of Financial Economics* 69 (2003).

<sup>119</sup> Sandra Renfro Callaghan, P. Jane Saly, and Chandra Subramaniam, "The Timing of Option Re-pricing," working paper, Texas Christian University, 2000.

reduces the likelihood of re-pricing,<sup>120</sup> and Brenner, Sundaram, and Yermack found that the presence of a non-independent board member on the compensation committee increases it.

### **Reload Options**

A significant number of firms automatically grant new options to executives who exercise their existing options. This practice of “reloading” is yet another twist on conventional option plans that further facilitates managers’ ability to reap benefits without performing well.

Basic reload options operate as follows: the holder of an option with a reload provision exercises that option before expiration and pays the exercise price with stock that he or she already owns. In return, the manager receives not only the shares that result from the exercise of the options but also a new option for each share tendered in exercising the options. The new reload options carry the same expiration date as the original options, but the exercise price is set to the stock price on the date of the reloading.

For example, a CEO who held ten reloadable options with a \$20 strike price would surrender five shares of stock to exercise the options if the market price at exercise stood at \$40 per share. That would yield ten shares from exercising the options, plus five new options with a \$40 strike price.<sup>121</sup> Reload options often allow multiple-reloading: the new options that the executive receives are themselves reloadable, providing the same reload rights as the original reloadable options.

Reload options are worth more than conventional options. By exercising the first generation options after a price spike, the recipient locks in a portion of the gain against a subsequent share price decline, while maintaining some of the upside potential, thanks to the reload feature.<sup>122</sup> Indeed, it is optimal for the holder of a multiple-reload option to exercise

---

<sup>120</sup> See Timothy G. Pollock, Harold M. Fischer, and James B. Wade. “The Role of Power and Politics in Repricing Executive Options.” *Academy of Management Journal* 45 (2002)

<sup>121</sup> As will be explained, there are several variations on the reload theme. For example, some reload plans provide additional reload options to replace shares that would have to be sold to pay the tax that is due on exercise.

<sup>122</sup> See Thomas Hemmer, Steve Matsunaga, and Terry Sherlin, “Optimal Exercise and the Cost of Granting Employee Stock Options with a Reload Provision,” *Journal of Accounting Research* 36 (Autumn 1998): 234.



whenever the stock price exceeds its previous high for the period starting with the original grant date.

Thus, reload options enable executives to profit from share price volatility by allowing them to capture temporary gains even if long-term share performance is flat. The incremental value of the reload feature depends on the volatility of the firm's stock price and on other factors. Examining one executive at one firm by way of example, Jane Saly, Ravi Jagannathan, and Steven Huddart estimated that basic reload options in that case were worth about 15 percent more than conventional options.<sup>123</sup>

In addition, reloads can be tweaked so that they come at little or no tax cost to executives. An executive who exercises nonqualified stock options usually owes ordinary income tax on the gain. To alleviate this burden, a large fraction of firms with reload programs issue additional reload options to cover the shares that must be set aside to pay the executive's taxes. The practice is justified as necessary to maintain the executive's total share price exposure.<sup>124</sup> This justification seems plausible at first blush, but in fact the tax reload provision is the equivalent of making a larger conventional option grant in the first place—a grant that is more valuable to the executive and more costly for shareholders.<sup>125</sup>

---

<sup>123</sup> See P. Jane Saly, Ravi Jagannathan, and Steven J. Huddart, "Valuing the Reload Feature of Executive Stock Options," *Accounting Horizons* 12 (1999): 220.

<sup>124</sup> The *Wall Street Journal* reported that in 1999, twenty-one of forty reload firms surveyed issue additional options to replace shares set aside to pay taxes on option exercise. See Christopher Gay, "Hard to Lose: 'Reload' Options Promote Stock Ownership among Executives; But Critics Say They're a Lot More Costly than Shareholders Realize," *Wall Street Journal*, 8 April 1999, p. R6.

<sup>125</sup> Saly, Jagannathan, and Huddart estimated that, with the tax reload feature, the reload options they studied were worth 24 percent more than conventional options, holding other terms of the options constant. See P. Jane Saly, Ravi Jagannathan, and Steven J. Huddart, "Valuing the Reload Feature of Executive Stock Options," *Accounting Horizons* 12 (1999): 220. According to their study, without the tax reload feature, these reload options would have been worth 15 percent more than conventional options. A few companies deviate from the standard reload design in other ways. Some issue a new option for every option exercised, rather than for each share surrendered in exercising the options. Others extend the term of the new options issued beyond the maturity date of the initial options. See Christopher Gay, "Hard to Lose: 'Reload' Options Promote Stock Ownership among Executives; But Critics Say They're a Lot More Costly than Shareholders Realize," *Wall Street Journal*, 8 April 1999,

Reloads and their various features are difficult to explain under the arm's length contracting approach. They clearly increase the likelihood that the executive will benefit from temporary stock price spikes. Reloads thus reward managers for stock price volatility and further decouple pay from performance. Not surprisingly, institutional investors object to their use.<sup>126</sup>

Defenders of reload options argue that the reload feature encourages executives to exercise options earlier and therefore to hold more shares.<sup>127</sup> However, if the executives are not prevented from selling the shares they receive on exercise, the reloads do not necessarily promote this result. Generally, executives are free to sell shares they obtain as a result of the exercise of options, and they do in fact sell most of these shares.<sup>128</sup>

In any event, if the goal is to increase managerial ownership, there are cheaper, more direct, and more effective ways to achieve it. Firms could simply reduce executives' freedom to sell shares after exercising options (a possibility which is the subject of the next chapter). In some cases, the reload feature may actually reduce an executive's shareholdings by giving him or her an incentive to "pay" for reload options with existing shares, rather than with cash.

Although arm's length contracting cannot easily account for reloads, the managerial power approach can. The reload feature makes the options more valuable to the executives, but does so in complex ways that are difficult to evaluate. Furthermore, although reloads are not necessary to promote increased stock ownership by executives and may in fact reduce such ownership, the increased ownership justification given for reloads is

---

p. R6. Both practices add value for executives.

<sup>126</sup> James E. Heard, "Executive Compensation: Perspective of the Institutional Investor," *University of Cincinnati Law Review* 63 (1995): 749, 759.

<sup>127</sup> See Christopher Gay, "Hard to Lose: 'Reload' Options Promote Stock Ownership among Executives; But Critics Say They're a Lot More Costly than Shareholders Realize," *Wall Street Journal*, 8 April 1999, p. R6; Jennifer Reingold, "Nice Option If You Can Get It," *Business Week*, 4 May 1998, p. 111.

<sup>128</sup> One group of economists examined S&P 1500 data from 1993-1995 and found that executives with relatively low stock holdings retain about 30 percent of the shares received on exercise of their options, while relatively high-ownership executives sold all of their shares. See Eli Ofek and David Yermack, "Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership," *Journal of Finance* 55 (2000): 1377-1378.

not patently incorrect. As a result, the primary negative consequence of reload options – increased likelihood of payout to managers even when they perform poorly – is not transparent to outsiders.

### The Move to Restricted Stock

As we have seen, firms have long been attached to the use of conventional options and reluctant to replace them with reduced-windfall options. Under pressure from shareholders, the use of performance-based options has been picking up somewhat. Interestingly, however, firms are displaying much greater willingness to replace conventional options with restricted stock than to replace them with reduced-windfall options. This pattern should not be surprising: restricted stock grants operate to increase windfalls rather than reduce them.

According to the various observers, the use of restricted stock grants is increasing significantly.<sup>129</sup> In 2002, some boards awarded restricted stock for the first time, and others increased dramatically the amount given to top executives.<sup>130</sup> The increased use of restricted stock is generally viewed as a response to shareholder concern about conventional options. “With Options Tainted, Companies Award Restricted Stock,” runs the headline of one newspaper article.<sup>131</sup> Unfortunately, however, firms that are replacing conventional options with restricted stock are ending up with an equity-based incentive plan that contains an even larger windfall element.

It is important to recognize that, although restricted stock is not usually labeled an “option,” is in fact an option. Consider a company that issues an option to an executive on a day when the market price is \$100. If the option is issued at-the-money, it will have a strike price of \$100. Should the executive exercise the option at a later date when the stock price is \$V, he or she will make a profit of \$V-\$100. In contrast, a restricted share that is sold when the stock price is \$V will provide the executive a benefit of \$V. A restricted stock, then, is simply an option with an exercise price of \$0.

---

<sup>129</sup> See, e.g., Joann S. Lublin, “With Options Tainted, Companies Award Restricted Stock,” *Wall St. Journal*, 3 March 2003, p. B1.

<sup>130</sup> *Ibid.* .

<sup>131</sup> *Ibid.*

Why have firms been so eager to move to options with an exercise price of zero? Are there reasons to believe that the optimal exercise price of options is zero? In fact, even an exercise price equal to the grant-date price – 100 in our example – is too low in many cases, especially when the exercise takes place a substantial time after the grant date. When the broader market or the firm’s sector rises, as is likely in the long run, using the grant-date price as the strike price may well provide an executive with large gains even if the executive has substantially underperformed his or her industry peers.

Reducing the exercise price from \$100 to \$0, which a restricted stock effectively does, makes the windfall problem worse. Such a reduction in exercise price increases the windfalls captured by an executives who performs poorly relative to the rest of the industry but enjoys a nominal increase in the firm’s stock price that is due to a rising market. Indeed, it enables poorly performing executives to capture a windfall even when the stock falls below its grant-date price.<sup>132</sup>

When advocating the use of restricted stock, its supporters do not rely, of course, on the fact that such stock will provide greater windfalls than conventional options. Rather, they emphasize certain advantages that restricted stock awards have over the conventional option plans that have been used by public companies. That these advantages indeed exist is probably the reason why shareholders have not resisted, or sometimes have even favored, replacing conventional options with restricted stock. What has been largely overlooked, however, is that these advantages are not unique to restricted stock awards and can be largely obtained without conferring on managers the large windfalls provided by restricted stock awards.

To begin, supporters of restricted stock awards argue that they are “restricted” and commonly preclude executives from selling them for a long period of time. This feature is supposed to provide executives with incentives to focus on long-term value and avoid short-term gaming that is

---

<sup>132</sup> Restricted stock may well create another problem because of the zero exercise price. While many of the shareholders are diversified, managers are likely to have a significant fraction of their wealth tied up in the equity instruments they get as compensation. If managers have large holdings of stock, they may tend to be more conservative than would be in the interests of their diversified shareholders. Because options with a positive exercise price make managers focus more on the upside, they tend to counteract executives’ tendency to be too conservative.

encouraged by executives' broad freedom to unload their options. But this feature is hardly unique to restricted stock. Any conventional option plan could be structured to include similar restrictions on managers' ability to exercise options or to sell the stock received from exercising them.

It is important to distinguish between two dimensions of equity-based compensation. One dimension is their holding period – how long must the executive wait before cashing out the equity by, for example, exercising options and selling the acquired shares. The longer the holding period, the greater is the executive's incentive to focus on long-term share value. A completely separate dimension is how the executive's payoff from the equity instrument is determined. Tying payoffs to long-term value does not require using options with an exercise price of zero – i.e., restricted stock. It can be done by using long-term options – not necessarily ones with a zero exercise price – that preclude managers from unloading them for a long period even after they have vested.

In addition, supporters of restricted shares view them as attractive because they supposedly provide better incentives than conventional options.<sup>133</sup> When a firm's stock price declines in value due to general market or sector developments, conventional options might become worthless, penalizing executives for a decline that was not due to their underperformance and possibly leaving them with insufficient incentive to create value. In contrast, no matter how steep the decline in nominal stock price, restricted stock will continue to provide executives with some value and incentive going forward.

But this non-fragility advantage of restricted shares comes at a steep price. Consider again the example of a firm whose nominal stock price is now \$100. Suppose that the likelihood of the firm's price falling below \$100 during a specified period is only 20 percent. Lowering the exercise price from \$100 to \$0 – i.e., moving from conventional options to restricted stock – would ensure that the equity compensation retains value and continues to provide incentives even in the event the stock price falls below \$100. But this would come at the price of paying an additional \$100 in the (four times more likely) event that the stock price does not fall below \$100 during the specified period.

---

<sup>133</sup> See Brian Hall and Kevin J. Murphy, "The Trouble with Stock Options," *Journal of Economic Perspective*, 17 (2003): 60.

### *More on Windfalls*

There are other ways to address the fragility problem of conventional options that do not involve such a high cost. However, firms have made no effort to use any of these methods. To illustrate the wastefulness the restricted stock “solution,” compare restricted stock to an option with an exercise price indexed to the performance of the bottom 5 percent of the firm’s industry. This option will not become worthless and will continue to provide incentives as long as the firm’s performance does not fall below this rather low benchmark. However, it generates much smaller windfalls than restricted stock.

In sum, unlike many observers we do not applaud the move to restricted shares. Rather we see it as fitting a consistent pattern -- that of equity-based compensation being designed in ways that provide pay without performance to managers at the expense of shareholders.

## CHAPTER 14: FREEDOM TO UNWIND EQUITY INCENTIVES

“[F]or every 1000 new options awarded, an executive sells 684 shares of stock.”

-- Eli Ofek and David Yermack, *Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership.*”

In this chapter, we discuss another key reason that existing equity-based compensation arrangements have failed to produce cost-effective incentives. Firms have taken surprisingly few steps to prevent or regulate the unwinding of the incentives created by option and restricted stock grants. Managers thus enjoy broad freedom to unload their options and shares, and when they do, either their incentives are weakened or their pay is increased as firms try to restore incentives by providing additional options or shares. Thus, shareholders either get weaker incentives for a given level of compensation, or must pay more for a given level of incentives. Furthermore, managers’ freedom to unload options and shares also provides them with perverse incentives to produce transient, short-term stock price increases.

### **Benefits of Restricting Early Unwinding**

Options and restricted shares are awarded to provide executives with stronger incentives to generate shareholder value. Because executives are risk-averse, they would prefer to receive the expected value of these incentive instruments in cash. Indeed, they might prefer a smaller amount of risk-free cash to risky incentive compensation that has a higher expected value. For this reason, once the options and restricted shares vest, executives often wish to convert them into cash. Such unwinding, however, eliminates the incentive benefits that come when the executive holds these instruments. An efficient contract would strike a balance between maintaining these incentives and satisfying managers’ legitimate liquidity and diversification needs.

The rationale for limiting executives’ freedom to unwind vested incentives is wholly separate from the rationale for vesting periods themselves. The purpose of a vesting period is to prevent an executive who

## *Unwinding Equity Incentives*

has just been granted options from immediately resigning and walking away with the options (or underlying shares). Once the incentives vest, the executive has “earned” them; they can no longer be taken away.

However, the fact that the options belong to the executive upon vesting does not necessarily imply that he or she should be permitted to immediately exercise the options and sell the acquired shares. An efficient option design may well involve paying the executive with options that cannot be exercised for a specified period even after they vest: options, for example, that vest in three years but can be cashed out only after two additional years have passed. If the executive continues to work for the company after the vesting date, the options (or, if exercised, the underlying shares) would provide beneficial incentives during that period.

Compare this restricted-unwinding arrangement to a situation where such options can be exercised, and the underlying shares sold, immediately upon vesting. Suppose the executive does in fact exercise the options and sell the underlying shares at once. In this situation, shareholders must either (a) provide the executive with new options – and bear substantial additional cost – to maintain the same amount of incentives; or (b) bear the costs associated with an executive who has weaker performance incentives during the two years following the vesting date than he or she would have had under the restricted-unwinding arrangement.

To illustrate, suppose the CEO of ABC Corporation is expected to serve for six years, and it is deemed desirable for incentive reasons that she own 10 million shares of ABC stock throughout her tenure. Suppose the CEO is granted 10 million shares and is permitted to sell them after 3 years. If she sells the shares, the firm will have to grant her another 10 million shares to hold for the next three years. Thus, during the 6-year period, the firm will have to grant the CEO an aggregate of 20 million shares to maintain the desired level of incentives associated with holding 10 million shares.

In contrast, if the CEO is precluded from selling granted shares, the firm will be able to maintain the desired level of incentives throughout her tenure by granting only 10 million shares at the start of the six-year period. To be sure, the CEO will require her reservation value—the amount that is necessary to retain her -- in each of these periods. But as long as the CEO’s reservation value is less than 20 million shares for the six-year period, a



contract that limits unwinding of shares will provide the desired level of incentives at a lower cost.

Indeed, an arrangement barring the sale of shares until the sixth year may well have an advantage over an unrestricted unwinding arrangement, even in cases where the executive resigns after three years. The options, of course, will have no incentive effects in the last three years of the six-year period, when the CEO no longer works for the firm. However, to the extent that the executive's actions during the *first* three years of the period are fully reflected in the stock price only after the six years have passed, she has an incentive during the first three years to generate long-term value for shareholders.<sup>134</sup>

To be sure, restrictions on executives' ability to cash out vested incentive instruments impose liquidity and diversification costs. These costs must be balanced against the incentive benefits of restricting the unwinding of these instruments. For this reason, we do not claim that such restrictions are desirable in all cases. Nor do we suggest that there is a single efficient time period for such restrictions. The efficient length is likely to vary from case to case, depending on, among other things, the expected length of the executive's tenure at the firm and his or her personal diversification and consumption needs. What is clear, however, is that there is no reason to assume that an efficient contract would allow an executive to unwind options and restricted stock as soon as they vest.

### **Managers' Widespread Freedom to Unwind Early**

Firms generally have not prevented executives from unwinding options and restricted shares once they vest. Thus it is not surprising that executives exercise many of their options well before expiration.<sup>135</sup>

A recent study that examined ten-year options granted to the executives of forty large companies determined that the options were

---

<sup>134</sup> The argument in this paragraph is more fully developed in Oren Bar-Gill and Lucian Bebchuk, "The Costs of Permitting Managers to Sell Shares," working paper, Harvard Law School, 2003.

<sup>135</sup> David M. Schizer, "Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility," *Columbia Law Review* 100 (2000): 468-472.

exercised after an average of 5.8 years.<sup>136</sup> Once they exercise options, executives sell, on average, more than 90 percent of the acquired shares.<sup>137</sup> The relatively few remaining shares often are fully or partially hedged in transactions that do not generate taxable income and are not always reported to the SEC.<sup>138</sup> For example, executives often utilize collars and equity swaps to lock in gains on their shareholdings following a stock price increase.<sup>139</sup> This, of course, reduces their incentive to boost the price further.

In addition to granting executives broad freedom to unwind vested options and shares, firms fail to restrict the use of financial instruments that can weaken or eliminate entirely the incentive effects of unvested options and restricted shares. Executives are generally allowed to hedge away their equity exposure before these instruments vest.<sup>140</sup> Indeed, boards do not even request restrictions on hedging.<sup>141</sup> At the moment, several serendipitous features of the federal income tax code may well reduce the attractiveness of hedging unvested options and (to a lesser extent) restricted stock through

---

<sup>136</sup> Jennifer N. Carpenter, "The Exercise and Valuation of Executive Stock Options," *Journal of Financial Economics* 48 (1998): 139.

<sup>137</sup> Paul L. Gilles, "Alternatives for Stock Options," *HR Magazine*, January 1999, pp. 40-48; Steven Huddart, "Employee Stock Options," *Journal of Accounting and Economics* 18 (1994): 207-231; Eli Ofek and David Yermack, "Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership," *Journal of Finance* 55 (2000): 1376-1377.

<sup>138</sup> Ellen E. Schultz and Theo Francis, "Fair Shares?: Why Company Stock Is a Burden for Many and Less So for a Few," *Wall Street Journal*, 27 November 2001, p. A1; Greg Ip, "Collars Give Insiders Way to Cut Risk," *Wall Street Journal*, 17 September 1997, pp. C1, C3; Stuart Weinberg, "Insiders Hedge With Zero-Cost Collars," *Wall Street Journal*, 7 August 2002, p. B5; Randall Smith and Jesse Eisinger, "The Insiders' Magic Way to Sell," *The Wall Street Journal*, 19 March 2004, p.C1.

<sup>139</sup> J. Carr Bettis, John M. Bizjak, and Michael L. Lemmon, "Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders," *Journal of Financial and Quantitative Analysis* 36 (2001): 345-370.

<sup>140</sup> A study of 375 CEO employment contracts collected by The Corporate Library by Stewart Schwab and Randall Thomas found that none restricted the CEO from hedging his or her unvested stock options. See Schwab, Stewart J. and Randall S. Thomas, "What do CEOs Bargain For?: An Empirical Study of Key Legal Components of CEO Contracts" (working paper, Cornell Law School and Vanderbilt Law School, 2004), p.5.

<sup>141</sup> *Ibid.* p. 13.

the derivatives market.<sup>142</sup> But even modest changes in tax rules could eliminate this desirable disincentive. In any event, there is little reason not to include contractual prohibitions on unwinding.

Firms frequently grant additional options to better align managers' interests with those of shareholders. It would likely be efficient – at least sometimes -- to prohibit managers from offsetting these incentives by selling shares they already hold, yet firms rarely do so. As a result, when firms grant options, executives often sell stock they already hold. A study by economists Eli Ofek and David Yermack found that, on average, managers sold approximately 680 already-owned shares for every thousand new options granted and sold 940 already-owned shares for every thousand new restricted shares granted.<sup>143</sup> These sales almost completely undid whatever beneficial incentive effect the equity grant had.

A number of firms have created “target ownership plans” that either encourage or require managers to hold a certain amount of shares – usually expressed as a multiple of the executive’s salary.<sup>144</sup> But the targets tend to be low. In an examination of 195 firms adopting such plans between 1991 and 1995, economists John Core and David Larcker found that only 138 disclosed the ownership target. Among these 138, the minimum level of ownership for the median CEO was four times base salary. Although this target may seem to mandate substantial stock ownership, it does not. An executive’s base salary is commonly dwarfed by other elements of the compensation package, such as the bonus and equity compensation. As a result, the target ownership amount may be less than one year’s compensation. Furthermore, only 23 percent of the 195 firms imposed a penalty for not meeting the target. In many cases, the targets themselves are purely voluntary.

To illustrate the general weakness of these ownership requirements, let us consider a firm that appears to have a substantial ownership target for its CEO. American Express requires its top executives to meet share ownership targets that are a multiple of their base salary. The targets range

---

<sup>142</sup> David M. Schizer, “Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility,” *Columbia Law Review* 100 (2000): 442-443.

<sup>143</sup> Eli Ofek and David Yermack, “Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership,” *Journal of Finance* 55 (2000): 1376.

<sup>144</sup> John E. Core and David Larcker, “Performance Consequences of Mandatory Increases in Executive Stock Ownership,” *Journal of Financial Economics* 64 (2002).

## *Unwinding Equity Incentives*

from three times base salary for lower ranking executives to twenty times base for the CEO. The base salary of Harvey Golub, the American Express CEO who retired in 2000, was approximately \$1 million in each of the years 1998, 1999, and 2000.<sup>145</sup> Thus, American Express's ownership guidelines required him to hold approximately \$20 million worth of shares, a seemingly substantial amount. However, Golub's base salary was only 4 percent of his total compensation of approximately \$25 million in 2000. More importantly, he received more than \$130 million in compensation during the period 1993-2000.<sup>146</sup> Thus Golub was required to hold equity worth less than 16 percent of the total compensation he had received during the previous eight years.

American Express, like many other firms, allows executives to count towards their "target" some of the value of unvested options and restricted stock. The company's executives may count 50 percent of unrealized stock option gain and 50 percent of the market value of restricted shares toward their targets.<sup>147</sup> Because executives cannot sell unvested options and restricted shares anyway, in many cases the target ownership requirements impose little additional constraint on managers' ability to unwind their equity incentives.

Given managers' consumption and diversification needs, an efficient contract might permit some unwinding before they leave the firm. Still, the arm's length contracting approach cannot easily explain the almost universal absence of restrictions on the unwinding of vested options and shares, on the hedging of unvested options and restricted shares, and on the sale of existing shares when new options are granted.

On the other hand, the absence of such restrictions can be explained readily under the managerial power approach. Broad freedom to unwind incentives by unloading options and shares early provides managers with inconspicuous diversification benefits; the costs imposed on shareholders by diluted incentives are correspondingly hard to spot. Furthermore, managers' unwinding provides a convenient justification for granting new options and

---

<sup>145</sup> American Express proxy filing, 2001.

<sup>146</sup> Execucomp Database.

<sup>147</sup> American Express proxy statement filed with Securities and Exchange Commission, March 10, 2000, p. 27, as reported in Steven Balsam, *An Introduction to Executive Compensation* (San Diego: Academic Press, 2002), 211.

restricted stock to restore incentives. Although the need to continually replenish managerial options and restricted shares considerably raises the costs to shareholders, it also clearly increases the benefits to managers.

### **Managers' Freedom to Time Their Sales**

Even if an efficient contract permitted managers to cash out a certain amount of their options and shares at a specified stage of their contract, it does not follow that it would grant control over the exact time of the unloading. Compensation contracts, however, often provide managers with broad freedom to do just that. When managers can control the timing of trades, they can use inside information to make additional gains. For example, they can sell early if they know the price is too high and is likely to fall.

Under U.S. securities laws, it is illegal for executives to trade on "material" inside information. However, these laws do not prevent managers from using private information to make significant profits when trading in their firm's shares.<sup>148</sup> Managers are able to put together many kinds of inside information. Even when no single piece of data is sufficiently concrete and important to be legally "material," knowing all this information and how it fits together often enables managers to form a better overall understanding of the firm's situation.

In addition, the Securities and Exchange Commission (SEC), the agency responsible for enforcing insider-trading laws, has a relatively small enforcement budget. The agency can afford to pursue only those cases that are easily won - cases usually involving abnormally heavy trading by executives several days before an important news announcement. As a result, many executives can use even their "material" inside information without much fear of detection. This explains the body of evidence indicating that managers are able to make considerable abnormal profits - that is, higher than market returns - when trading in company stock.<sup>149</sup>

---

<sup>148</sup> For a full discussion of this issue, see Jesse M. Fried, "Reducing the Profitability of Corporate Insider Trading through Pretrading Disclosure," *Southern California Law Review* 71 (1998): 334-348, 364.

<sup>149</sup> Jesse M. Fried, "Reducing the Profitability of Corporate Insider Trading through Pretrading Disclosure," *Southern California Law Review* 71 (1998): 322-323; H. Nejat Seyhun, *Investment Intelligence from Insider Trading* (Cambridge, Mass.: MIT Press,

The magnitude of managers' insider trading profits is largely a function of their informational advantage, not a function of their own performance. Permitting managers to make such gains is unlikely to be an efficient way to reward them for performance. Of course, an arm's length contract might allow an executive to sell a certain number of shares in a given year for liquidity or diversification reasons—but that does not mean the executive should choose the exact timing of the sale. After all, most liquidity and diversification needs can be anticipated and planned for. One could adopt a variety of restrictions on the timing of sales without hindering an executive's ability to satisfy legitimate liquidity and diversification needs.

One approach would require that stock sales be carried out gradually, over a specified period, perhaps pursuant to a prearranged plan. Alternatively, as one of us has proposed, executives could be required to disclose their intended trades publicly and in advance.<sup>150</sup> Under such a pretrading disclosure requirement, the announcement of an unusually large sale would signal the possibility that the executive knows bad news about the firm. This would drive the price down, reducing executives' ability to make a profit by trading on inside information.

Firms, however, impose few such restrictions on executives' ability to time the unwinding of their incentives, although some have adopted "trading windows" and "blackout periods" to restrict the times when a manager can sell or buy shares. Many companies, for example, permit managers to trade only during the two- or three-week period after quarterly earnings have been released. These restrictions are designed to reduce the possibility that a firm will be held liable for an employee's insider trading violation.<sup>151</sup> They stem not from a desire to improve pay arrangements but

---

1998). Managers can also boost their insider trading profits by using share repurchases to buy the public's shares indirectly at a low price. See Jesse M. Fried, "Insider Signaling and Insider Trading with Repurchase Tender Offers," *University of Chicago Law Review* 67 (2000): 421-477; Jesse M. Fried, "Open Market Repurchases: Signaling or Managerial Opportunism," *Theoretical Inquiries in Law* 2 (2001): 865-894.

<sup>150</sup> For a survey of the evidence, see Jesse M. Fried, "Reducing the Profitability of Corporate Insider Trading through Pretrading Disclosure," *Southern California Law Review* 71 (1998): 303-392. In the latter half of the 1980s, insiders were able to use inside information to make about \$5 billion in extra trading profits.

<sup>151</sup> J. Carr Bettis, Jeffrey L. Coles, and Michael L. Lemmon, "Corporate Policies Restricting Trading by Insiders," *Journal of Financial Economics* 57 (2000): 192.

rather from the adoption of tough laws in the 1980s that made firms liable if they had not taken reasonable steps to prevent illegal insider trading by their employees.<sup>152</sup> Moreover, these trading windows and blackout periods do not prevent managers from trading profitably on their inside information.<sup>153</sup> Executives subject to these restrictions are still frequently able to sell their shares before dramatic stock price declines, thereby avoiding major losses.<sup>154</sup>

We know of only one firm, Ameritrade, that has ever imposed additional restrictions on executive trading – and it did so only briefly.<sup>155</sup> In early February 1999, ten Ameritrade insiders and one relative of an insider sold tens of thousands of shares just as the price hit a peak, and right before the stock price plummeted. At the time, Section 16(a) of the Securities Exchange Act of 1934 required that executives disclose their trades by the tenth day of the month following the trade. When the Ameritrade insiders' sales were revealed in early March, shareholders were outraged. To mollify them, Ameritrade announced several days later that, in the future, it would require insiders to announce in advance any plans to sell shares. Executives would even have to announce the number of shares they planned to sell. Ameritrade's chairman of the board explained, "I feel that instituting a policy which ensures [that shareholders] know in advance when insiders intend to sell stock is simply the right thing to do." After some time had

---

<sup>152</sup> Jesse M. Fried, "Reducing the Profitability of Corporate Insider Trading through Pretrading Disclosure," *Southern California Law Review* 71 (1998): 345.

<sup>153</sup> See Kumar Sivakumar and Gregory Waymire, "Insider Trading Following Material News Events: Evidence from Earnings," *Financial Management* 23 (spring 1994): 23-32.

<sup>154</sup> For example, an executive of Micro Warehouse Inc., which permits executives to trade only during a nine-day period that begins five days after each quarterly earnings announcement, sold \$2.4 million of stock in late April/early May, a month before an announcement about disappointing second quarter earnings drove the share price down by more than 60 percent. See Bridget O'Brian, "Insider Selling of a Stock Headed South May Mean Others Should Also Bail Out," *Wall Street Journal*, 17 July 1996, p. C14. For an explanation of why trading windows do not completely prevent executives from trading on inside information, see Jesse M. Fried, "Reducing the Profitability of Corporate Insider Trading through Pretrading Disclosure," *Southern California Law Review* 71 (1998): 346.

<sup>155</sup> Randall Smith and Danielle Sessa, "Ameritrade Says Insiders' Sales Must Now Be Announced First," *Deseret News*, 17 March 1999.

passed, however, Ameritrade quietly cancelled the policy. There does not appear to be a single case in which any advance notice of insider selling was given.

As noted above, the lack of restrictions on managers' timing of sales means managers can profit from their access to inside information. Recent years have provided dramatic examples. Examining the 25 largest public firms that went bankrupt between January 2001 and August 2002, the *Financial Times* found that executives of these firms sold almost \$3 billion of stock between 1999 and 2001 as the market value of the firms dropped from \$210 billion to zero.<sup>156</sup> For example, Gary Winnick, the CEO of Global Crossing, sold more than \$700 million worth of shares in the year before the firm filed for bankruptcy, at the same time the company was allegedly inflating sales revenues.<sup>157</sup>

There are also examples of considerable selling before dramatic stock price declines in firms that did not end up filing for bankruptcy. A study published by *Fortune* in September 2002 examined trading by executives in the shares of publicly held firms which had reached a market capitalization of at least \$400 million and whose shares had subsequently fallen at least 75 percent.<sup>158</sup> The firms were ranked by the amount of executive sales. At the top 25 firms, 466 executives collectively sold \$23 billion before their stocks plummeted. At the top of the list was Qwest Communications. Qwest insiders sold more than \$2 billion while they were overstating revenues. Shortly thereafter Qwest stock fell more than 95 percent. Other examples are almost as dramatic. JDS Uniphase insiders and controlling shareholders sold almost \$2 billion worth of stock as the price plummeted. AOL/Time Warner insiders sold \$1.5 billion in shares before the stock price dropped more than 80 percent.<sup>159</sup>

Studies suggest that this pattern is systematic and long-standing. One recent study found that executives of small publicly traded companies

---

<sup>156</sup> Andrew Hill, "Inside Track," *Financial Times* (London), 2 August 2002, p. 10.

<sup>157</sup> Henny Sender and Rebecca Blumenstein, "Questing the Books: Global Crossing Creditors Review Sales, Swaps," *Wall Street Journal*, 25 February 2002, p. A6.

<sup>158</sup> Mark Gimein, "You Bought, They Sold," *Fortune*, 2 September 2002, pp. 64-65.

<sup>159</sup> William S. Lerach, "Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders," *Stanford Journal of Law, Business and Finance* 8 (2002): 103.



exercise their options and sell the underlying stock shortly before the price of the stock underperforms the market.<sup>160</sup> Another study reported that insiders sell heavily before earnings declines.<sup>161</sup> Yet another study concluded that insiders manage earnings to delay the onset of bond default and sell their own shares at higher prices.<sup>162</sup>

Although the broad freedom to make such profits is difficult to explain from an efficient contracting perspective, it is easily explained under the managerial power approach. These insider trading profits, which ultimately come at the expense of public shareholders, provide extra value to executives in a form likely to go unnoticed by shareholders because the costs do not show up in any of the firm's publicly disclosed accounting information or in compensation figures. Such profits are generally well camouflaged except in notorious cases where large sales of stock preceded dramatic declines in the stock price. .

Given managers' interest in camouflaging these transactions, it is not surprising that, until the Sarbanes-Oxley Act closed the loophole in 2002, many firms took advantage of a rule that enabled them to delay reporting insider sales for up to a year. Before the reforms took effect, Section 16(a) of the Securities Exchange Act of 1934 generally required executives to disclose their trades to the SEC by the tenth day of the month following the trade. Under that regime, many firms permitted or even facilitated transactions that were economically equivalent to sales but which allowed executives to avoid making the usual post-trade disclosure to the SEC. An example of such a transaction is the use of company stock to repay executive loans. Although using stock in this way is economically equivalent to selling stock to shareholders, these transactions were not covered by Section 16(a) and so did not need to be reported to the SEC by the tenth day of the following

---

<sup>160</sup> See Jennifer N. Carpenter and Barbara Remmers, "Executive Stock Option Exercises and Inside Information," *Journal of Business* 74 (2001): 513-534.

<sup>161</sup> See Bin Ke, Steven Huddart, and Kathy Petroni, "What Insiders Know about Future Earnings and How They Use It: Evidence from Insider Trades." *Journal of Accounting and Economics* 35 (2003).

<sup>162</sup> See Messod Beneish, Eric Press, and Mark E. Vargus, "The Relation between Incentives to Avoid Debt-Covenant Default and Insider Trading," working paper, Indiana University, 2001.

month. Instead, firms were required to disclose these transactions only once a year, within forty-five days of the end of the fiscal year.<sup>163</sup>

The evidence indicates that stock sales back to the firm are followed by greater-than-average negative stock returns in the following one or two years.<sup>164</sup> This evidence is consistent with the hypothesis that managers who sell on particularly bad news would seek to camouflage their sales through such hidden transactions. Tyco was one firm that enabled executives to use the repayment of loans to hide executive stock sales. Dennis Kozlowski, Tyco's chairman, and Mark Swartz, its CFO, sold \$105 million in shares to the company in late 2000 and 2001, before Tyco's accounting irregularities were revealed and the stock price plummeted. These sales to the company took place even as Kozlowski was publicly announcing that he rarely sold his shares.<sup>165</sup>

Looking ahead, the 2002 Sarbanes-Oxley Act's stricter insider trading disclosure rules will reduce firms' ability to let managers profit from trading on private information. Sarbanes-Oxley requires executives to report a trade to the SEC by the end of the second business day following the transaction.<sup>166</sup> When executives know bad news is likely to emerge, they frequently sell large blocks of shares over a period of time rather than in a day or two.

Requiring executives to make disclosures to the SEC by the end of the second business day following their trades will alert the market to the possibility that managers are selling because of the prospect of bad news within several days of the trade. If the trades are suspiciously large or otherwise unusual, the market will likely intensify its scrutiny of the firm and bid the stock price lower. This stock price adjustment, in turn, will reduce managers' profits from any subsequent sales.

---

<sup>163</sup> David Leonhardt, "It's Called a 'Loan', But It's Far Sweeter," *New York Times*, 3 February 2002, sec. 3, p. 11; David Leonhardt, "Executives Beyond Enron Took Months to Report Sales," *New York Times*, 11 February 2002, p. C1.

<sup>164</sup> Shijun Cheng, Venky Nagar, and Madhav V. Rajan, "Do Delayed Insider Disclosures Convey Information about Future Earnings?," working paper, University of Michigan Business School, 2002.

<sup>165</sup> Alex Berenson, "2 Tyco Officials Sold Stock by Returning It to Company" *New York Times*, 30 January 2002, p. C1. The SEC now requires near-contemporaneous disclosure of such sales.

<sup>166</sup> Sarbanes-Oxley Act, sec. 403(a).

The amount of camouflaged compensation under consideration is thus likely to decrease in the future. However, the fact that firms have provided such income in the past is important for understanding the forces that shape executive compensation. Firms could easily have imposed a requirement that managers promptly disclose trades or announce their intended trades in advance. This would have reduced even more sharply executives' ability to make hidden insider trading profits. It is telling that firms generally chose not to require such enhanced transparency. In fact, many took active steps to delay the disclosure of insider trades as much as possible.

### **Perverse Incentives**

We have thus far discussed how the broad freedom to unload options and shares has provided executives with personal gains while failing to strengthen their incentives to benefit shareholders. In fact, such freedom has created perverse incentives.<sup>167</sup>

Executives who are free to unload shares or options may have adverse incentives to raise short-term stock prices by running the firm in a way that improves short-term results at the expense of long-term value. They may also seek to provide the market with an overly positive picture of short-term results and long-term prospects. Finally, they also may have incentives to choose projects that are less transparent, or to reduce the transparency of existing projects, because lack of transparency enables them to profit more from their freedom to unload their holdings in the short run.

A growing body of empirical work supports the view that managers' freedom to unload options and shares has provided them with adverse incentives. Several studies find evidence that managers whose compensation is more directly tied to share prices are more likely to manipulate earnings.<sup>168</sup> In fact, one of the studies also finds that managers with stock

---

<sup>167</sup> A formal model of these perverse incentives is developed in Oren Bar-Gill and Lucian Bebchuk, "The Costs of Permitting Managers to Sell Shares," Working Paper, Harvard Law School (2003).

<sup>168</sup> Daniel Bergstresser and Thomas Philippon, "CEO Incentives and Earnings Management: Evidence from the 1990s," Working paper, Harvard Business School (2002); Messod D. Beneish, "Incentives and Penalties Related to Earnings Overstatements that Violate GAAP," *The Accounting Review* 74 (1999): 425-457.

and exercisable stock options tend to engage in earnings manipulation, but finds no evidence that managers with large amounts of unexercisable stock tend to do so.<sup>169</sup> This pattern indicates to us that it is not the mere holding of options and shares – but rather the freedom to unload them in the short run – that produces incentives to engage in misreporting.

The empirical evidence ties the freedom to unload equity-based compensation to restatements of financial statements and to fraudulent statements. Messod Beneish found that managers of firms whose earnings were overstated sold at a high rate before the overstatement was corrected.<sup>170</sup> Scott Summers and John Sweeney found that firms that fraudulently misstate their earnings have a higher level of selling activity – measured by number of transactions, number of shares sold, or the dollar amount of shares sold.<sup>171</sup> Shane Johnson, Harley Ryan, and Yisong Tian found that executives at firms that committed fraud exercised significantly larger fractions of their vested options than other executives.<sup>172</sup>

Finally, there is evidence that executives' freedom to unload holdings have provided incentives to improve financial results in ways that reduce shareholder value. Merle Erickson, Michelle Hanlon, and Edward Maydew found that firms that restated their financial statements under following SEC allegations of accounting fraud during the years 1996-2002 collectively paid an extra \$320 million in taxes—but only after they had overstated their

---

<sup>169</sup> Bin Ke, "The Influence of Equity Compensation on CEOs' Incentives Manage Earnings," Working paper, Pennsylvania State University (2002).

<sup>170</sup> Messod D. Beneish, "Incentives and Penalties Related to Earnings Overstatements that Violate GAAP," *The Accounting Review* 74 (1999): 425-457. Another study found that top managers of firms that experienced accounting regularities and were subsequently subject to SEC enforcement actions had exercised their options in the preceding period at a higher rate than top managers of other firms. Simi Kedia, "Do Executive Stock Options Generate Incentives for Earnings Management? Evidence from Accounting Restatements," Working paper, Harvard Business School (2003).

<sup>171</sup> Scott L. Summers and John T. Sweeney, "Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis," *The Accounting Review* 73 (1998): 131-146.

<sup>172</sup> Shane A. Johnson, Harley E. Ryan, and Yisong S. Tian, "Executive Compensation and Corporate Fraud," Working paper, Louisiana State University and York University (2003).

## *Unwinding Equity Incentives*

earnings by \$3.36 billion, which in turn allowed managers to sell their shares at a higher price.<sup>173</sup>

---

<sup>173</sup> Merle Erickson, Michelle Hanlon, and Edward Maydew, "How much will firms pay for earnings that do not exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings," *The Accounting Review*, forthcoming 2004.