COMMENTARY

By Jennifer Reingold

AN OPTIONS PLAN YOUR CEO HATES

In 1998, Black & Decker Corp. CEO Nolan D. Archibald took home $36.6 million, $31.9 million of which came from the exercise of 1 million stock options he had been granted over the past nine years. The payout, while not quite massive enough to make BUSINESS WEEK's list of the top 20 best-paid executives for that year, was nothing to sneeze at. So what did Archibald do to deserve such a huge haul? Nothing earth-shaking. From the time of Archibald's two grants to the time he exercised them, Black & Decker's total shareholder return trailed that of the Standard & Poor's 500-stock index, rising at a 15% average annualized rate, compared with 19% for the S&P. If Archibald had been forced to beat the market in order to cash in, his options would have been worth zilch.

In today's options-obsessed corporate climate, it doesn't take much for executives to rake in the millions. With seven-figure grants now commonplace, big bucks go to anyone who can get his stock to inch above the exercise price. Indeed, Alfred Rappaport, professor emeritus at Northwestern University's Kellogg Graduate School of Management, points out that total return to shareholders was positive for each of the 100 largest U.S. companies between 1987 and 1997.

NO COASTING. Many cynical pay watchers say that's just the way it is. If executives are taking home boatloads of cash simply because of a rising market and because boards are willing to dole out options by the bucketful, well, so be it. But that complacency could change if the market's gains continue to narrow. As of Feb. 15, 74 of the 88 industry groups in the S&P 500 had negative returns for 2000. As a new round of shocking pay stories from this proxy season hits the presses, outrage could climb.

If that happens, it may focus attention on a controversial alternative to the standard options package. By using indexed stock options, which have no value unless the company's stock outperforms a peer group or a market index, companies can still ensure huge paydays for the true executive superheros. Unlike the current system, however, indexed options also make sure that executives who are just floating their yachts on a rising tide get little to show for it. "Indexed options hold the executive to a higher standard," says Robin A. Ferracone, chairman of pay consultant SCA Consulting, which performed an analysis for BUSINESS WEEK correlating the pay of several executives with their company's total return and that of the S&P 500. Had SCA used a peer group index, Archibald and the other executives might have fared somewhat differently.

Indexed stock options put an element of risk into the reward—and few companies have tried them yet

Despite the support of such heavyweights as Federal Reserve Chairman Alan Greenspan and a growing clamor from a few institutional investors, indexed stock options remain very unpopular. Executives hate them because they inject more risk into the current windfall setup. Employers shun them because unlike traditional options, they require companies to take an accounting charge against earnings. Only one major company, Level 3 Communications Inc., a Broomfield (Colo.)-based telecommunications-infrastructure outfit, currently uses them. "Most executives like it the way it is," says Ira M. Millstein, senior partner at law firm Weil, Gotshal & Manges and a governance expert. "Maybe when the market goes the other way, this will catch on."

How, exactly, do indexed options work? Simply put, they reward relative rather than absolute performance. Unlike premium-priced options, a more popular technique in which options are set at a higher level than the current price, indexed options have no value unless the underlying stock does better than a preset index. In a rising market, the bar is a high one. But in a declining market, an executive at a company with a falling stock price can still cash in, as long as the decline is less steep than that of his peers.

The difference in payout under the two types of options can be dramatic. Take the case of a hypothetical 1,000-share option grant at $10 per share that's tied to the performance of the S&P 500. If the company's stock rose by 20%, to $12, while the market rose 40%, the options would have no immediate value, since the company had underperformed. With a standard, "plain-vanilla" option, that grant would have paid $2,000. But if the overall market fell 30% while the stock dropped just 10%, to $9, that indexed grant would be worth $2,000—the difference between the index and the company performance. If the stock rose in a declining market, the payout would be yet higher.

FEW SUPPORTERS. One drawback of indexed options is that they don't pay as much as standard options when managers do outperform. If the company stock rose to $23 while the index rose to just $15, the options would be worth $8,000—compared to $13,000 with the plain-vanilla options. To make up for that shortfall, the number of indexed options granted would have to be roughly doubled, says Russell H. Miller, partner at SCA. With "grossed-up" options, that top performer would have earned $16,000 instead of $8,000.

Discussing mere thousands, however, has little real-world relevance these days. That's why BUSINESS WEEK worked with SCA to show how indexed options would affect the pay of the top dogs. Using data from BUSINESS WEEK's 1999 report on executive compensation (Apr. 19, 1999) and SEC filings, SCA analyzed the pay of a group of highly paid CEOs from the BUSINESS WEEK report. It measured how they would have done had they been required to beat the S&P 500 over the period from when their option packages were granted until they were exercised. SCA also ran a model demonstrating what "grossed-up" indexed options would have been worth.

The results show what true pay for performance should look like (table). Black & Decker's Archibald would have had to rely on the rest of his pay package (a measly $4.5 million) with options indexed to the S&P, although he might have done better had the analysis measured his performance against a peer group. America Online Inc.'s Stephen M. Case should love the idea: He would have earned $176.5 million, up from $158.1 million, with grossed-up indexed options, since his stock crushed the S&P, rising 112% to the index's 23% over the grant period. "For an aggressive performer," says Ferracone, indexed options "could be very attractive."

Then there's Walt Disney Co.'s Michael D. Eisner, who collected $569.8 million in fiscal 1998 from exercising a breathtaking 22 million shares granted over 9 years. Had those options been indexed, he would have earned "just" $257.5 million, an amount that still would have broken all pay records at the time. With grossed-up indexed option grants, he would have made $502.1 million, a

INDEXED OPTIONS BOOST PAY FOR TOP PERFORMERS AND PUNISH THE LAGGARDS

CEO/COMPANY	1998 PAY* (MILLIONS) ACTUAL OPTIONS PAY	WITH INDEXED OPTIONS	WITH INDEXED OPTIONS BASED ON A LARGER GRANT†	TOTAL RETURN‡	TOTAL RETURN S&P 500‡
1 EISNER/DISNEY	$569.8	$257.5	$502.1	22%	18%
2 KARMAZIN/CBS	195.9	195.8	332.9	53%	19%
3 CASE/AOL	158.1	153.5	176.5	112%	23%
4 WEILL/CITIGROUP	156.6	73.3	113.6	57%	32%
5 SILVERMAN/CENDANT	61.1	57.6	72.0	56%	17%
6 WELCH/GE	46.5	23.6	69.6	31%	21%
7 WHITMAN/EBAY	42.7	42.7	44.8	NA**	NA
8 KOZLOWSKI/TYCO	41.4	27.0	66.1	87%	30%
9 BONSIGNORE/HONEYWELL	3.6	0.6	1.3	25%	23%
10 ARCHIBALD/BLACK & DECKER	31.9	0.0	0.0	15%	19%
11 WARNER/J.P. MORGAN	5.1	0.0	0.0	22%	22%

*Compensation from option exercises only, not salary, bonus, other long-term pay. **eBay went public in September 1998 †Accounts for volatility and dividend yield. ‡From date of grant to date of exercise. Pre-IPO performance not included. S&P returns correlated to company's fiscal year.

DATA: SCA CONSULTING, BUSINESS WEEK 49TH ANNUAL EXECUTIVE PAY SCOREBOARD

decrease from his actual haul, in part because he just barely outperformed the S&P—22% to 18% over the period. Overall, SCA says that 80% of the 20 best-paid CEOs in 1998 would have done better with grossed-up indexed options.

Although indexed options provide all the right incentives, they have few supporters in the mainstream corporate world, in part because they might expose some poor performers but also because they have a slew of their own problems. Start with the strangest one, an accounting anomaly that requires the value of indexed options to be calculated on a quarterly basis and charged to earnings. The Financial Accounting Standards Board (FASB) allows traditional options to avoid any charge to earnings—a free ride that has contributed mightily to the popularity of options over cash. Why the difference? Because the exercise price of indexed options fluctuates depending on the value of the index it's tied to. The FASB has ruled that indexed options must be charged to earnings every quarter so that investors can see the current option-related liabilities. Level 3 Communications' 1999 income statement reflects $111 million in expenses from its Outperform Stock Option Plan. Level 3 is currently in a quiet period and wouldn't comment on the plan.

So far, Level 3 has few imitators, even though its stock has soared 212% since it started handing out indexed options in April, 1998. The accounting charge is the biggest reason indexed options haven't caught on, though proponents argue that analysts could easily see through the charges, just as they've come to accept other oddities in a company's financials. "I think Wall Street would accept that those accounting charges were just paper charges," says Barry Bingham, director of executive compensation at Monsanto Co. Still, while Bingham finds indexed options "intriguing," Monsanto has so far experimented instead with premium priced option plans, where options are set above the current stock price but don't require relative outperformance—and carry no accounting charges.

> **If the market takes a definite turn for the worse, look for indexed options to gain favor**

Dilution, or the reduction in value per share from the issuance of more shares, is another drawback. Already, the flood of traditional stock options has created a disturbing level of dilution. According to pay consultant Pearl Meyer & Partners Inc., the number of shares available for compensation programs as a percentage of shares outstanding was 13.7% in 1998 and rising. That would climb even higher with indexed options if they required bigger grants. Experts say it would be hard to get around the problem simply by rejiggering the exercise price to increase the payout for spectacular performance. That could run the risk of turning the incentive into a simple cash bonus instead of an option.

While there's hardly a groundswell of support for indexed options yet, there is a buzz around the issue that is sure to intensify if the market continues to narrow. Last year, shareholder resolutions calling for indexed or performance-based options were filed at four companies, including Chubb, a longtime stock laggard, Gannett, and J.C. Penney. Sponsored by pension funds, including those of the AFL-CIO and the Communications Workers of America, the resolutions gained the support of proxy adviser Institutional Shareholder Services. "What we want to see is that they're grading themselves against a curve," says Patrick S. McGurn, director of corporate programs at Institutional Shareholder Services. The Chubb proposal received 33% of the vote, "a huge number for a first-time proposal," says McGurn. Now the AFL-CIO and two New York City pension funds may soon put forth similar proposals at other companies.

Still, it may take a falling market for indexed options to catch on. "What's going to trigger the interest here is when a very broad cross section of companies starts to see either declining stock prices or flat stock prices," says Rappaport. If the market falls, traditional options will have no value at all. Companies will either have to return to cash-based pay or try wooing execs with indexed options, which could still pay off if the underlying stock falls less than the market. In fact, falling stocks could be just the thing to get widespread agreement from executives that the market's overall trends don't always reflect their company's performance. Until that point, the pay wagons are sure to keep on rolling for executives, regardless of how well they do.

Reingold covers management and executive pay for BUSINESS WEEK.

OPTIONS WITH A STING

Heavyweights such as Fed Chairman Alan Greenspan support indexed options, but most companies and executives don't. The debate:

PROS

- The big money goes only to those who outperform their peers or a stock index.
- In a down market, executives can reap gains even if their company's stock falls, as long as the losses are less than those in its benchmark.
- Poor-performing executives will feel financial pressure to improve their results—or leave.

CONS

- Accounting rules require companies using indexed options to take a hit to earnings. Standard options don't require charges.
- For executives to accept the greater risk of indexed options, companies may have to give out bigger grants, which means greater dilution.
- Companies say it will hurt their ability to attract talent.