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A New Equity Device

The recent market crash exposed the flaws in stock options as an effective equity incentive and reward vehicle for key employees for most public companies.

Frederic W. Cook and Kathryn L. Neel
FREDERIC W. COOK & CO. INC.

Do stock options have a future? Among high-growth companies, including pre-IPO and early public companies, the answer is most assuredly yes. They offer employees a share in the future growth of the company and value created for shareholders for a relatively modest cost and cash outlay. But for mature companies and the rest of us, their future is highly debatable.

Those in favor of stock options agree that they have many positive features. They provide alignment of interests between a company's shareholders and its employees by offering employees an ownership opportunity in the company that provides value only if the stock price goes up. They also provide flexibility for diverse financial strategies by providing a long-term horizon for exercisability and have some nice tax advantages.

However, the recent market crash exposed the flaws in stock options as an effective equity incentive and reward vehicle for key employees for most public companies. It was, in our opinion, the second nail in the coffin of stock options, the first being an irreversible accounting charge for stock options imposed by the Financial Accounting Standards Board (FASB) in 2006.

With a fixed accounting expense in place for employee stock options, the only real benefit to including them in the compensation program, rather than plain vanilla restricted stock, is to provide market leverage to employees in relation to shareholders. Leverage is a reasonable objective in aligning the interests of key employees with shareholders, but it may be argued that stock options provide excessive and unbalanced leverage because of their unlimited upside and no downside.

Excessive leverage, risk taking and misaligned executive incentives are blamed for contributing to the current financial crisis and the resulting effect on the economy and consumer spending. As a result, American businesses and households are in a painful process of deleveraging. It follows that the same deleveraging process will occur in executive compensation programs, with the most visible target being the most leveraged compensation vehicle: stock options.

The Problems with Stock Options

Before considering the alternatives, let's list the problems with stock options:

1. **Options are financially inefficient under current accounting principles (FAS 123R).** The expense is not reversible if the option goes underwater; hence, a wasted expense for no compensation.
2. **Options lose motivational and retention value if they go**

underwater. Employees may ascribe a value of zero even though an expense is still recorded (disconnect between perceived value and accounting expense).

3. **Options are subject to single-day pricing of the strike price.** Option price is very important to the ultimate value of the option. But, perversely, the higher the price at grant, the greater the expense and the lesser the perceived potential for gain. In addition, current market volatility can cause a plus or minus 10-percent price change or more a day. So grant timing is critical, but cannot be legally or ethically managed. Option price is not subject to averaging techniques (e.g., 20-day prior average closing price).
4. **Flexibility of employees to exercise vested options any time they choose, thought by many to be an advantage of options, can create vast disparities in outcomes** between similarly performing executives based on the whims of timing. Therefore, as a compensation device for services rendered, options are an inefficient and inequitable vehicle for delivering an intended value of compensation.
5. **Many senior executives, for a variety of reasons, wait too long to exercise valuable options** and hence risk the total loss of in-the-money values when the market crashes, as has happened recently in many companies. Many executives are concerned about the public perception of an exercise before the full term has expired, despite it being in their best interest to exercise earlier.
6. **"Blackout windows" can interfere with timing flexibility** and can even result in forgone exercises of valuable options.

Criteria for a New Equity Device

If you believe the problems with stock options warrant considering an alternative, what would you look for in a replacement? Here's our list of criteria:

- less market leverage (upside and downside) than regular stock options, but more market leverage than plain time-vested restricted stock
- no requirement to set company financial or market performance goals in advance

Market-Leveraged Stock Units Term Sheet

Type of Grant: RSUs earned by stock price performance (market-leveraged stock units or MSUs)

- Dividend equivalents are deemed reinvested and subject to the same earnout formula as the MSUs

Maturity Date: Five years from grant (could be shorter or longer)

Vesting: Could be:

- 20 percent per year cumulative
- 25 percent per year cumulative, starting on the second anniversary
- $33^1/_3$ percent per year cumulative, starting on the third anniversary.

Form of Payment at Maturity: Actual shares, net of taxes

Number of MSUs Earned at Maturity: Number of MSUs granted, plus reinvested MSUs, times (fair-market value on maturity date divided by FMV on grant date), subject to a maximum of 200 percent of MSUs granted and created by dividend reinvestment

- For example, if 1,000 MSUs are granted at FMV $30 and mature at FMV $45, 1,500 MSUs are earned (1,000 X [$45/$30])
- And if 1,000 MSUs are granted at FMV $30 and mature at FMV $20, 667 MSUs are earned (1,000 X [$20/$30]).

Measure of FMV: Grant date FMV and maturity date FMV are average closing price for 60 trading days preceding grant or maturity dates

- Note — actual value of stock at maturity may be different (higher or lower) than the maturity date FMV used to calculate MSUs earned

Accounting Value for FAS 123R Expensing: Should be fixed grant date accounting (not variable), with a higher grant date fair value (GDFV) than straight restricted stock because of the possibility of greater than 100 percent earnout, and with no true-up to actual shares earned above or below the number of MSUs granted. (Subject to confirmation.)

IRS/409A Implications: Should be no issues, except value at maturity may not be deductible for NEOs under IRC §162(m), unless there is a threshold FMV earn-out below which no MSUs are earned. (Subject to confirmation.)

Legal/SEC Stock Exchange: Shareholder approval may not be required for plan amendment to allow for MSUs. (Subject to confirmation.)

- does not rely on single-day pricing (grant date or exercise date)
- alignment with shareholders' interests, providing payout based on absolute total shareholder return
- virtual certainty of earning some payment based on retention through the vesting period; the expense already taken is not fully wasted
- fixed compensation expense, known in advance
- no exercise timing flexibility and related insider concerns (i.e., automatic payments at maturity)
- payments in stock, net of taxes, with voluntary pretax deferral possible if desired
- does not create "winners and losers" based on exercise timing decisions.

Market Stock Units

Our suggestion for a replacement for stock options in mature companies is market-leveraged stock units (MSUs), which are an outright grant of restricted stock units with a long maturity.

At the maturity date the number of shares earned and paid is the number of MSUs granted times the ratio of the fair market value at the maturity date to the fair market value at the grant date, subject to a cap of 200 percent.

Thus, if the stock price goes up, the result is an increase in the shares earned, up to 200 percent earnout, at an increased stock price. And conversely, if the price declines, the result is a decrease in the shares earned at a decreased stock price.

The problem of single-day pricing that bedevils stock options is solved by using an averaging of prior-period stock prices (e.g., 60-90 days) at the grant date and the maturity date.

The MSU gives up the flexibility inherent in options of being able to choose the exercise date. But as mentioned earlier, this flexibility comes at a high price in inequitable outcomes and the risk of seeing option gains evaporate if the options are held too long.

For those who feel that this device, as well as stock options, for that matter, may provide too much upside at a time when stock prices are severely depressed and believe in the theory of "a rising tide lifts all boats," additional performance criteria (such as relative total shareholder return) may be considered.

For those willing to consider alternatives to stock options, a sample MSU term sheet can be found on page 114. ws

Authors' Note: The views expressed in this article are ours and do not reflect the views of the firm or its principals.

ABOUT THE AUTHORS

Frederic W. Cook and Kathryn L. Neel are members of Frederic W. Cook & Co. Inc., an executive compensation consulting firm. They can be reached at 914-460-1100.

Car Max and MSUs

Our stock price, like many others, suffered last year from the credit freeze, market collapse and ensuing recession. I have been a long-time believer in stock options for growth stocks like KMX. But, their extreme leverage, their financial and motivational inefficiency when they go under water, and the losses sustained by our key employees convinced us to try market stock units (MSUs) as a replacement for a portion of our annual stock option awards.

We see MSUs as being restricted stock unites (RSUs) with leverage. They are a hybrid instrument with the characteristics of both options and RSUs, but without some of the disadvantages of each. So, we thought we'd give them a try.

—Thomas G. Stemberg, Chair, Compensation Committee,CarMax Inc