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Eisner, Semel Are in Out-of-the-Money Options: Graef Crystal

Jan. 7 (Bloomberg) -- Out-of-the-money option grants, which should be the norm in corporate America, are only a bit less rare than saber-tooth tigers.

An out-of-the-money option is one where the strike price is set higher than the market price on the date the option is granted.

I put on boots, grabbed a stout walking stick and started hiking through 3,593 option grants made in 2000 through 2002 to CEOs running U.S. companies with 2002 net sales of \$1 billion or more. I found only 105 grants that were out of the money on their grant dates. And of those, only 46 could be considered seriously out of the money, which I defined as a strike price that was 25 percent or more higher than the market price at grant.

(Data for this study were furnished by Equilar Inc., an independent provider of pay information.)

It's obvious from these findings that CEOs react to an out-of-the-money grant in the same manner they probably did when their mothers tried to force cod liver oil between their tightly sealed lips. After all, an out-of-the-money grant denies a CEO the first portion of stock price appreciation that occurs after the grant is made.

It's that first portion of appreciation that really needs to be taken out of a CEO's pay package.

The Vest's Sleeves

Consider that on Monday, an investor could have purchased a zero-coupon Treasury bond with a 10-year maturity and been guaranteed a compounded annual return of 4.73 percent a year.

Now consider a CEO who receives an option covering 1 million shares on a stock with a market price of \$50 a share and no dividend. If that stock appreciates to \$79.37 a share by the end of the option's 10-year term, that CEO, assuming that his strike price was the same \$50 as the market price on the grant date, would walk away with \$29.4 million in option gains.

Yet all that CEO did was to give his shareholders the sleeves out of his vest. A stock price of \$79.37 in 10 years represents a 4.73 percent a year return, and that level of return could have been had, risk-free, by investing in a Treasury bond.

Still, there are a few hardy souls out there who have accepted out-of-the-money option grants, and even options that are way out of the money.

Disney's Eisner

Two such CEOs are Michael Eisner of Walt Disney Co. and Terry Semel of Yahoo! Inc.

Eisner, in 1989 and again in 1996, received out-of-the-money option grants, along with at-the-market grants. In 1996, of 24 million option shares granted on a post-split basis, 9 million were out of the money, with 3 million carrying a strike price that was 25 percent above the market price at grant. Another 3 million carried a strike price 50 percent above the market price, and a final 3 million had a strike price that was 100 percent above the market price.

(I was a consultant to Disney's board compensation committee during the negotiations that led to the

1989 and 1996 option grants. Eisner had his own attorney representing him.)

Disney's performance since the Sept. 30, 1996, grant date has been such that all of Eisner's 9 million out-of-the-money options were still out of the money -- to the tune of \$84 million -- as of Monday's \$24.14 close price. Had those grants carried strike prices equal to the market price at grant, Eisner's options would have been in the money by \$27 million.

Yahoo's Semel

As for Yahoo's Semel, on April 16, 2001, at about the time he joined the company, he was given options on 5 million shares, carrying strike prices that ranged from a low of 170 percent above the market price at grant all the way to 426 percent above the market price. One thing you can say for Terry Semel is that he doesn't fool around when it comes to playing fair with his shareholders.

As of Monday's \$46.90 closing price, Semel's option with the strike price that was set 170 percent above the market price at grant was in the money by \$42 million. His other two options were out of the money by a collective total of \$48 million. Had these last-mentioned options carried strike prices equal to the \$17.62 a share market price on the grant date back in April 2001, they would collectively have been in the money by \$73 million as of Monday's close.

A few other CEOs have accepted out-of-the-money grants in more than a single year. They include Bruce Nelson of Office Depot Inc.; Paul Charron of Liz Claiborne Inc.; and Stuart Miller of Lennar Corp.

Allergan's Pyott

Unhappily, though, quite a few of the CEOs who accepted out-of-the-money grants in earlier years have lost their nerve in more current years. An example here is David Pyott of Allergan Inc. In 2001, he accepted three different option grants carrying strike prices that were 120 percent, 144 percent and 173 percent above the market price on the grant date. But in 2002, he reverted to at-the-market grants.

At the time the 2001 grants were made, the market price was \$76.60, and the strike prices were set at \$91.92, \$110.30 and \$132.36. But by April 24, 2002, Allergan's stock price had dropped to \$64.79. That decline evidently caused Pyott to go weak in the knees, because he then accepted an option covering 283,377 shares with a strike price equal to that \$64.79 market price.

Doing what's right by shareholders shouldn't be left to a handful of CEOs like Eisner and Semel, who know to do the right thing. On the contrary, doing what's right by shareholders should be imposed on all CEOs by their boards of directors. Only then will we begin to avoid lavishing millions on CEOs who end up giving their shareholders the same -- or even a lesser -- rate of return than the shareholders could have received from risk-free Treasury bonds.

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