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A Popular Reward: Restricted Stock

Job Performance Link Is Debatable

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As stock options become costlier and more controversial for companies, another form of executive compensation is gaining favor -- and drawing criticism.

It's known as restricted stock, a grant of stock that generally passes to an executive over a period of time.

The rise of restricted stock reflects the continuing effort to align pay with performance -- or, according to some corporate governance analysts, the continuing effort to avoid aligning them.

In a sense, restricted stock puts the executive in the same boat as ordinary shareholders because its value rises or falls with the share price.

But unlike stock options, which allow the recipient to purchase shares at a fixed price, restricted stock costs the executive nothing. And unlike options, which pay off only if the share price rises, restricted stock rewards the executive regardless.

"It's been generally derided as things such as 'pay for pulse' or 'remuneration for respiration,'" said Patrick McGurn, executive vice president of Institutional Shareholder Services. "In essence, it requires you to only, as one consultant I know says, fog a mirror in order to receive value after some extended period of time."

"Restricted stock is performance-based pay," responded Randall S. Thomas, a professor at Vanderbilt University Law School. "If the stock price goes down, the stock is worth less."

Last year, 43.4 percent of chief executives at big companies received some form of restricted stock, up 5.5 percentage points from 2003, according to Equilar Inc., which researches executive compensation.

The median value of those awards rose 17.5 percent to more than \$2.3 million, Equilar's Tim Ranzetta said.

The study, which looked at 403 chief executives at companies in the Standard and Poor's 500-stock index who had been in their jobs at least three years, was designed to exclude large awards to newly appointed chief executives.

At a sample of smaller companies in the S&P 1,500, the median restricted stock award to chief executives rose 14 percent to \$421,513, Ranzetta said.

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Meanwhile, the median value of chief executive stock option awards fell 4.8 percent to \$2.95 million at S&P 500 companies, and fell 23.1 percent to \$329,609 in the sample of smaller companies, Equilar found.

When stock options caught fire in the 1990s, they were billed as a way to link executives' fortunes to those of shareholders.

But as the stock market bubble burst, the downside of stock options became more apparent. They have since been blamed for massive executive windfalls, artificially inflated stock prices, and, ultimately, a disconnect between pay and performance.

In the view of some regulators, lawmakers and private sector observers, the potential to reap stock option riches created incentives for executives to boost company stock prices through risky or fraudulent behavior, and contributed to a wave of accounting manipulations.

"We want the executive to care about the performance of the company's stock price in a very personal way," Thomas said. The trouble at companies such as Enron is that "they cared too much," he said.

In a rising market, options rewarded executives for any increase in the stock price, even if it lagged the market averages. And, through the quirks of accounting rules, options gave the appearance of costing other shareholders nothing -- until they were cashed in, putting more stock in circulation and diluting the value of other investors' holdings.

Unlike salary and cash bonuses, options don't have to be counted as an expense on a company's income statement when they are issued, a fact that has let companies reward their executives without damaging their bottom line.

A new accounting rule to take effect in the future, however, will require companies to count options as immediate expenses, thus eliminating much of their appeal.

"What is the advantage of stock options if you've lost the advantage of not having to record the expense?" said David Amy, chief financial officer of Sinclair Broadcast Group Inc.

To avoid having to book option expenses, some companies such as Hunt Valley-based Sinclair recently have speeded up their vesting, allowing executives and other employees to cash in earlier than scheduled, and before the new rule takes effect. As of April 1, at least 40 companies had disclosed that they were vesting options earlier than planned, Equilar said.

"The decision to accelerate the vesting of all unvested options, which the Company believes to be in the best interest of its shareholders and employees, was made primarily to reduce compensation expense that would have been recognized in future periods" under the new rule, Sinclair said in a recent report filed with the Securities and Exchange Commission, using language echoed by other companies.

Martek Biosciences Corp. of Columbia said that it will be able to avoid recording about \$28 million of compensation expense in the future because it vested options in December and January.

In December, newspaper publisher Gannett Co. made immediately exercisable almost 3.9 million options with original vesting dates ranging from December 2005 to December 2007, including 300,000 options held by the company's chairman and chief executive, Douglas H. McCorkindale.

"The options were accelerated to reduce the expense impact in 2005 and beyond of a new accounting standard for stock based compensation," Gannett said in a report filed with the SEC.

Companies can impose performance-related conditions on an executive's right to sell restricted stock, but last year, only 18 percent of restricted stock awards in an Equilar study were linked to a performance standard.

Among the major awards of restricted stock at local companies, Coventry Health Care, an HMO company, awarded former chief executive Allen F. Wise \$9.7 million in restricted stock in June 2004, up from \$3.3 million in 2003. He ceased to be chief executive at the end of December and took on the role of chairman, the company reported. By the end of last year, Wise held restricted stock worth a total of \$19.9 million, which he will be free to sell by the time of his planned retirement in August 2007, according to a company SEC filing.

Defense contractor Lockheed Martin last year awarded president Robert J. Stevens, who has since become chairman and chief executive, \$2.3 million in restricted stock, and it awarded millions in restricted stock to other top executives. The awards generally vest over four years and were conditioned on the executives signing agreements not to compete with Lockheed if they left for another job, the company reported.

Gannett last year awarded McCorkindale \$1.6 million in restricted stock, which vests over a year in monthly installments.

Less than a year and a half at the helm of MCI Inc. paid off for chief executive Michael Capellas in April 2004 when the telecommunications company, formerly known as Worldcom Inc., emerged from bankruptcy protection. For passing that milestone, the company awarded him \$12 million in restricted stock, as approved by a court-appointed monitor when he joined MCI. For Capellas's overall performance helping the company recover from a watershed accounting deception, the board last year awarded him another \$6 million in restricted stock, plus a bonus of \$5 million.

While the restricted stock vests in quarterly installments over three years, the unvested shares last year generated dividends of \$589,061 for Capellas.

MCI gave Capellas restricted stock instead of stock options because its court-appointed monitor, former SEC chairman Richard Breeden, prohibited it from issuing options for five years as part of his plan to restore trust in the company, MCI spokeswoman Brittany Hoff Feinson said by e-mail.