

AGENDA

Bristol Myers Reinstates Options Linking Pay, Performance

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By [Janine Sagar](#)

Bristol Myers Squibb recently awarded 15 of its executives performance-based stock options. The \$20 billion pharmaceutical giant reinstated performance-based exercise thresholds on its senior executive option grants last year after dropping them from the company's comp plan in 2002.

The company brought back the performance thresholds on the option awards "to enhance the pay-for-performance link for long-term incentives," a Bristol Myers spokesman says.

Richard Steinberg, CEO of Steinberg Governance Advisors, a consulting firm, says he's seen a definite increase in the use of performance-based stock options. With all of the attention being paid to executives' salaries, the corporate climate is ripe for this kind of compensation vehicle. It comports with shareholders' demands by ensuring that an executive's pay rises and falls in tandem with the company's level of success.

"Compensation committees are trying to match the compensation elements with performance and with motivating the CEO to achieve certain objectives," says Steinberg.

Unlike other forms of long-term compensation, performance-based stock option awards usually put two obstacles in the way of an executive's ability to cash in. That makes them popular with corporate governance advocates at a time when an increasing number of shareholders are demanding pay for performance.

"First the stock price has to go up, and then [the executives] have to meet other hurdles, such as operating metrics," explains Dhananjay "D.J." Shetty, a compensation consultant at Frederic W. Cook.

For example, the 15 Bristol Myers executives may not exercise their new options "until the closing share price of common stock achieves a price of at least 15% above the option grant price and remains at that price for seven consecutive trading days," according to company filings. Further, the "option vests 25% of the shares annually, on a cumulative basis, commencing one year after the date of grant."

That's different from an executive's ability to exercise a plain-vanilla or restricted stock option grant. Restricted stock option awards may be contingent on an executive's remaining with the company for a certain time, but they don't require management to achieve any performance metric. Once they're vested, the executive can walk away with

cash as soon as the value of the company's shares rise above the strike price by any amount.

Restricted stock grants are also more likely than performance-based stock options to put money in an executive's pocket. Like performance-based options, restricted stock vests only after the executive remains with the company for a certain time or the company achieves some performance metric. However, even if the company's stock price goes down, the stock still holds value.

Robert Kirchner, a member of the compensation committee of Longview Fibre, a \$900 million paper packaging products manufacturer, prefers performance-based stock over any kind of options because of options' potential for dilution. His board doesn't award any options to executives.

"To get the same amount on options, you're looking at the difference between the market price and the then-exercise price. You've seen these awards; sometimes they involve quite a large number of shares. If you grant performance-based stock, it's a direct grant of the stock at the full price of the stock."

In other words, a company would have to use more options to pay an executive a certain amount than it would have to use to compensate that executive that same amount using stock.

Finally, there's the issue of FAS123(R), which required all companies to expense their stock options in fiscal years beginning June 15, 2005.

"Options pose accounting issues," says Shetty. "You have this fixed expense which you've got to expense even if the option is not earned in the end. The company could incur an expense and the employee gets no value."

Despite these drawbacks, performance-based stock options seem to be making a small comeback. Coca-Cola Enterprises, Qwest Communications, E-Trade and SLM Corp. all used them this year, according to the compensation research firm Equilar.

Frederic W. Cook has yet to compile current stats on the use of performance-based stock options, but in its 2005 long-term incentive grant practices report, the compensation consulting firm predicted that the use of this compensation vehicle would increase. It made that prediction based on two facts, according to Shetty. "They provide a strong link between pay and performance. Plus, expenses on such options are reversible if not earned and the performance metrics are not connected to the stock price and instead are connected to some other metric like return on equity."

Bob Profusek, a member of the compensation committee at Valero Energy and a director at CTS Corp., believes traditional options are on their way to extinction. He bases his belief, in part, on the fact that traditional options have the potential to motivate executives to act in the company's short-term interests.

“While I personally disagree that options were even a significant cause of the so-called Enron phenomenon,” he says, “these attacks, and the change in option accounting, have caused a general move away from traditional time-vested options for management in favor of performance-based options and restricted stock.”