

June 4, 2001

**Money & Investing****Stock Option Backlash Brews  
As Use Spins Out of Control**By **RUTH SIMON and IANTHE JEANNE DUGAN**

Staff Reporters of THE WALL STREET JOURNAL

**Citrix Systems Inc.** asked shareholders last year to approve a standard plan to boost the number of stock options that the server-software maker could dole out.

▶ **1** Web Resources  
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▶ **2** Tech, Telecom  
Workers Face Difficult  
Choice When Companies  
Turn to 'Repricing' Options

▶ **3** Options About Stock  
Options, and a  
Geography of the Pitfalls

The result was anything but routine.

Many shareholders balked; they complained that the options would dilute their stakes, making their stock worth less. Citrix tried lobbying them. When that didn't work, the Fort Lauderdale, Fla., company allowed voting on the proposal to continue after its annual meeting was adjourned. The proposal finally squeaked by, but a major shareholder sued -- and Citrix in January scrapped the options plan.

How the investing world has turned upside down.

Not long ago, stock options were widely viewed as a no-lose proposition for everyone. Employees could buy stock in their company at a favorable price, encouraging them to work harder because they had a vested interest in the company doing well. Employers, especially tech companies, didn't have to pay such high salaries, and often got a tax deduction for the additional stock-option pay. Other shareholders gained because, while their holdings were diluted, all those hard-working employees would improve their company's performance -- and with it the stock price.

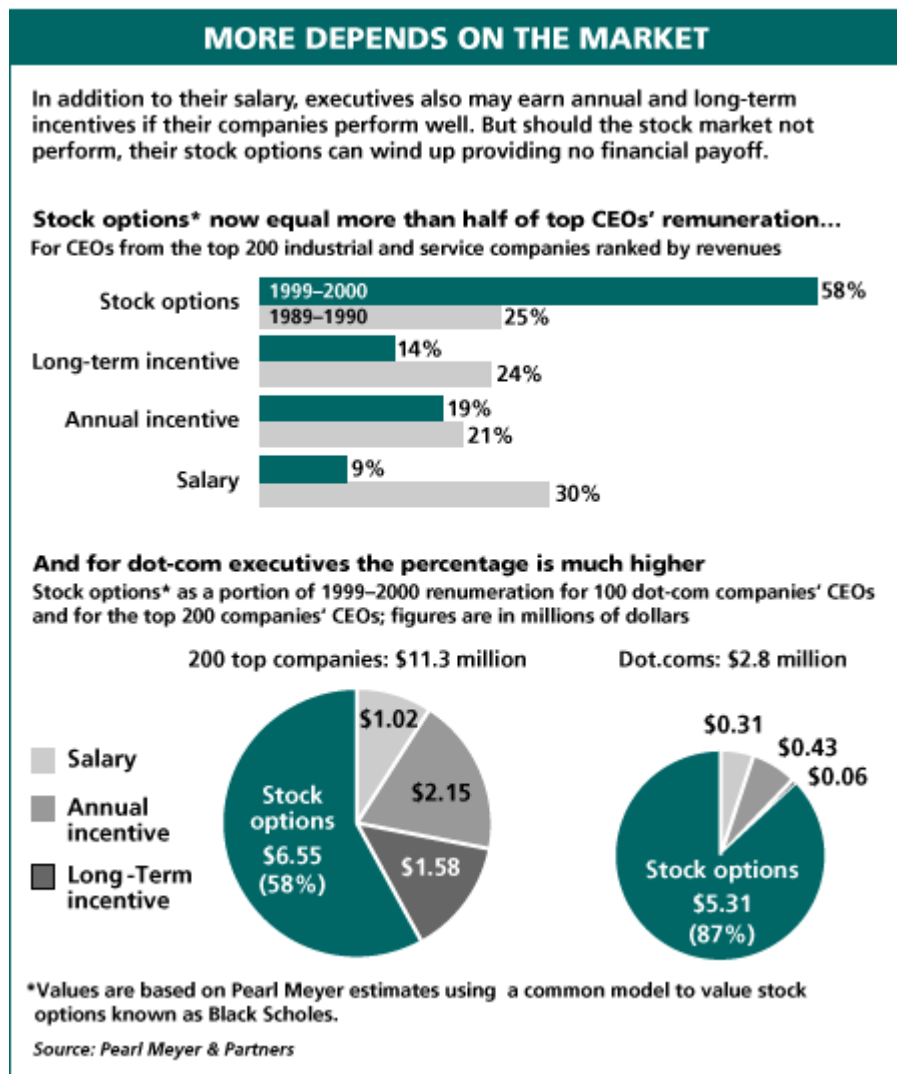
But in the dot-com-led boom of the late 1990s, employee-stock options began to spin out of control. And now the subsequent bust has exposed the dark side of the options game. Stock options "are proving to have some very significant side effects," says Patrick McGurn, vice president of Institutional Shareholder Services, which advises institutional investors on proxy issues.



This all started innocently enough. In the 1990s, companies increasingly began using options as a cheap form of pay. As many as 10 million employees now hold stock options, up from one million in 1991, the National Center for Employee Ownership says. At the largest dot-com companies, stock options made up 87% of chief-executive pay last year, according to pay consultants Pearl Meyer & Partners.

When the stock rose, employees -- often top executives -- made staggering sums. **Cisco Systems Inc.** CEO John Chambers, for instance, received \$156 million in option-related profits in fiscal 2000, dwarfing his roughly \$1.3 million salary and bonus.

But when stocks headed south, many companies simply handed out more options at a lower price so employees weren't penalized for poor performance. Some companies repriced underwater options to protect employees from losses, defeating the purpose of pegging gains to performance, critics say. More than 70 companies -- including **Amazon.com Inc.**, **RealNetworks Inc.** and **Sprint Corp.** -- have repriced options or allowed employees to turn in out-of-the-money options for new options that will be issued later, according to Institutional Shareholder Services. Others let employees cancel already-exercised options when shares fell in value.



That is like moving the goalposts in the middle of a football game, some investors grouse. "If a company does well, those holding options should be able to take part in that performance," says Eric Roiter, general counsel for Fidelity Management & Research Co., the investment arm of giant mutual-fund company FMR Corp. "If the company doesn't fare well, it completely undermines the purpose of an option plan to simply change the rules."

Humdrum performance can be rewarded, too, critics say. **Apple Computer Inc.** handed out so many stock options to CEO Steven Jobs that he could take home \$548 million in stock option-related gains if the computer maker's shares climb just 5% a year over the next 10 years, according to regulatory filings. An Apple representative declined to comment.

Even consultants who helped companies develop ever-more-generous stock option plans say the pendulum has swung too far. Concedes Pearl Meyer, president of Pearl Meyer & Partners: "We've overdosed."

Now, some employees are stuck. Though many have profited handsomely from options over the years, others face a tangle of tax bills, margin loans and litigation, partly because of their own greed or ignorance and partly because of brokers who encouraged them to embrace high-risk investment strategies. These employees typically didn't sell any of the shares they bought when exercising options, which many people do to cover taxes on the gains; they then were left with no money to pay the taxes when the stock price plummeted.

Few would suggest getting rid of stock options entirely. These "golden handcuffs" remain an effective way to attract and retain top talent. But academic studies are raising questions about how much shareholders really benefit when companies dole out large chunks of options. And some investors suggest that current pay practices be changed.

Meanwhile, some are voting with their wallets. Where most stock plans used to sail through with little dissent, 22% of shareholders who voted registered their opposition to option plans in 2000, says Drew Hambly, a senior research analyst at the Investor Responsibility Research Center in Washington, a corporate-governance research group. Ten option plans were shot down by shareholders last year, up from three in 1997. Companies and employees, meanwhile, are struggling with the fallout as huge numbers of stock options have lost their value.

In the Citrix matter, shareholders were unhappy with the stock-option plan because it allowed the company to issue so many additional stock options that it could have diluted their interests by 73%, according to an analysis by the Investor Responsibility center. The plan also allowed Citrix -- whose stock price has fallen 55% in the past year, far more than the average decline of 31% for software companies -- to reprice stock options that had lost their value without first getting shareholder approval.

The proposal managed to win approval by a slim 50.5% to 49.5% majority two weeks after its annual meeting in May 2000. But the Louisiana State Employees' Retirement System, which owns more than 17,000 Citrix shares, sued in Delaware chancery court, alleging that Citrix "improperly manipulated the shareholder voting process."

In January, Citrix withdrew the disputed plan. It put another option proposal, for directors and officers, before shareholders in May, but that plan was also rejected, by a roughly 2-to-1 majority. "We benchmark our plan against other plans," says Scott Davidson, Citrix's director of investor relations. He adds that both plans were "within a range of multiple companies within the industry."

Throughout corporate America, the payoff from massive grants could be smaller than expected, new research shows. Technology companies with the most generous stock-option plans saw their share prices drop an average of 45% last year, compared with a 4% increase in market value for companies that kept their programs in line with industry averages, according to a study released in April by Watson Wyatt Worldwide, a compensation and benefits consulting firm in Washington.

An earlier Watson Wyatt study, completed in 1997, found that companies with such "high dilution" underperformed in a rising market. "In a bull year and a bear year ... companies with the highest overhang were being discounted," or marked down by investors, says Ira Kay, director of compensation consulting at Watson Wyatt.

There is a more basic problem for many employees: Their options currently are worthless. At 40% of companies that issued stock options in 1999, those options were underwater in January, according to TIAA-CREF, the huge pension fund. And woe to those employees who borrowed money to exercise their options or didn't set aside enough money to pay their taxes and have seen their riches evaporate.

Kathleen Shannon, a former senior marketing manager for **Network Appliance** Inc., said in an interview that her brush with stock options left her with a house she can't afford and more than \$400,000 in debt.

Ms. Shannon, 33 years old, saw roughly \$2 million in option-related gains evaporate after she followed a financial strategy recommended by an investment professional that soured, according to a suit she filed

Thursday in Santa Clara County Superior Court in California.

Ms. Shannon had never owned any stock until she exercised options to buy a split-adjusted 13,332 shares of the data-storage company in February 2000, the suit says. Ms. Shannon says she paid a split-adjusted \$5.11 a share for the stock. At the time of the exercise, the suit says, the market value of the stock was \$126 a share, or roughly \$1.3 million. (The company had a 2-for-1 stock split after she exercised her options.)

For advice she turned to Rick Voytek of Lincoln Financial Advisors in San Ramon, Calif., a unit of **Lincoln National** Corp. The suit alleges that Mr. Voytek advised her to exercise her stock options, hold onto the shares, which were worth more than \$1 million at the time, and to borrow against her portfolio to pay the exercise costs, borrowings that Ms. Shannon says totaled \$68,000. He told her she would slice her tax bill if she held onto the shares for a year, long enough to qualify for the lower long-term capital gains rate on any increase in the stock above the exercise price, according to the suit, which was filed against Mr. Voytek and Lincoln National.

Ms. Shannon, who was earning about \$90,000 a year, said she told Mr. Voytek she would like to own a house one day. He said that Ms. Shannon could use the mortgage-interest tax deduction, according to the suit. On his advice, she said in the interview, she bought a \$589,000 townhouse in Redwood Shores, Calif., using a \$125,000 margin loan to cover the down payment and additional borrowing to pay part of her \$3,500-a-month mortgage payment. After technology shares soared, the value of Ms. Shannon's portfolio climbed to roughly \$2 million by September 2000, according to the suit. When the stock started heading south later that autumn, Mr. Voytek told Ms. Shannon not to worry, according to her lawyer, James Rummonds.

But the strategy backfired. Network Appliance shares tumbled more than 60% from their peak, and in February, Ms. Shannon said in the interview, she began receiving margin calls -- demands that she put additional cash or stock to back up her loans -- which totaled as much as \$290,000. About the same time, her accountant told her she had an alternative minimum tax liability of roughly \$430,000, the suit says. Ms. Shannon said she never realized she would have to pay taxes on profits she hadn't even taken. But by exercising the stock options and holding onto the shares, she triggered an AMT liability that was based on the total of her normal taxable income plus the unrealized gains.

In the interview, Ms. Shannon said she had to sell off all her stock to pay off her margin debt, a move that triggered another \$100,000 in taxes, on the difference between the exercise price and the stock's value, which was still above her split-adjusted \$5.11 a share cost. Because of the quirks of the tax law, only a small portion of the bill can be offset by her alternative minimum tax payments. She said she has been looking for a job for three months, but with the collapse of the tech boom she isn't getting any offers. Her house is on the market because she can't afford the monthly mortgage payment. She added: "It's very devastating."

Darcy Rudnay, a spokeswoman for Lincoln National, declined to comment on the suit, saying the company hadn't seen it yet.

Mr. Voytek's attorney, Paul Rice, said, "We fully expect to win this case when it goes to trial, and it is a trial where we will present our evidence, not in comments to the press."

For years, companies benefited from issuing stock options. For one thing, they didn't have to pay as much in salaries and bonuses. And the cost of stock options was typically relegated to a footnote in companies' earnings statements.

Many companies have reaped hefty tax deductions -- equal to the difference between the exercise price and the stock's current value -- when employees exercised their stock options. According to TIAA-CREF, 162 large companies that reported options-related tax deductions in 1999 (the most recent year for which data are available) reported a total of \$15.3 billion in options-related tax savings. Cisco reduced its taxes payable by \$2.49 billion in fiscal 2000 because of option exercises and will carry forward another \$590 million that can be used to offset reported income taxes in the future, according to University of Washington accounting professor

Terry Shevlin.

But this tax-related earnings boost could boomerang as fewer employees exercise stock options because of sinking share prices. **Yahoo!** Inc.'s options-related tax deduction dropped to just \$2.1 million in this year's first quarter from \$47.6 million in the year-earlier period. The decline "looks like a big part" of why net cash provided by operations dropped to \$71.1 million from \$129.8 million during this period, Prof. Shevlin says. Yahoo declined to comment.

So, what can be done to clean up the mess caused by excesses?

Some academics suggest replacing upfront megagrants with smaller blocks of stock options that are issued each quarter. Such plans would be more cumbersome to administer, but could take some of the sting out of falling share prices. Some consultants also are urging companies to sell employees restricted stock -- shares that can't be sold for three or four years -- at a discount. Though often decried as a giveaway, restricted stock provides incentives to work hard even if share prices fall, supporters say.

Others suggest that companies should tie gains from stock options to an index so executives are rewarded for truly performing well, not for a bull market. Critics counter, however, that this approach could raise tricky accounting questions and leave executives demoralized if their good efforts were ignored because of a rising stock market.

At the very least, some big shareholders say they should have a bigger say in how many options are handed out. TIAA-CREF, for example, has asked the New York Stock Exchange and Nasdaq Stock Market to tighten up their rules so all option plans that include executives and directors are put to a shareholder vote.

"There's got to be balance and judgment as to what is appropriate," says Peter Clapman, senior vice president for corporate governance for TIAA-CREF. "Shareholders want to align management more with shareholder concerns," he adds, "but not simply ... give significant money to management in situations where their performance didn't merit it."

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