The Washington Post, Wednesday, January 30, 2002

Stock Option Madness

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As the Enron scandal broadens, we may miss the forest for the trees. The multiplying investigations have created a massive whodunit. Who destroyed documents? Who misled investors? Who twisted or broke accounting rules? The answers may explain what happened at Enron but not necessarily why. We need to search for deeper causes, beginning with stock options. Here's a good idea gone bad -- stock options foster a corrosive climate that tempts many executives, and not just those at Enron, to play fast and loose when reporting profits.

As everyone knows, stock options exploded in the late 1980s and the '90s. The theory was simple. If you made top executives and managers into owners, they would act in shareholders' interests. Executives' pay packages became increasingly skewed toward options. In 2000, the typical chief executive officer of one of the country's 350 major companies earned about $5.2 million, with almost half of that reflecting stock options, according to William M. Mercer Inc., a consulting firm. About half of those companies also had stock-option programs for at least half their employees.

Up to a point, the theory worked. Twenty years ago, America's corporate managers were widely criticized. Japanese and German companies seemed on a roll. By contrast, their American rivals seemed stodgy, complacent and bureaucratic. Stock options were one tool in a managerial upheaval that refocused attention away from corporate empire-building and toward improved profitability and efficiency. All this contributed to the 1990s' economic revival.

By holding down costs, companies restrained inflation. By aggressively promoting new products and technologies, companies boosted production and employment. But slowly, stock options became corrupted by carelessness, overuse and greed. As more executives developed big personal stakes in options, the task of keeping the stock price rising became separate from improving the business and its profitability. This is what seems to have happened at Enron.

The company adored stock options. About 60 percent of employees received an annual award of options, equal to 5 percent of their base salary. Executives and top managers got more. At year-end 2000, all Enron managers and workers had options that could be exercised for nearly 47 million shares. Under a typical plan, a recipient gets an option to buy a given number of shares at the market price on the day the option is issued.

This is called "the strike price." But the option usually cannot be exercised for a few years. If the stock's price rises in that time, the option can yield a tidy profit. The lucky recipient buys at the strike price and sells at the market price. On the 47 million Enron options, the average "strike" price was about $30, and at the end of 2000, the market price was $83. The potential profit was nearly $2.5 billion.

Given the huge rewards, it would have been astonishing if Enron's managers had not become obsessed with the company's stock price and -- to the extent possible -- tried to influence it. And while Enron's stock soared, why would anyone complain about accounting shenanigans? Whatever the resulting abuses, the pressures are not unique to Enron. It takes a naive view of human nature to think that many executives won't strive to maximize their personal wealth.

This is an invitation to abuse. To influence stock prices, executives can issue optimistic profit projections. They can delay some spending, such as research and development (this temporarily helps profits). They can engage in stock buybacks (these raise per-share earnings, because fewer shares are outstanding). And, of course, they can exploit accounting rules. Even temporary blips in stock prices can create opportunities to unload profitable options.

The point is that the growth of stock options has created huge conflicts of interest that executives will be hard-pressed to avoid. Indeed, many executives will coax as many options as possible from their compensation committees, typically composed of "outside" directors. But because "directors are [manipulated] by management, sympathetic to them, or simply ineffectual," the amounts may well be excessive, argue Harvard law professors Lucian Arye Bebchuk and Jesse Fried and attorney David Walker in a recent study.

Stock options are not evil, but unless we curb the present madness, we are courting continual trouble. Here are three ways to check the overuse of options:

(1) Change the accounting -- count options as a cost. Amazingly, when companies issue stock options, they do not have to make a deduction to profits. This encourages companies to create new options. By one common accounting technique, Enron's options would have required deductions of almost $2.4 billion from 1998 through 2000. That would have virtually eliminated the company's profits.

(2) Index stock options to the market. If a company's shares rise in tandem with the overall stock market, the gains don't reflect any management

contribution -- and yet, most options still increase in value. Executives get a windfall. Options should reward only for gains above the market.

(3) Don't reprice options if the stock falls. Some corporate boards of directors issue new options at lower prices if the company's stock falls. What's the point? Options are supposed to prod executives to improve the company's profits and stock price. Why protect them if they fail?

(4) Within limits, stock options represent a useful reward for management. But we lost those limits, and options became a kind of free money sprinkled about by uncritical corporate directors. The unintended result was a morally lax, get-rich-quick mentality. Unless companies restore limits -- prodded, if need be, by new government regulations -- one large lesson of the Enron scandal will have been lost.