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THE DETERMINANTS OF SHAREHOLDER VOTING ON STOCK OPTION PLANS

Randall S. Thomas*

Kenneth J. Martin**

Over the past decade, executive compensation has become a controversial topic. Increasingly, corporate boards of directors are confronted by angry shareholder groups over the size and composition of executive pay packages. One of the most important focal points for these tensions arises when a board asks shareholders to approve the creation of new stock option plans or to amend existing plans. This Article seeks to identify the factors that lead shareholders to support or to oppose stock option plans. We examine the justifications for the widespread use of stock options and identify several benefits from stock option plans as well as criticisms leveled against the methods that boards have used to implement the plans.

In addition, we conduct an empirical analysis of the determinants of shareholder voting on stock option plans in the 1998 proxy season. We examine the four companies in our sample in which shareholders defeated the plans, and then we perform a cross-sectional analysis of voting results. Our principal finding is that, while shareholders generally vote to approve stock option plans, shareholders are particularly sensitive to the potential dilution caused by the plans, whether that dilution is in terms of total company dilution or individual plan dilution. Also, we find that several characteristics of the plans, such as option repricing, payments in restricted stock, and the provision of loans to executives for the purchase of shares, appear to be the most significant factors leading to increased shareholder opposition.

* Professor of Law, Vanderbilt Law School.
** Professor of Finance, College of Business and Economics, New Mexico State University.

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INTRODUCTION

Over the past decade, executive compensation has become a controversial topic. Increasingly, corporate boards of directors are confronted by angry shareholder groups about the size and composition of executive pay packages. Skirmishes between directors and shareholders surface in a variety of forums, both inside and outside the boardroom.

One of the most important focal points for these tensions arises when shareholders are asked by the board to approve the creation of new stock option plans or the amendment of existing stock option plans. While these votes once resulted in routine approval of management proposals with only minimal shareholder dissent, today the level of shareholder opposition has risen dramatically and the outcomes of these votes are much less certain. In several prominent instances, shareholders have rejected management-proposed stock option plans.

This Article seeks to identify the factors that lead shareholders to support or oppose stock option plans. Our analysis proceeds on two levels. First, we examine the justifications for the widespread use of stock options, or pay for performance, to better understand the theoretical rationale for this component of executive pay. We identify several benefits from stock option plans, including improved incentives for managerial performance and the alignment of shareholders' and managers' interests. Once we have laid out the case in favor of stock option plans, we discuss some of the criticisms leveled against the methods that boards have used to implement such plans.

The remainder of the Article is an empirical analysis of the determinants of shareholder voting on stock option plans. We begin by briefly reviewing the legal rules that determine when shareholders must approve stock option plans. We then examine the four companies from our sample in which shareholders defeated management proposed stock option plans or amendments in 1998 and try to determine what common threads exist in these cases. Finally, we dissect the voting results for a large sample of stock option plans from the 1998 proxy season to better understand why shareholders vote the way they do.

In the empirical portion of the Article, we begin by observing that shareholders approve an overwhelming percentage of the plans submitted to them. On balance, we conclude that most shareholders believe that these plans bring value to the company. The more difficult question is why we find differing levels of opposition to these plans.

To address this question, we first use univariate statistical tests to see what factors appear to negatively influence shareholder votes. We find that the dilutive effects of the plan, whether the proposal is for a new plan or an amendment to an existing plan, the breadth of
participant eligibility, and the strength of firm performance prior to the shareholder vote all significantly affect the percentage of shares voted against the plan. Several plan features also appear to affect the level of shareholder opposition, including whether the plan provides for the issuance of discount options, the repricing of options, the acceleration of vesting restrictions, and the issuance of restricted stock. Omnibus plans and evergreen plans seem to generate statistically significant higher levels of shareholder opposition, as do plans with change of control provisions and plans where companies provide executives with loans to purchase their shares upon exercise of their options. Surprisingly, plans with reload provisions and plans that permit executives to use pyramiding in the purchase of stock are not treated differently by shareholders from other plans.

We then employ a series of multivariate regression equations to determine more precisely which of these results are independently significant. Many of the earlier univariate results are confirmed in this analysis. Thus, we continue to see that shareholders view increases in dilution as a negative factor in voting on stock option plans, both in terms of the total dilutive effect of all stock option plans at a company and the incremental dilutive effect of an individual plan. Furthermore, we find that there is a statistically significant interactive effect between the total dilutive effect and the incremental dilutive effect of the plan. We interpret these findings to mean that shareholders are very concerned about the level of dilution created by stock option plans, but that, at low levels of total company dilution, there are greater levels of negative votes for individual plans with significant dilutive effects.

Proposals to add shares to existing stock option plans are met with greater levels of shareholder resistance than those that propose the adoption of a new plan, even when the level of dilution from the two proposals are identical. We hypothesize that shareholders form expectations about the level of dilution associated with the adoption of a stock option plan and that these expectations are disappointed when they are asked to authorize an increase in the number of shares to be awarded under the plan. This leads to a higher negative vote on amendments to plans.

Firm performance significantly impacts the level of shareholder opposition to stock option plans. We find that shareholders are more likely to support stock option plans at relatively poorly performing firms than at firms that are experiencing better performance. We interpret this finding to mean that investors are more inclined to try to incentivize managers at poorly performing firms to do better than they are to reward executives at stronger companies for performing well.

With respect to the features of stock option plans, we continue to find significant relationships between the level of shareholder opposition to stock option plans and the presence of option repricing, the issuance of restricted stock, and the provisions of loans to execu-
tives to purchase shares when they exercise their options. We further find some support for statistically significant positive relationships between the percentage of negative votes on stock option plans and whether the plan offers discounted options or has evergreen features.

Several variables do not have statistically significant effects on shareholder voting patterns. These include whether the plan is an omnibus plan, permits the award of reload options, has change of control provisions, allows for pyramiding of stock options, or has provisions accelerating options. Furthermore, contrary to the univariate results, we find that, except at technology companies, the breadth of employee eligibility to receive options has no significant relationship with the level of shareholder opposition to stock option plans.

I. UNDERSTANDING STOCK OPTION PLANS

A. The Importance of Stock Option Plans

Stock option plans have become an accepted part of corporate America’s pay packages. In a typical incentive stock option plan:

The company gives the executive the right to purchase a certain number of shares at a stipulated price, called the “strike price” or “option price,” within a designated period of time. The strike price is higher than the current market value of the shares when the options are awarded. The concept is to give the executive an incentive to increase the value of the company’s stock above the strike price. The vast majority of plans award options with a strike price equal to the fair market value of the underlying stock on the date of the option grant. Top executives at U.S. corporations receive approximately 50% of their compensation in the form of stock options. The value of these options has increased dramatically in recent years. For example, the average value of stock option grants went from $155,000 in 1980 to $1,200,000 in 1994, or, in percentage terms, an increase of

2. See Kathy B. Ruxton, Investor Responsibility Research Ctr., Executive Pay 1998 13 (1999). A small minority of firms give options with a strike price above the current stock price, so-called “premium” priced options. See id. Another small group of firms awards “parsops,” or performance-accelerating stock options, where the option vests more quickly if certain goals are met, such as the stock price increases above a fixed level. See id. at 14.
over 683% in real inflation-adjusted values. During this same time period, the percentage of CEOs holding stock options increased from 30% to almost 70%.

One study of 1189 firms in the S&P Super 1500 using 1998 data calculated that the median realized gain for corporate leaders exercising stock options was $1,261,460, while the median future value of CEO option awards was $3,884,740.

Another revealing statistic is the rapid increase in the number of mega-grants of stock options, that is, awards initially valued at more than $10 million, given out by the largest 200 American companies. In 1996, fifty-four CEOs at these 200 companies received a mega-grant of stock options. By 1998, this number had risen to 111 out of 200. In other words, the number of mega-grants of stock options at the largest American companies had doubled since 1996.

As stock option awards increase in size and value, the existing shareholders of a company face potential dilution of their ownership stake if the company issues more shares of its stock to satisfy the exercise of new stock options. When these options are exercised,

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5. See id. at 663.
6. See RUXTON, supra note 2, at 3. Realized gains are defined as the actual amount that CEOs gained by exercising their options in the sample year. About 40% of CEOs realized gains on their options in 1998. See id. Realized gains on stock options and other long-term compensation are highly variable because, even though their value may result from several years' performance, the reported gain is realized all in one year. See PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 424-25 (1992).
8. See id.
9. See id.
existing shareholders will have a smaller claim on the company's assets and property. This dilutive effect has three parts: lower per share earnings, less voting power, and a shift in the allocation of stock price gains. The first impact is easily understood: more shares dividing up a fixed pot of earnings leads to a reduction in the amount of earnings per share. The second effect, reduced voting power, is a bit more subtle. If managers exercise stock options to increase their stake in the company, then they may be able to short-circuit the market for corporate control. For example, if a company has a supermajority voting provision for engaging in extraordinary corporate transactions, such as mergers, and management already owns a substantial amount of the company's stock, the board's decision to award a mega-grant of stock options may effectively give management a blocking position over all mergers.

The third effect of dilution is that existing shareholders give up a portion of the gains they would otherwise realize from increases in the company's stock price. This occurs because, as the company's stock price increases, option holders will choose to exercise their options to capture the increase in option value over the exercise price. As more shares are issued to cover these options, the increased supply of stock in the market will lower the price of all shares.

Dilution can be calculated in a variety of different manners. The most accurate measure is total company dilution because it "provides an understanding of the dilution caused by all company-sponsored programs." This measure looks at all of the company's plans and counts all shares that are proposed in the plan being voted on plus any proposed, available, or outstanding shares in all other plans. Most institutional shareholders use total company dilution as their principal measure for evaluating the dilutive effects of stock option plans.


Dilution may be evaluated four ways: (1) by only the proposed shares; (2) by the proposed plan, including the proposed shares and any available or outstanding shares under the plan; (3) by total plans, including proposed, available and outstanding shares under all company plans; or (4) by per-year dilution represented by the proposed shares divided by the plan length.

Ruxton, supra, at 17.

11. Ruxton, supra note 10, at 17. The statistical computations of total company dilution are explained infra Part IV.

12. The difficulty with this measure is that it requires examining the footnotes of the company's financial statements to compile the information needed to calculate it.

13. See Ruxton, supra note 10, at 18 (stating that, in a 1996 survey, the Investor Responsibility Research Center ("IRRC") found that 30% of the surveyed institutions had guidelines mandating a negative vote for stock option plans if the total company dilution measure exceeded 10%, while virtually all of
The dramatic increase in the value of stock option compensation and its effect on other shareholders has focused increasing attention on the underlying benefits and costs of stock options. In the next section, we explore the theoretical justifications for stock options and some of their problems.

B. What Are the Purposes of (and Problems with) Stock Option Plans?

Companies offer three main justifications for stock option plans: first, they can be used to attract or retain highly qualified managers and employees; second, they incentivize managers and employees to perform better; and third, they help align the interests of managers and employees with those of the stockholders of the company. With regard to the first justification, many companies use stock option plans to recruit and keep talented executives and employees. Stock option plans allow small companies to compete with the larger public corporations in hiring and keeping talented individuals that they might not otherwise be able to afford. Furthermore, stock option plans are an attractive form of compensation for companies because of their favorable accounting treatment and preferred tax status.

Stock options are frequently justified on a second basis: that they represent "pay for performance," that is, that they base an ex-

the remaining institutions would consider voting against such plans). However, some shareholders disregard dilution measures because they believe that the company can use the money that executives pay for these shares for productive purposes. See id. The same cannot be said about awards of restricted stock or discounted options because executives pay little or nothing for these shares. See id.


16. See Clawson & Klein, supra note 15, at 39. For example, Silicon Valley start-up companies do not have the capital or borrowing power to attract experienced and talented executives from the larger corporations. See id. Yet, the high growth potential of these companies makes their equity securities very attractive. See id.

17. See Thomas, supra note 14, at 144. Under existing accounting rules, these options can be issued without charging anything to the company's earnings. See id.

executive's remuneration on her company's increase in value. Stock options may improve executives' and employees' performance because the options' value depends on the company's stock price exceeding the exercise price of the option. Executives and other employees have financial incentives to work to get stock prices up. The clearer the link between the company's stock price and the executives' or employees' performance, the greater the incentive effects (and the more justified the rewards). In other words, pay for performance is a way of incentivizing managers to work harder to increase firm value by giving them a share of any gains that they help to create. In recent years, institutional investors have advocated the use of pay for performance on these grounds.

Finally, stock option plans provide managers and employees with a proprietary interest in the company. By doing so, stock options help align managers' interests with those of shareholders. Stock-based pay, therefore, is claimed to be superior to more fixed components of compensation, such as salary and bonuses, because it rewards managers for thinking like shareholders.

Stock options can be used to get managers to take more (justified) risks. To understand this point, consider the following. Man-

19. Id. at 306 (stating that stock options have been approved by Congress as performance-based compensation). In theory, boards could use changes in salary and bonuses to incentivize managers to perform better. However, under current conditions, it seems very unlikely that this will occur. See Brian J. Hall, A Better Way to Pay CEOs?, in EXECUTIVE COMPENSATION AND SHAREHOLDER VALUE: THEORY AND EVIDENCE 35, 42 (Jennifer N. Carpenter & David L. Yermack eds., 1999). Political pressures will prevent boards from awarding huge bonus payments that are likely to attract criticism from the media and shareholders, whereas friendly boards are unlikely to cut executive pay sharply when things go poorly. See id.

20. See Bank, supra note 18, at 306.

21. But see Clawson & Klein, supra note 15, at 33 (arguing that this assumption is wrong).


23. See Melton, supra note 14, at 502-03.

24. See EDWARD LAZEAR, PERSONNEL ECONOMICS FOR MANAGERS 122 (1997); Hall, supra note 19, at 36; see also Kevin J. Murphy, Executive Compensation, in HANDBOOK OF LABOR ECONOMICS 2485, 2510 (Orley Ashenfelter & David Card eds., 1999) (discussing the incentive implications of stock options).

25. A related idea is that executives and directors should have long-term equity interests in their companies so as to better align their incentives with those of shareholders. Some scholars have argued that reform efforts should focus on getting officers to hold large amounts of equity, in the form of restricted stock not capable of transfer, for long periods of time. See Joshua A. Kreinberg, Note, Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive, 45 DUKE L.J. 138, 172-73 (1995) ("[E]xecutives should be required to ride the corporate enterprise's roller coaster of fortune.").

26. See Murphy, supra note 24, at 2510 n.29 (citing D. Hirshleifer & R. Suh, Risk, Managerial Effort and Project Choice, 2 J. FIN. INTERMEDIATION 308 (1992)).
agers and shareholders exhibit different degrees of risk aversion. Managers are heavily invested in the corporations that they manage with their jobs and salaries at risk if the corporations become insolvent. Executive salaries are a fixed claim against the corporation whose value declines if the firm’s value fluctuates substantially. Furthermore, the value of a manager’s human capital may decline if her company takes risks that do not payoff. The success or failure of a project proposed by an executive will reflect on how that executive is perceived within the company and by outsiders. Bad outcomes will hurt the executive’s future earnings. These factors lead managers to be risk-averse in their corporate decision-making because they have little to gain if the company does well and much to lose if it does poorly.

By contrast, diversified shareholders are more inclined to have the corporation undertake riskier projects with higher returns. By holding a portfolio of stocks from different companies, they can eliminate the risk that any one company’s performance will have too dramatic an effect on their investments as a whole. Thus, shareholders are less risk-averse than managers with respect to the future of any particular corporation whose stock they hold.

A compensation plan needs to include provisions that give managers incentives to undertake risky, high return projects that maximize expected firm value. The expected value of stock options rises

27. In other words, managers are undiversified because both their human capital and financial capital are invested largely in their own companies. For this reason, and the fact that they are often restricted in their exercise or sale of the options, company executives will place a lower value on stock options than other investors would. See id at 2511. These effects will be mitigated or offset by managers’ access to superior information about the company’s future prospects, which may allow them to time their exercise of the options. See id. at 2511 n.30 (citing David L. Yermack, Good Timing: CEO Stock Option Awards and Company News Announcements, 52 J. FN. 449 (1997)).

28. See MILGROM & ROBERTS, supra note 6, at 430.

29. See id.

30. See id.

31. See id. at 429 & n.14. In large public corporations, with large numbers of shareholders who can spread their risks widely, shareholders may be effectively risk neutral. See id.


The difference in the relative risk aversion of managers and shareholders creates a tradeoff between risk sharing and incentive pay. Optimal risk allocation principles argue in favor of putting risks on the party that is least risk-averse, as that party will demand less of a risk premium for bearing those risks. If managers are more risk-averse than shareholders, then the risks associated with non-manager induced changes in the company’s stock price should be placed on the shareholders and not on the managers, as managers will demand an extra premium for bearing those risks. Thus, risk allocation principles call for the elimination of performance incentives from executive pay. In other words, “[p]lay for performance, when the performance measure is noisy, inevitably imposes an inefficient level of risk on management. The risk premium that
with the volatility of the underlying stock's price. Managers that receive option grants, therefore, have incentives to undertake business projects that increase the volatility of the company's asset values. An appropriately designed compensation package will pay executives a relatively fixed salary plus a sufficiently large amount of stock options to offset their inclinations to be too risk-averse.

Stock options have the additional advantage of rewarding success and not penalizing failure. This asymmetrical payoff structure "helps to offset the greater weight that risk-averse managers give to the decrease in the value of their human capital that follows a failure than they give to the increase that follows success and that thus leads them not to want to take risks." Again, such a payoff structure encourages managers to implement risky projects that shareholders would want them to undertake.

Despite these sound theoretical justifications, the critics of pay for performance have become more numerous in the past few years. Accepting the idea that giving executives stock interests in the company will incentivize them to work harder to improve the company does not end the debate over the appropriate level of their compensation. Even if managers' pay should be tied to increases in stock prices during the relevant time period, and these increases can be attributed to the efforts of the managers, "the question is still open as to what portion of that additional wealth should be paid to the CEO." Thus, even if the theory of pay for performance is accepted, this only marks the beginning of the inquiry.

Several crucial questions about incentive pay remain unanswered. For example, if an executive is highly motivated by $1 million in stock options, then will she be more motivated and work harder if the board awards her $2 million in stock options? If so, will the improvement in performance be worth the additional cost? Do executives (or boards) even understand the incentives provided

executives must be paid to bear that risk is the price of pay for performance systems." Ronald J. Gilson, Executive Compensation and Corporate Governance: An Academic Perspective, in 25TH ANNUAL INSTITUTE ON SECURITIES REGULATION 666 (PLI 1992).

33. See Smith & Watts, supra note 32, at 147.
34. See Murphy, supra note 24, at 2510 (citing studies that discuss the relationship between stock options and business projects that increase the volatility of the company's asset values).
35. See Smith & Watts, supra note 32, at 147-48. In order to preserve the incentive features of the compensation package, the board may need to restrict the executive from cashing in the stock options through the use of longer vesting periods. See Hall, supra note 19, at 45. Also, the board may wish to stop the executive from selling off all of her stock by establishing guidelines or goals about how much of the company's stock an executive must own. See id.
36. MILGROM & ROBERTS, supra note 6, at 431.
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by stock options? In order to understand the incentives generated by stock options, executives must understand how different actions and events affect the value of their options. Valuing a stock option requires using the Black-Scholes formula and is not an intuitive process.

How do the executive’s incentives change over time? Will the board of directors need to give her higher levels of stock options next year in order to maintain her incentives at that time? Or do executives develop the habit of working hard to grow the company, so that they will keep working hard no matter what the pay? Do social comparisons matter, so that if executives at one company get pay increases, while those at a second company do not, the latter’s efforts decrease? If so, this suggests that the absolute level of pay may be less important than relative pay levels.

On a more practical level, a lack of correlation frequently exists between pay and performance. For example, CEO pay increased an average of 9.4% in 1991, while their companies’ corporate profits declined 7% and median stock prices fell 7.7%. In a similar vein, CEO compensation in the 1980s increased 212%, while earnings per share rose only 78%. These statistics illustrate how the rhetoric of pay for performance may not correspond to reality.

There are also many design problems in pay for performance contracts. Many so-called performance-based compensation packages do not base remuneration on the actual performance of the executive or the corporation. Instead, pay is based on economic indicators, which may not accurately reflect how an executive is performing. For example, stock price increases may be caused by market fluctuations and not by the efforts of a company’s management.

Existing types of pay for performance compensation packages may not appropriately align an executive’s pay with her company’s performance from the shareholders’ perspective. To understand this point, it is first necessary to explain a bit about the valuation of stock options. Under current practices, CEOs are typically awarded stock options with a ten year duration and an exercise price equal to the current stock price for the company’s common stock (“at the money” options). The value of these options is sensitive to the price

38. See Hall, supra note 19, at 39.
39. See id. Hall suggested that boards ought to adopt the practice of “scoring,” or valuing, their executives’ stock options each quarter so that the executives and boards can better understand how the value of these options changes with the stock market. Id. at 44.
40. See Bogus, supra note 1, at 7.
42. See id. at 66.
43. See id.
44. See Hall, supra note 19, at 39-40.
of the company's stock, but the value of one option is less than the value of one share of the company's stock.\textsuperscript{45} Thus, for the same \textit{ex ante} value transfer, the board of directors can award an executive a larger number of stock options than stock shares.\textsuperscript{46} Awarding stock options rather than stock will greatly increase the pay to performance sensitivity of the executive's pay because of the leverage effect of stock options.\textsuperscript{47}

However, the sensitivity of pay to performance could be further increased by awarding "out of the money" options or indexed options.\textsuperscript{48} Out of the money options are even more sensitive to changes in the company's stock price than at the money options.\textsuperscript{49} This means that a board can award even more out of the money options than it can at the money options to achieve the same \textit{ex ante} value. The leverage effect of out of the money options will be greater than that of at the money options.\textsuperscript{50} Similar logic applies to the use of indexed options rather than at the money options.\textsuperscript{51}

Shareholders would much prefer that boards award CEOs out of the money or indexed options than at the money options, because they "raise the hurdle" for CEOs.\textsuperscript{52} The out of the money option forces the CEO to raise the stock price by substantially more than its current level in order for the option to have value when it is exercised. The indexed option requires the company to beat the stock

\textsuperscript{45} If the value of the common stock changes, then the value of the stock option changes, too. The amount of the change that occurs is the option's delta. An option's delta, that is the change in the value of the option for a derivative change in the stock's price, is less than one.
\textsuperscript{46} See Hall, supra note 19, at 40. In the example that Hall used, the board could award three times as many stock options as shares of stock for the same \textit{ex ante} value transfer. \textit{Id.}
\textsuperscript{47} Perhaps the best way to illustrate the additional leverage created by stock options is with an example. Hall compared the value of a one million share transfer where the stock was trading at $1.00 per share with the value of an equivalent value (\textit{ex ante}) transfer of three times as many stock options. \textit{Id.} If the company's stock price rose from $1.00 per share to $1.25 per share, he calculated that the value of the stock would rise by $0.25 million, whereas the value of the options would increase by $0.43 million. See \textit{id.}
\textsuperscript{48} See \textit{id.} at 43.
\textsuperscript{49} In other words, out of the money options have a lower delta than at the money options.
\textsuperscript{50} The intuition is that the board can award more of the lower valued, out of the money stock options than at the money options for the same \textit{ex ante} value. If the company's stock price increases, the value of the out of the money options increases more than the value of the at the money options. See Hall, supra note 19, at 42.
\textsuperscript{51} Indexed options have exercise prices that rise with a market index change. See \textit{id.} at 43. Executives only make money on indexed options if the company's stock price rises by more than the market index. See \textit{id.} Each option is therefore worth substantially less than at the money options, and, as a result, the board can award more of them for the same \textit{ex ante} value. The net effect is to increase the sensitivity of executive pay to company performance. See \textit{id.}
\textsuperscript{52} See \textit{id.}
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market before there is any payoff to the CEO. In fact, these types of options are rarely used today.

Stock option repricing is another point of shareholder concern. Companies claim that stock options lose their incentive value if the stock price falls far enough below the exercise price that there is little chance the executive will exercise the option. Thus, they claim that the incentive effects of this form of compensation no longer exist. To restore these incentives, companies drop the exercise price of these existing options to the current level of their stock price, thereby “repricing” them.

Shareholder critics claim that option repricing is an egregious abuse of their rights. These investors argue that the alignment of shareholder and management incentives only exists if executives are unrewarded when stock prices fail to rise or fall. Shareholders further complain that they do not enjoy similar treatment for their

53. See id. at 43-44.
54. See Murphy, supra note 24, at 2508-09 (stating that 95% of stock options granted today are at the money options, while only 1.5% of options were at above market prices and only one company granted indexed options). Murphy found the absence of indexed options and other relative performance measures in executive compensation to be “a puzzle worth understanding.” Id. at 2539.

Ruxton found that, out of the 1189 firms in the S&P Super 1500 covered in her study, only 36 firms, or 3%, repriced stock options in 1998. Ruxton, supra note 2, at 18. Most of these firms were in the Technology Sector, with 20 of the 36 firms being from that industry group. See id. Most technology firms are in the S&P 600 SmallCap index. While these numbers are fairly low, Ruxton pointed out that the practice could become much more widespread if there were a sustained decline in the stock markets. Id. at 19.
56. See Graef S. Crystal, In Search of Excess 176 (1991); Charles M. Yablon, Overcompensating: The Corporate Lawyer and Executive Pay, 92 Colum. L. Rev. 1867, 1880 (1992). With repricing, no downside risk exists for an executive whose salary purportedly depends on his company's performance. See Kreinberg, supra note 25, at 151 (“Revaluation allows directors to remove effectively the downside risk of performance pay while maintaining some semblance of a competitive compensation.”). However, under Treasury Department regulations, stock options that have been revalued will not be classified as performance-based compensation for purposes of the deductibility limit:

If the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (e.g., in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of the grant), none of the compensation attributable to the grant or award is qualified performance-based compensation . . . .

Treas. Reg. § 162.27(e)(2)(vi)(A) (as amended in 1995); see also Bank, supra note 18, at 307 (stating that the amount of compensation must be based only on a rise in the value of the stock).
57. See Crystal, supra note 56, at 216.
stock when the price of the company's shares falls.68

Stock option compensation may lead managers to manipulate earnings or other accounting figures so as to insure that the company meets or exceeds analysts' expectations and that the company's stock price rises.69 Executives holding options also have a tendency to avoid dividends and engage in share repurchases.70 This raises important questions about whether managers are running the company to increase the value of their stock options or to raise the value of the common stock held by the shareholders.71 This issue may be critical at certain times in the corporation's life cycle, such as when deciding to take the company public. Managers may bring the company to market too quickly in order to realize immediate value for their stock options.

Numerous other criticisms have been levied against pay for performance. These complaints include: many performance-based compensation packages use inadequate accounting indicators to measure the company's performance,62 pay for performance packages based on attaining economic performance measures may lead managers to engage in unethical behavior to insure that the company meets performance goals,63 and the derivatives market can be used

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58. A related practice is called the reload option. "Reload provisions issue new options to replace shares sold to pay the exercise price of exercised options. The new options are granted at fair market value with a term equal to the remaining term on the option exercised." Murphy, supra note 24, at 2508 n.27. This gives executives a "heads I win, tails we start over" deal. American Law Institute's Principles Widely Accepted by Boards, Courts, 67 U.S.L.W. 2105, 2106 (U.S. Aug. 25, 1998) (quoting John C. Coffee Jr., Columbia University School of Law).

59. See Kreinberg, supra note 25, at 152 ("[E]xtreme short-run stock price can be manipulated through the disclosure or delay of disclosure of certain bits of information that do not rise to the level of materiality necessary for securities law violations."); Loewenstein, supra note 37, at 208; see also Paul Healy, The Effect of Bonus Schemes on Accounting Disclosure, 7 J. ACCT. & ECON. 85, 106 (1985) (finding that management selected accounting procedures in a manner that maximized the value of its bonus awards).

60. See Murphy, supra note 24, at 2510 (citing studies that examine the relationship between stock options and dividends).

61. One commentator has suggested that option-based compensation for executives, combined with the fact that they are unable to diversify their investments, has made managers the real owners of the companies that they run. See Richard A. Booth, It's Bosses, Not Shareholders, Who Own the Company, WALL ST. J., Apr. 13, 1998, at A22.

62. See Kreinberg, supra note 25, at 150. For example, using return on equity as an indicator can lead to management "subtly manipulating" various discretionary responsibilities to award themselves higher compensation without providing any long-term benefit to the company. Id. at 152. Thus, shareholders may be lulled into a false sense of security by compensation classified as performance-based and will be less likely to investigate pay practices.

63. See id. at 153 ("If an individual's pay hinges upon the attainment of a certain economic indicator, he may be willing to allow questionable practices to occur in order to reach the indicator.").
SHAREHOLDER VOTING

by executives to trade stock options for fixed payment streams based on factors other than the company's performance.64

Many companies argue that the alleged "abuses" are necessary parts of incentive pay. Option repricing, for example, is claimed to be needed to insure that managers continue to have incentives to perform even if their company's stock price drops after the grant of their original options.65 This is particularly important, companies

64. Bank asserted that the real problem with stock-based compensation is that the derivatives market can be used to circumvent the goals of performance-based compensation. Bank, supra note 18, at 314. According to Bank, the "explosion" of the derivatives market in recent years, combined with the recent innovative applications of it, may have become "the single biggest threat to the notion that stock-based executive compensation will better align pay with performance." Id. One common way that executives use the derivatives market is by employing an "equity swap." Id. at 318. An equity swap is a type of derivative contract in which the holder of the stock pays a second party the stock's dividends for a certain period of time and also pays the second party the net gain in the stock's value at the end of that period. See id. In return, the second party agrees to pay the owner of the stock the income from a diversified investment based upon the value of the stock and will also pay for any loss in value to the stock at the end of the specified period. See id. Unexercised stock options can also be sold in the derivatives market. See id. at 322 ("Even a plain vanilla sale of an executive stock option can yield a greater return than the simple difference between the stock price and the exercise price.").

By employing the derivatives market, executives not only can collect a salary that qualifies as performance-based for purposes of corporate tax deduction, but one which also allows them to avoid the risk of owning the company's stock. See id. at 318 (stating that investors can change the risk profile of their portfolio by using derivatives such as equity swaps). In addition to avoiding risk, executives also avoid the capital gains tax (since the stock is not sold) and still retain voting power in the company. See id. at 319-20.

Bank pointed out three further areas of executive compensation where the derivatives market creates problems. Id. at 323-29. First, use of the derivatives market leads to a situation where an executive's compensation is not based at all on his or her company's performance, which is what stock-based compensation was designed to do. See id. at 324. What is worse, some equity swaps can be designed so that an executive's compensation is dependent on the failure of his or her own company or on the success of a competitor. See id. Also, Bank pointed out that shareholders may be fooled into thinking that the executive's pay is linked to performance because he or she still owns and votes the stock. Id. at 324-25 (noting that the SEC disclosure requirements may not alleviate this problem).

Another basic problem of the derivatives market in issues of executive compensation is that it makes valuation difficult. See id. at 326 (noting the difficulty of valuing compensation when the derivatives market is used). Bank noted that "by pushing executives further into strategies of financial innovation, executive compensation reform may be driving the true value of pay packages underground." Id.

A fourth problem that Bank pointed out was that the derivatives market allows executives to be taxed on a contingent basis when, in reality, they are receiving a fixed income. Id. at 327. As a result, the executive gets "the security of a fixed-return asset with the deferred tax payments of a contingent-return asset." Id. at 328.

65. See id. at 320.
say, where the decline in stock prices is caused by economic factors beyond executives' control.66

Other criticisms can be addressed through an appropriately designed pay for performance package. For instance, the criticism that stock options may reward executives even though the rise in the stock's price was due to market factors can be taken care of by using an indexed option.67 Critics' concerns that management will manipulate the short-term price of the company's stock can be overcome by requiring executives to hold their stock for longer periods of time.68 Stock options can be made to have a downside risk for executives by using a "purchased stock option."69 Finally, the government could prohibit executives from using derivative instruments as a way of realizing immediate value on their stock options.70

II. SHAREHOLDER VOTING ON STOCK OPTION PLANS

Until a few years ago, most, if not all, companies' stock option plans had to be approved by their shareholders.71 As boards of directors awarded ever-larger numbers of stock options, shareholder resistance to approving these plans increased substantially. One study found that:

Where once there was an assumption that any plan presented by management and directors for approval would receive no more than token 3% to 5% disapproval, the 1995 and 1996 proxy seasons saw significantly stronger shareholder resistance to these plans, as votes against stock option plans in the

66. See id.
67. See id. at 312. An indexed option is one where "the exercise price of the option is adjusted to the price movements of a designated index such as the Standard & Poor's 500 or to an index more narrowly tailored to the company's industry group." Id.; see also Clawson & Klein, supra note 15, at 47 ("[T]he most rational stock option plan structure is to adjust the exercise price of the stock option up or down, depending upon the performance of a company's stock relative to a market index, an industry index, or some combination of both.").
68. See Bank, supra note 18, at 313. To do this, a company can use what is known as a "deposit share option program," which requires executives to deposit shares that they already own with the company in return for an option grant. Id.
69. Id. A purchased stock option is simply an option that requires the executive to pay a significant amount of money before it is granted, thus resulting in a real loss if the price of the stock falls below the exercise price. See id.
70. See id. at 330 (noting that the SEC now requires insiders to disclose their participation in equity swaps). The SEC has issued some regulations concerning the use of equity swaps. See id. However, Bank is skeptical that such regulations will be successful in preventing new derivative instruments from being created to replace equity swaps. Id.
range of 20-40% become more commonplace. While only three companies' proposals were defeated in that time period, another twenty-eight proposals received negative votes of 40% or more. More recent data for stock option plans put up for votes between July 1997 to June 1998 show that fifteen plans were defeated out of the more than 2000 plans proposed. These defeated plans would have potentially increased the dilution of existing shareholders by between 8% and 33%. 

In recent years, several little-noticed changes in Securities and Exchange Commission ("SEC") and stock exchange regulations have chipped away at the requirement that stock option plans be approved by shareholders. Prior to 1996, Rule 16b-3 required shareholder approval of employee benefit plans that were to be exempt from Section 16(b), the short swing prohibition for corporate insiders. In 1996, the SEC reformulated the rule so that exempt plans need only be approved by the board of directors, a disinterested committee of the board of directors, or the shareholders. Many companies choose one of the new alternative director approval routes.

By itself, this change did not alter the need for shareholder approval of most stock option plans. Shareholder approval for many stock option plans still was necessary for several other independent reasons. First, a few important corporate codes require shareholder approval of stock option plans, and all states mandate shareholder approval if the corporate charter must be amended to increase the number of authorized shares of stock for a stock option plan.

Second, the federal tax code provides companies with tax benefits for certain types of shareholder-approved stock option plans.

72. Id. at 10.
73. See id. at 10-11, 29 tbl.5.
74. See Joann S. Lublin & Leslie Scism, In New York: Stock-Option Plans Breed Resentment Among Investors, WALL ST. J. EUR., Jan. 12, 1999, at 5B (citing Richard Wagner, president of Strategic Compensation Research Associates). Furthermore, those plans that were approved frequently had high percentages of votes against them. See id.
75. See id.
76. See 17 C.F.R. § 240.16b-3(b)(1)-(2) (1995) (amended 1996). Before 1996, Rule 16b-3 stated that an employee benefit plan was exempt from Section 16(b) if it had been approved "[b]y the affirmative votes of the holders of a majority of the securities" or by their written consent. Id.; see also Wagner & Wagner, supra note 71, at 11-12 (discussing the effects of the SEC's reformulation of Rule 16b-3).
77. See 17 C.F.R. § 240.16b-3(d)(1)-(2) (1999).
78. See, e.g., N.Y. BUS. CORP. LAW § 505(d) (McKinney Supp. 1999) (stating that "[t]he issue of ... rights or options to one or more directors, officers or employees of the corporation ... shall be authorized by a majority of the votes cast at a meeting of shareholders"); see also Wagner & Wagner, supra note 71, at 13 (discussing the treatment of option plans under various state laws).
79. See Wagner & Wagner, supra note 71, at 13-14.
80. See id. at 14-15.
Section 162(m) of the Internal Revenue Code ("IRC") allows companies to deduct executive compensation in excess of $1 million if it is paid out under the terms of a performance-based stock option plan. The IRC's definition of performance-based plans requires that they be approved by shareholders.

Finally, all national stock exchanges have rules requiring shareholder approval of many stock option plans. However, the SRO requirements have been under attack. For example, until 1998, the New York Stock Exchange ("NYSE") required that listed companies seek shareholder approval for virtually all stock option plans that were not "broadly based." In January 1998, however, the NYSE sought SEC approval to expand the types of option plans that were exempt from shareholder approval. One of the proposals expanded the definition of broad-based plans and created a non-exclusive "safe harbor" for those plans in which 20% of the company's employees, half of whom must be neither officers nor directors, are eligible to participate. Plans falling within the safe harbor would not require shareholder approval. The SEC received no comments on the proposed rule changes and approved them on April 8, 1998.


Incentive stock options ("ISOs") are a second type of stock option plan that is tax advantaged but requires shareholder approval. See Wagner & Wagner, supra note 71, at 15. ISOs create no taxable income for employees when they exercise the option and purchase the stock. See id. Furthermore, if the employee holds the stock for a minimum of one year, there is no taxable gain to the employee until she sells the underlying stock. See id. However, ISO plans are used primarily for lower or middle level corporate employees because their awards are limited to a maximum value of $100,000. See id.

82. See 26 U.S.C. § 162(m)(4)(C)(ii) (1994). It is possible that stock option plans directed solely to officers and directors who are not "covered individuals" under the IRC's definition could be considered performance-based, but this would require excluding the company's CEO and four other highest paid individuals. See Wagner & Wagner, supra note 71, at 14.

83. See Wagner & Wagner, supra note 71, at 12-13.

84. See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc., Exchange Act Release No. 34-39659, available in 1998 WL 63612, at *1 (Feb. 12, 1998). The one exception was for plans designed to induce someone not previously employed with the company to join the firm. See id.

85. See id.

86. See id. at *2. In addition, the proposal stated that, when deciding if a plan is broad-based, a variety of factors would be examined, such as the number of people covered by the plan and the nature of the employees. See id. Another significant proposed change was that non-broad-based plans that dilute shareholder equity less than 5% would no longer require shareholder approval. See id.

87. See id.

The adoption of the rule changes triggered an uproar among institutional investors. They objected that companies could easily design option plans under them which would not need shareholder approval. In response to these objections, the NYSE established a task force to study the question. At the recommendation of the task force, the NYSE again proposed changes to the shareholder approval rules in October 1998. Under the new proposals, an option plan is classified as “broadly-based” if a majority of the company’s full-time, exempt employees in the United States are eligible to participate in it and if, within the shorter of three years or the term of the plan, a majority of the shares awarded under the plan go to employees who are not officers or directors.

A number of large institutional investors objected to the revised proposals. On December 28, 1998, the SEC extended the period in which it would receive comments on the new proposal. Thus, as of this writing, the “20%” rule remains intact.

Even where there is no need to seek shareholder approval for a stock option plan, companies may still seek this authorization so that the board of directors gains substantial protection from deriva-
tive suits alleging breach of fiduciary duty.\textsuperscript{95} For example, in Delaware, if the board of directors that approves the stock option plan is comprised of "interested" directors, they will bear the burden of proof in a lawsuit challenging their actions.\textsuperscript{96} By getting the shareholders to ratify this decision, the directors in most cases will be protected from personal liability against charges that they violated their duty of loyalty and their duty of care.\textsuperscript{97}

Although shareholder approval is still required in many circumstances, increasing shareholder opposition levels have led some boards to devise strategies to avoid shareholder votes when possible.\textsuperscript{98} For example, one such strategy is to add a provision to a shareholder-approved plan that allows management to replenish the pool of authorized shares in the plan using repurchased shares.\textsuperscript{99}

\begin{itemize}
\item \textsuperscript{95} See Wagner & Wagner, \textit{supra} note 71, at 24.
\item \textsuperscript{96} See DEL. CODE ANN., tit. 8, § 144 (Supp. 1998); see also Eric J. Wittenberg, \textit{Underwater Stock Options: What's a Board of Directors to Do?}, 38 AM. U. L. REV. 75, 85-86 (1988) (stating that, if the board is disinterested in the transaction and satisfies its other fiduciary duties, then its decision to approve the stock option plan will normally be protected by the business judgment rule when being reviewed by the courts).
\item \textsuperscript{97} See Lewis v. Vogelstein, 699 A.2d 327, 335-36 (Del. Ch. 1997) (holding that shareholder ratification of a stock plan that includes directors as potential beneficiaries will act as an impediment to the allegation of violation of duty of loyalty or duty of care).
\item \textsuperscript{98} As discussed \textit{infra} Part IV, this opposition appears to be growing over time. One possible reason for this increase in shareholder disapproval might be the increase in institutional investor activism because of high levels of executive and director stock ownership—over 3.5% average beneficial ownership at large American companies. See Wagner & Wagner, \textit{supra} note 71, at 10. This number grows to 11.9% if we take into account the tremendous potential dilution of shareholders' equity that could result if already authorized but unissued and already granted but unvested stock options are actually granted and exercised. \textit{See id.}
\item Wagner argued that, although resistance had grown and should cause some concern, the reports of this trend are often overstated. Richard Wagner, \textit{Obtaining Shareholder Approval of Stock Plans}, INSIGHTS, Dec. 1997, at 13. He stated that "75 percent of companies seeking plan or share authorization still enjoy the support of 80 percent of their voting shareholders, and more than half enjoy 90 percent plus support." \textit{Id.}
\item Wagner found that one of the main reasons that stock option plans fail or that there is high resistance to them is because of poor communication between management and the shareholders. \textit{Id.} at 13-14. In response to this problem, he proposed four guidelines that management should follow in order to be successful in gaining shareholder approval for stock option plans. First, "[d]ecide what the business needs even if it 'violates' some interest group's or institution's guidelines." \textit{Id.} at 14. Second, "[i]dentify and heed those who own the business not just to the loudest voices." \textit{Id.} at 15. Third, "[j]ustify the business need and then propose only what is required." \textit{Id.} Finally, "[c]ommunicate business and competitive strategy directly to the owners, in the proxy and perhaps in personal contact." \textit{Id.} at 16.
\item \textsuperscript{99} See Wagner & Wagner, \textit{supra} note 71, at 17-18. Wittenberg suggested a similar strategy when dealing with underwater options. Wittenberg, \textit{supra} note 96, at 104-05. He recommended that, when devising stock option plans,
Although these plans do not directly dilute the remaining shareholders' stake in the company,\footnote{100} this strategy nevertheless causes a transfer of voting control and wealth of the company from the unaffiliated shareholders to corporate management.\footnote{101}

III. FOUR CASE STUDIES OF DEFEATED STOCK OPTION PLANS

In our data set for the 1998 proxy season, shareholders defeated only four companies' proposals to amend stock option plans. In this section, we examine each of these companies and their proposed plans to try to determine what led to this result.

A. Gymboree Corporation

The Gymboree Corporation ("Gymboree") is based in Burlingame, California.\footnote{102} The company specializes in designing, manufacturing, and retailing high-quality children's apparel.\footnote{103} It operates 434 stores in the United States and abroad.\footnote{104} After a management change in 1997 that successfully dealt with the company's persistent inventory problems, the company was rated the "Stock of the Week" by the San Francisco Chronicle.\footnote{105} Gymboree's stock closed at $24.94 on July 11, 1997.\footnote{106}

In the following months, the company engaged in a $30 million stock repurchase program\footnote{107} and had several strong quarters of financial results, with the result that its stock price rose 26% in 1997, to close at $28.69 per share on December 4, 1997.\footnote{108} This upward trend continued into 1998, leading Gary White, president and chief executive officer, to state that, "Fiscal 1997 was a year of building

\footnotesize{the committee in charge should write in a provision that allows it to issue new options when the stock price falls under the exercise price. See id. By doing this, the committee no longer needs to get shareholder approval every time it wishes to reissue because, if the shareholders ratified the master stock option plan, they will have already given their permission. See id. Finally, by wording the plan correctly, the directors can also be protected from corporate waste and/or other charges by the business judgment rule, as long as they operate with sound judgment. See id. at 105.

100. This is true because the replenished shares are coming from repurchased shares. See Wagner & Wagner, supra note 71, at 18.

101. See id. Repurchased share programs may also become very expensive for the company if the market price of the company's stock goes up and, thereby, leads to a "buy high, sell low" situation. See id. at 21.


103. See id.


105. See Emert, supra note 102, at B3.

106. See id.

107. See Gymboree Board Authorizes, supra note 104.

for Gymboree," and that Gymboree was positioned for strong and profitable growth in 1998.109

Investors, therefore, were quite disappointed when, on April 10, 1998, Gymboree reported that "its first-quarter and full-year net income would fall below year-earlier levels and analysts’ projections."110 Its stock tumbled sharply in response, dropping 9.4% to $21.625 per share.111

Just a little more than a month later, Gymboree held its annual shareholder’s meeting to vote on, among other things, amendments to its 1993 stock option plan.112 The most important proposed amendment would have changed the plan into an evergreen plan,113 adding two million shares to the plan114 and automatically increasing that number on the date of each subsequent annual stockholders’ meeting so that the number of shares reserved for issuance under the plan always would equal two million shares.115 If enacted, the plan’s initial increase of two million shares would have raised the total dilution from all stock option plans to 21%.116

The Gymboree shareholders overwhelmingly defeated this proposal, with 80.2% of shareholders117 voting against it (including 12.9% that abstained).118 The incredibly high negative shareholder

111. See id.
113. See Lublin & Scism, supra note 74, at 5B. "An evergreen plan lets boards automatically grant a certain portion of outstanding shares every year as options." Id.
114. See Gymboree Corp., supra note 112, at 8. This would bring “the total number of shares reserved for future grant under the 1993 Plan to 2,353,815 shares, and raising the number of shares available since inception of the Plan to 6,025,000." Id.
115. See id. The second amendment was to “impose annual limits on the number of shares subject to stock option grants . . . as ‘performance-based’ compensation within the meaning of Section 162(m) of the Internal Revenue Code.” Id. The final amendment was to “provide for the award of ‘common stock equivalents,’ pursuant to which recipients will be entitled to receive shares of Common Stock on a future date (such as the recipient’s retirement or other termination of employment).” Id.
117. See MANAGEMENT PROPOSALS ON EXECUTIVE STOCK PLANS, IRRC BACKGROUND REPORT 9 (1999) [hereinafter MANAGEMENT PROPOSALS]. Institutional investors control 90% of the company’s voting power. See id.
118. See id. Undeterred by this failure, on February 9, 1999, Gymboree held a special shareholders meeting to contemplate a revised proposal. See id. A Gymboree spokesperson commented that “[t]hey have heard the shareholders' views and are taking actions which are more consistent with what shareholders want.” Lublin & Scism, supra note 74, at 5B. The revised plan will still seek the two million additional shares. See MANAGEMENT PROPOSALS, supra note
vote on the Gymboree proposal appears to be explained by several factors. The evergreen nature of the plan and its high potential to dilute existing shareholders undoubtedly played an important role in the outcome of the vote. However, the unexpected drop in the company's stock price only a month before the annual shareholders' meeting may have served to underscore the shareholders' concerns about the plan itself.

B. Structural Dynamics Research Corporation

Structural Dynamics Research Corporation ("SDRC") is based in Milford, Ohio.\footnote{119} The company specializes in making and distributing software products that perform a wide variety of tasks ranging from product data management to computer aided drafting.\footnote{120} The products are geared to helping manufacturers "improve product quality while reducing product development time and cost."\footnote{121} The company "employs about 1,860 people and has 61 offices in 13 countries throughout North America, Europe, and the Asia/Pacific region."\footnote{122}

After an accounting scandal and an interim period of caretaker management by one of the company's founders,\footnote{123} in June 1997, SDRC hired a new CEO and president.\footnote{124} This management change was followed by generally strong economic results that raised the company's stock price. As of April 29, 1998, the company's stock price had reached $27.25.\footnote{125}

\footnotesize{\begin{itemize}
\item \footnotemark[117] at 9. "However, it would remove language from the plan that specifically contemplated repricing underwater options (leaving the plan silent on that issue), lower the per-employee annual limit from 500,000 shares to 400,000, and omit the evergreen feature." Id.
\item \footnotemark[119] See Ex-SDRC Exec Tolani Gets 1 Year In Jail, CIN. ENQUIRER, Sept. 6, 1997, at B16 [hereinafter Ex-SDRC Exec].
\item \footnotemark[120] See SDRC New CEO: SDRC Board of Directors Announces Successful Conclusion of Search for New Chief Executive Officer, BUS. WIRE, June 19, 1997, available in WESTLAW, BWIRE Database.
\item \footnotemark[121] Id.
\item \footnotemark[122] Id.
\item \footnotemark[123] See SDRC Selects William Weyand as New CEO, CIN. ENQUIRER, June 20, 1997, at B12 [hereinafter SDRC Selects William Weyand]. The accounting scandal consisted of a former executive, Tony Solani, causing SDRC to inflate revenue and earnings reports to the government and investors. See Ex-SDRC Exec, supra note 119, at B16. Solani, during his period of misconduct, received $680,617 from stock transactions and bonuses. See id.
\item \footnotemark[124] See SDRC Selects William Weyand, supra note 123, at B12. Bill Weyand formerly was an executive vice president for Measurex Corp. See id. Measurex founder David Bossen said, "Weyand is known for achieving consistent revenue and profit growth in operations under his direction." Nick Miller, SDRC's New Chief Brings Global Know-How: Weyand Succeeds Co-Founder as CEO, CIN. POST, June 23, 1997, at 8B.
\end{itemize}
On May 7, 1998, SDRC held its annual shareholders meeting, at which management proposed that the shareholders approve the adoption of SDRC’s long-term stock incentive plan.\(^\text{126}\) While SDRC had an existing incentive plan, approved by shareholders in 1994, management told shareholders that this plan contained insufficient stock to meet the future needs of the company.\(^\text{127}\)

The new plan would provide an additional 4.2 million shares for awards to qualifying employees, representing about 11% of the company’s stock.\(^\text{128}\) Furthermore, the new plan gave the board and the plan administrators tremendous discretion in awarding this stock.\(^\text{129}\) Most notably, the board could reprice stock options without shareholder approval.\(^\text{130}\) Total potential dilution from all of the company’s stock plans would have reached 30.8%.\(^\text{131}\)

Despite the company’s strong performance, its shareholders rejected the 1998 incentive plan, with 53.7% of them voting against it or abstaining.\(^\text{132}\) Some institutional shareholders voted against the plan because they felt that it would dilute their holdings too much.\(^\text{133}\) An SDRC spokesman stated, “Out of our top five institutional shareholders, three were for the plan and two were against. But the two opposed are the largest, with about 25 percent of the company’s stock . . . .”\(^\text{134}\) The absence of a restriction on repricing stock options may have also likely played a part in the shareholder vote.

C. VLSI Technology, Inc.

VLSI Technology, Inc. (“VLSI”) is based in San Jose, California.\(^\text{135}\) The company specializes in designing and manufacturing integrated circuits.\(^\text{136}\) The products are geared toward the communications, consumer digital entertainment, and computing markets.\(^\text{137}\)


\(^{127}\) See id. at 13.

\(^{128}\) See Mike Boyer, SDRC Proposal Rejected; Big Shareholders Fear Stock Dilution, CIN. ENQUIRER, May 8, 1998, at B12. Under the 1994 plan, the amount of stock that could be granted could not exceed 4% of the outstanding stock. See id. The 4.2 million shares for the 1998 plan represents about 11% of SSRC’s 37 million shares outstanding. See id.

\(^{129}\) See Structural Dynamics Research Corp., supra note 126, at 14.

\(^{130}\) See id. at A8-A9. The board did not need shareholder approval to amend the plan, except in six circumstances. See id.

\(^{131}\) See HAMBLY & MONACO, supra note 10, at 36.

\(^{132}\) See MANAGEMENT PROPOSALS, supra note 117, at 9.

\(^{133}\) See Boyer, supra note 128, at B12. The plan would have created 11.7% potential dilution. See MANAGEMENT PROPOSALS, supra note 117, at 9.

\(^{134}\) SDRC Vote: No on New Options, CIN. POST, May 8, 1998, at 10C.


\(^{136}\) See id.

\(^{137}\) See id.
VLSI employs approximately 2200 employees worldwide. From May 1997 to January 1998, VLSI shares bounced around as the company's fortunes fluctuated. However, after the markets had closed on February 26, 1998, VLSI announced that first-quarter earnings would be “significantly” under analysts’ estimates. This announcement sent VLSI stock down $5.438 (22%), closing at $19.313 on the volume of 1.5 million shares traded.

On May 14, 1998, VLSI held its annual shareholders’ meeting. The board sought shareholder approval for a variety of different amendments to existing stock option plans. These included: amending the 1992 Stock Plan to increase, from 9,500,000 to 11,500,000, the number of shares reserved for issuance in it and amending the 1986 Directors’ Stock Option Plan by, among other things, adding 300,000 shares to the number reserved for issuance. Under the terms of the proposed amendments to the 1992 Stock Plan, the plan administrator would be able to set the option exercise price at less than fair market value. The increase in the number of shares covered by the plan would have also potentially diluted shareholders by an additional 4.4%. This proposal failed, with 63.5% of the shareholders voting against it. The proposed amendments to add 300,000 shares to the 1986 Directors Stock Option Plan failed, with 50.6% of the shareholders voting against it. If these proposals had passed, the total company dilution from all of the VLSI stock option plans would have reached 43.9%. These negative votes may perhaps be best explained as a function of the
high degree of dilution created by the company's stock option plans and the company's poor recent performance.

D. PhyCor Inc.

PhyCor Inc. ("PhyCor") is based in Nashville, Tennessee.150 The company is a "physician practice management company that operates multi-specialty clinics and manages independent practice associations (IPAs)."151 As of April 1997, it operated "47 clinics with approximately 3,250 physicians in 27 states and managed IPAs with over 15,800 physicians in 23 markets."152

After a series of small acquisitions, on October 29, 1997, PhyCor announced that it would be acquiring its larger, major rival, MedPartners Inc.153 The deal was valued at more than $8 billion, with a $6.98 billion stock swap and PhyCor assuming about $1.2 billion in debt.154 As soon as the markets opened the next day, PhyCor’s stock plummeted due to investor fears that it had agreed to an excessive price for the acquisition.155 The stock fell $5.56 to $24.00 per share.156

In December 1997, rumors of merger troubles began to surface as the spread between PhyCor and MedPartners stock grew to $6.00 per share.157 On January 7, 1998, PhyCor and MedPartners called off the merger.158 This failed merger was very costly to PhyCor: on January 12, 1998, it disclosed more than $100 million in merger-related charges in its fourth-quarter 1997 and first-quarter 1998 re-

150. See PhyCor Reports First Quarter Results, BUS. WIRE, Apr. 22, 1997, available in WESTLAW, BWIREPLUS Database.
151. Id.
152. Id.
153. See Julie Bell & Stacy Hartmann, PhyCor Deal Creates Giant, TENNESSEAN, Oct. 30, 1997, at 1E. After the acquisition, the combined company would have represented 5% of all physicians in the United States. See id.
154. See Martha Brannigan, PhyCor, MedPartners in $6.98 Billion Deal, WALL ST. J., Oct. 30, 1997, at A3. The proposed deal was still subject to shareholder ratification, approval of various state and federal agencies, and other customary conditions. See id.
155. See Shares of PhyCor, MedPartners Fall on Worries About Merger Plans, DOW JONES ONLINE News, Oct. 31, 1997, available in WESTLAW, WIRESPLUS Database. Investors also worried that Phycor's risk profile would be increased and that its growth potential would be reduced. See id.
156. See id.
157. See PhyCor/MedPartners to Be Reworked?, 10 MERGER & ACQUISITIONS REP., Dec. 15, 1997, available in 1997 WL 12988409 [hereinafter PhyCor/MedPartners To Be Reworked?]. Usually, as the deal draws closer to closing, the spread narrows; in this case, however, it had been widening. See Julie Bell, PhyCor Merger May Be in Trouble, Analysts Say, TENNESSEAN, Dec. 10, 1997, at 1E. During this time, there was talk that the deal would be restructured to the detriment of MedPartners. See PhyCor/MedPartners to Be Reworked?, supra.
158. See David R. Olmos, MedPartners, PhyCor Scrap Shaky Merger, L.A. TIMES, Jan. 8, 1998, at D2. The reason cited by the two companies was differences in business philosophies and practices. See id.
PhyCor’s stock promptly dropped 15%, to close at $19.00. On June 1, 1998, the day before its annual shareholders meeting, PhyCor’s stock fell to a 52-week low of $16.13.

On June 2, 1998, PhyCor held its annual shareholders meeting, at which it asked its shareholders to approve amendments to its 1988 Incentive Stock Plan and to adopt a new 1998 Incentive Stock Plan. In amending the 1988 plan, management sought to increase the number of available shares by 1.3 million. This plan would have permitted the board to award non-qualified options at 50% of the fair market value. Shareholders rejected this proposal, with 63.2% voting against the amendments.

On June 1, 1998, the day before its annual shareholders meeting, PhyCor held its annual shareholders meeting, at which it asked its shareholders to approve amendments to its 1988 Incentive Stock Plan and to adopt a new 1998 Incentive Stock Plan. In amending the 1988 plan, management sought to increase the number of available shares by 1.3 million. This plan would have permitted the board to award non-qualified options at 50% of the fair market value. Shareholders rejected this proposal, with 63.2% voting against the amendments.

The proposed 1998 plan would have had six million shares reserved for issuance. Again, non-qualified options could be granted at 50% of the fair market value. The plan was silent as to whether shareholder approval would be needed before management could reprice the options, thereby allowing them to do so. This proposal failed, with 62.9% of the shareholders voting against it.

Collectively, these proposals would have increased total potential dilution to 35.5%. This is “well above the average dilution levels for other smallcap companies and an industry peer group.” That, on top of the company’s poor stock performance and the ability of the plans’ administrators to issue discount options and to reprice options, may have persuaded shareholders to vote against them.

E. Summary of Important Factors

The common thread that ties together the defeat of these four companies’ stock option plans is the relatively high level of total company dilution for shareholders resulting from all of their plans. When we look at the companies at which stock option plans were defeated, the total potential dilution arising from all stock option plans, including those proposed in 1998, ranged from a low of about 20% at Gymboree to a high of 43.9% at VLSI. However, total poten-
tial dilution is not the only important factor. For example, at Gymboree, the defeated plan was an evergreen plan, which would have been indefinitely replenished without shareholder approval if it had been adopted. To make matters worse for management, the company's stock price dropped suddenly on bad earnings news shortly before the company's annual shareholders' meeting. Similar stories emerge for the other companies discussed: high potential dilution accompanied by some other factor seem to explain the stock option plan's defeat. In the case of SDRC, the plan's failure to prohibit stock option repricing appears to have been important to shareholders already worried about excessive dilution. For VLSI and PhyCor, the potential for plan administrators to issue discount options may have tipped the scale.

To better unpack these effects, we need to isolate the impacts of each of these factors on how shareholders vote on stock option plans. In the next section, we turn to univariate statistical tests and multiple regression analysis to isolate the influences of the different aspects of stock option plans on shareholder voting.

IV. DATA AND RESULTS

A. Data

We obtain a shareholder voting database from the Investor Responsibility Research Center ("IRRC") that contains voting results on 637 management proposals on stock option plans as well as information on various features of those plans. Voting results are reported in one of two ways—either as the percent of votes cast or as a percent of total outstanding voting securities. Since most firms report results based on the percent of votes cast, we convert the votes that are reported as a percent of total outstanding voting securities into a measure of the percent of votes cast.\(^{172}\) We include abstentions together with votes against the proposals to determine the variable AGAINST, the percent of votes cast against a proposal.\(^{173}\)

We begin by noting that only five proposals in our sample were defeated by shareholders, or less than 1% of the plans proposed. On average, we find the average level of shareholder opposition equaled

\(^{172}\) At most firms, a majority of the votes cast is sufficient to approve the adoption or amendment of a stock option plan. While other firms require an affirmative vote of a majority of the firm's outstanding shares to approve these plans, for our purposes, the main concern is to have comparable data. We are much less concerned with which plans pass or fail.

\(^{173}\) State law generally treats abstentions as "no" votes for shareholder votes on stock option plans. See generally RANDALL S. THOMAS & CATHERINE T. DIXON, ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL (3d ed. 1998). Average abstentions in our sample amount to only 0.7%. The median level of abstentions was 0.2%. In a total of six proposals, abstentions were between 5% and 10%, and in seven proposals abstentions were between 10% and 18%, the maximum percent of abstaining votes.
18.6%. This indicates a strong level of shareholder support for stock option plans generally. However, there were wide variations in the level of support for the plans that were approved. In the remainder of this section, we empirically examine the determinants of the variable AGAINST. We begin by presenting the results of univariate tests of various factors that lead shareholders to vote against management proposals on stock options.

B. Univariate Tests on Different Features of Stock Option Plans

1. Dilution

The potential dilutive effect of stock options on existing shareholders appears from the case studies to be a major determinant of how shareholders vote on management-sponsored stock option proposals. In this Article, we use two measures of dilution: total dilution and dilution pertaining to each individual proposal. Total dilution, indicated by the variable TOTALDIL, is calculated as all shares reserved for future grants of stock options plus the number of shares subject to outstanding options divided by the total number of voting securities. As noted above in Section I.A, many institutional shareholders vote against stock option proposals if the total dilution of all the company's stock option plans total more than 10%. A total of 489 (77%) of the 637 proposals studied in this Article involve TOTALDIL greater than 10%.

In addition to total dilution, investors also may consider the amount of dilution created by the individual proposal being voted upon. We term this measure of dilution DILPROP, which is calculated as the number of shares reserved for future grants of options plus the number of shares subject to outstanding options in a given proposal divided by the total number of voting securities outstanding. Stock option proposals that involve DILPROP less than 5% are considered "routine" under stock exchange rules. This means that brokers and other intermediaries can vote on them when their clients fail to execute their proxies.\(^7\) Proposals for plans involving more than 5% dilution are not routine, and therefore, the beneficial owners must give voting instructions to these intermediaries.

Companies try to keep the dilution on any individual proposal below the 5% threshold so that brokers can cast routine ballots for two reasons. First, brokers normally vote for management's proposals.\(^8\) Second, it reduces the number of abstentions and nonvotes.\(^9\) Abstentions are counted as votes against a proposal when the proposal must pass with an affirmative vote of the majority of the votes cast. Nonvotes are counted as votes against a proposal when the

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174. See id.
175. See id.
176. See id.
proposal must pass with an affirmative vote of a majority of all outstanding shares. In either of these situations, the company’s proposals are more likely to pass if brokers can vote because the matter is classified as a routine matter under stock exchange rules. Of the 637 proposals studied in this Article, we find that DILPROP is greater than 5% for 201 (32%) of them.

In Panel A of Table 1, we report the average vote against stock option proposals, AGAINST, by whether TOTALDIL is below 10% (“low” TOTALDIL) or above 10% (“high” TOTALDIL), and whether DILPROP is below 5% (“low” DILPROP) or above 5% (“high” DILPROP). The results show that average AGAINST is highest, 24.8%, for the 185 proposals in which TOTALDIL is high and DILPROP is high. This average is significantly greater than the average AGAINST of 18.3%, which occurs when DILPROP is low and TOTALDIL is high. The t-statistic for the difference is 5.07. The average AGAINST for high TOTALDIL and high DILPROP (24.8%) is also significantly greater than the average AGAINST of the low TOTALDIL/high DILPROP combination (AGAINST = 9.2%, t-statistic = 6.55). However, no significant difference exists in average AGAINST between low and high DILPROP when TOTALDIL is low. These results suggest that, on average, stockholders cast more no votes when TOTALDIL is high, but their evaluation of DILPROP may depend on the level of TOTALDIL.

2. Adoption of New Plan Versus Adding Shares to Existing Plan

We next examine average AGAINST, TOTALDIL, and DILPROP by whether the proposal involves the adoption of a new plan or the addition of shares to an existing plan. Typically, adoption of a new plan is the replacement of an existing plan by a new plan. The new plan may include new features and will always include the maximum number of shares that can be granted under the plan. Panel B of Table 1 reports that average AGAINST for plans that add shares to existing plans, 21.0%, is significantly greater than for plans being adopted, 16.6% (t-statistic = -4.21). Proposals that add more shares to existing plans also have significantly more total dilution (TOTALDIL = 17.8%) than proposals in which a new plan is being adopted (TOTALDIL = 15.3%, t-statistic = -3.67), although average DILPROP is very similar for new plans (4.9%) and plans that add shares (4.3%).

3. Participant Eligibility

The stock option plans in our sample have three basic levels of participant eligibility as reported in Panel C of Table 1. In 268 of the 637 proposals (42%), all employees are eligible to participate in the plan. In 251 proposals (39% of the total), the plans are primarily for a limited group of executives and/or directors. Finally, in 118
proposals (19%), only outside directors may participate in the stock option plan. Proposals for plans benefiting all employees experience significantly higher AGAINST (22.1%) compared to plans for either executives (18.1%) or outside directors (11.9%). The t-statistic comparing average AGAINST for all employees’ plans versus executives’ plans is 3.41, while it is 8.27 when comparing all employees’ plans with outside directors’ plans. However, it is also the case that TOTALDIL is significantly higher for all employees’ plans (18.1%) compared to executives’ plans (15.2%), even though DILPROP is not. Outside director plans have the smallest average DILPROP and AGAINST. However, TOTALDIL for outside directors is not significantly different from plans for executives (t-statistic = 0.07). These results suggest that the more widespread the stock option plan, the greater is the no vote. However, since TOTALDIL is higher for plans in which all employees can be eligible, this conclusion must await further testing in a multivariate regression model.

4. Firm Performance

We also compare average AGAINST for firms that have market adjusted stock price performance that is above the median for the sample and those that have market adjusted stock price performance that is below the median for the sample. We obtained 1-year, 3-year, and 5-year total stock returns from the June 1998 Standard & Poor’s ExecuComp database. ExecuComp contains executive compensation data as well as firm performance data for firms contained in the S&P Super 1500 index. We calculate a market average return for 1-year, 3-year, and 5-year periods by averaging the returns for all firms on the database that have been publicly traded for 1, 3, and 5 years, respectively. Market-adjusted returns are then calculated as the difference between a firm’s return over the specified interval and the market average return over the same time period. One-year market-adjusted returns are denoted MARET1YR, 3-year returns are denoted MARET3YR, and 5-year returns are denoted MARET5YR.

A total of 415 firms in our sample have 1-year stock returns available. The average (median) MARET1YR is -2.79% (-6.74%), with the lowest market-adjusted return being -116.92% and the highest being 507.47%. The average (median) MARET3YR is -0.06% (-1.87%), while the low return is -73.40% and the high return is 120.27%. The average (median) MARET5YR is 1.05% (-1.55%), while the low return is -43.88% and the high return is 73.62%.

For MARET1YR, MARET3YR, and MARET5YR, we split the sample at the respective medians to form two groups, “low” returns and “high” returns. Panel D of Table 1 shows average AGAINST by the two groups of returns. For 1-year market-adjusted returns, no difference in average AGAINST exists. However, proposals at firms for which 3-year market-adjusted returns are low garner a signifi-
cantly lower vote against the plans. In other words, stockholders vote more favorably, on average, for proposals when the company's stock price performance has been low than when stock performance has been high. Although, Panel D also shows that, with a TOTALDIL of 14.4%, dilution is significantly lower for firms that have had low 3-year stock performance than for firms with high 3-year market-adjusted stock returns (TOTALDIL = 16.7%, t-statistic for difference in average TOTALDIL = 2.64). Similar results are obtained using MARET5YR. In the regression estimation, we examine whether the impact of prior firm performance is a significant determinant of AGAINST or whether TOTALDIL is a mitigating factor.

5. Features of Stock Option Plans

The IRRC database contains information about the features of each stock option plan. In this section, we examine the impact of several of these features on average AGAINST for those plans which contain them. Shareholders may vote against plans with these features for a variety of reasons, including that they believe that the feature can lead to even higher dilution than the plan initially creates; that they believe the feature can increase the likelihood actual dilution will, in fact, take place; or because they believe that the plan is simply giving participants "too good of a deal."

a. Evergreen plans. Evergreen stock option plans set aside a low, specified percentage of the company's outstanding shares for award each year. Evergreen plans have no termination date, while their cousin, quasi-evergreen plans, do have a termination date, typically several years after their creation.

Many shareholders have opposed the adoption of evergreen plans because, once adopted, they are no longer subject to shareholder approval for the rest of their life. Even though these plans allow only a low percentage of the company's stock to be awarded on an annual basis, over time, these plans can result in substantial dilution of existing shareholders. Although a substantial number of institutional shareholders have voting policies dictating an automatic no vote on these plans, there is some evidence that shareholder opposition to these plans is decreasing over time.

As stockholders generally cast more no votes when dilution is high (see Table 1), they are more likely to oppose features that can lead to even more dilution without their approval. This sentiment is reflected in the average AGAINST of 28.2% for plans with evergreen or quasi-evergreen provisions, compared to an average negative vote

177. See supra note 113 and accompanying text.
178. See HAMBLY & MONACO, supra note 10, at 10-12.
179. See id.
180. See RUXTON, supra note 10, at 22.
181. See id.
of 18.0% without the feature (see Table 2). The difference between these levels is statistically significant ($t = 3.77$).

b. *Discount options.* The overwhelming majority of companies grant their executives stock options with their exercise price set at fair market value for the company's stock, that is, "at the money." However, in a handful of cases, companies have awarded their executives stock options with below-market, or discounted, exercise prices.

Many shareholders have criticized this practice, arguing that discount options give executives less incentive to work to raise the company's stock price than "at the money" options. Without such incentives, the argument that awarding stock options better motivates managers loses much of its force. Not surprisingly, many institutional investors' voting policies require a no vote on plans containing these provisions.

The average AGAINST of 24.2% for plans that can issue discount options is significantly higher than for plans without the feature ($t$-statistic = 5.97). This result is consistent with stockholders who, on average, disapprove of issuing discount options.

c. *Repricing underwater options.* Almost all stock options are issued "at the money," that is, with an exercise price set at the current market price for the stock. If the company's stock price should drop below this exercise price at some point before the options are exercised, they are said to be "underwater" or "below the money." Underwater options do not have immediate economic value because they cost more to exercise than the underlying security is worth. The most direct way to restore the value of these options is for the company to reprice them, either by lowering the exercise price of the options themselves, or by issuing new replacement options with a lower strike price.

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182. ISOs must have a minimum exercise price of 100% of fair market value in order to qualify for preferential tax treatment. *See id.* at 20. While nonqualified stock options do not have such a requirement, most companies follow the same practice of setting the exercise price at fair market value. *See id.*

183. In 1998, IRRC found that only 12 of the 1189 companies whose proxy statements it examined had given their executives discounted options. *See id.* They also found that 29 companies in the same sample had given their executives options that were premium priced, that is, whose exercise price was set above fair market value. *See id.*

184. *See id.*

185. IRRC calculated that 24% of the institutions responding to its survey had such policies, and another 55% stated that discounted options could lead them to vote against a stock option plan. *See id.*

186. *See supra* note 44 and accompanying text.

187. *See Wittenberg, supra* note 96, at 76.

188. *See id.*

189. *See id.* at 76-77.
Shareholders frequently object to boards of directors repricing options. They claim that repricing amounts to a "giveaway" to managers by providing them with price protection that other shareholders do not qualify to receive. In response, corporate boards often point out that underwater options cannot provide managers with the appropriate incentives to perform better and that stock price declines may be caused by drops in the overall market or industry-wide conditions. The case for repricing is most compelling where the decline in the company's stock price can be attributed to forces beyond management's control. Still, options should be "substantially" underwater for an extended period of time before most experts say repricing should be considered.

Existing empirical research supports the opponents to repricing. Don M. Chance, Raman Kumar, and Rebecca B. Todd found that option repricings occur in the wake of poor firm-specific performance, not during general market or industry-wide declines. Further, they found that "repricings are not accompanied by offsetting factors either in option terms or other cash compensation, and that many firms reprice more than once." A majority of the repriced options had significant value prior to repricing and would have been at the money within two years of the change. Finally, they discovered that "repricing is more likely for firms with insider-dominated boards." Menachem Brenner, Rangarajan K. Sundaram, and David Yermack reached similar conclusions for a larger sample of executives and firms.

Companies are not required to submit option repricings for shareholder approval. When they are submitted for such approval, they are not required to be submitted for shareholder approval. See RUXTON, supra note 10, at 19 (pointing out that this signals a lack of confidence in the company's future by permitting executives to be compensated even if the company's stock price falls and that the stock market reacts negatively to this signal).

190. See RUXTON, supra note 10, at 19 (pointing out that this signals a lack of confidence in the company's future by permitting executives to be compensated even if the company's stock price falls and that the stock market reacts negatively to this signal).
191. See id.
192. See id. (citing experts who suggest two years or more as an appropriate time period to wait before repricing an underwater option because options have long lives and may recover their value before they expire).
194. Id. at 3.
195. See id. However, they found that the costs of repricings are relatively small to shareholders even though they greatly benefit a few executives. See id.
196. Id.
198. See RUXTON, supra note 10, at 18-19 (noting the SEC's response to Versar's inquiry of whether "shareholder approval was required for an exchange program under which plan participants could exchange underwater options for new, lower-priced options"). The SEC's staff opined that Versar's option re-
proval, many shareholders will vote against stock option plans whose language would allow the plan administrators to reprice underwater options. In fact, many institutional investors have voting policies which lead them to vote against all such proposals.

Table 2 shows that investors do not approve of repricing underwater options. The average AGAINST for plans that allow repricing is 25.1%, whereas it is only 16.1% for plans that do not allow repricing. The difference is statistically significant (t-statistic = 7.71).

d. Omnibus awards. Omnibus plans give the compensation committee broad discretion to use a wide variety of stock-based compensation techniques to reward executives. Commonly dubbed "blank check stock option plans," these plans give their administrators almost total control over the terms and forms of compensation awarded to managers.

In our data set, omnibus plans are defined as those plans where the plan administrators can dispense five or more types of awards, or where they have discretionary authority to grant "other stock-based awards" of an unspecified nature.

Shareholder opposition to these plans is two-fold. First, omnibus plans give plan administrators so much discretion that shareholders fear that executives will be awarded less risky forms of stock-based compensation that will do little to align the incentives of managers with those of shareholders. Second, some shareholders claim that these programs are too generous to managers. For these reasons, a significant number of institutional investors automatically vote against these plans.

The results of Table 2 reflect shareholder concerns and show that the average AGAINST for plans that include omnibus awards is 21.1%, whereas it is 17.1% in plans without the feature. The difference is statistically significant (t-statistic = 3.64).

e. Time lapsing restricted stock. Time lapsing restricted stock


See RUTXON, supra note 10, at 19 ("These shareholders say plans should explicitly prohibit the practice and company boards and compensation committees should be willing to promise not to adjust underwater awards.").

See id. (noting that IRRC surveys showed that "about one-third of institutions say that their policies require withholding their support for a plan proposal that includes repricing of underwater options; about half of the respondents say this feature might affect their vote").

See id. at 22.

Id.

Id. On top of the great degree of discretion for administrators, these plans often reserve a large number of shares for award. See id.

See id. at 23.

See id.

See id.
is company stock that is given or sold, at a deep discount, to a corporate executive subject to the limitation that it cannot be sold during a fixed period of time.\textsuperscript{207} Usually the restriction lasts for five years, although there are instances where the restriction will continue until the executive's retirement.\textsuperscript{208}

Restricted stock is a very popular form of long-term incentive compensation.\textsuperscript{209} In 1996, roughly 28\% of companies in the S&P 500 granted restricted stock to their executives.\textsuperscript{210} A broader study of CEO pay at 1189 companies in the S&P Super 1500 found that, in 1998, 29.4\% of the sample companies in the S&P 500 gave their CEOs restricted stock with the median award worth $943,506.\textsuperscript{211} The median value of CEOs' restricted stock holdings also increased dramatically in 1998.\textsuperscript{212}

Some shareholders have criticized compensation committees that award large grants of restricted stock because they have value whether the company’s stock performs well or not.\textsuperscript{213} These critics claim that restricted stock rewards executives merely for remaining with the company, rather than for performing well.\textsuperscript{214}

In our sample, 281 of the 637 proposals (44\%) include restricted stock awards. The results in Table 2 show that the average vote against plans containing this type of award is 20.8\%, which is significantly greater than the 16.9\% vote against plans without restricted stock awards (t-statistic = 3.74).

\textbf{f. Reload options.} The reload option is a relatively recent innovation in stock option plans that has been the subject of substantial controversy. The reload option acts as a means by which executives can lock in gains on their existing stock options generated by increases in their company’s stock price without giving up the opportunity to realize further gains if the company’s stock price should

\textsuperscript{207} Other restrictions can also be imposed on the resale of the stock. For example, the executive may not be able to sell the shares until certain profit goals are realized or until her retirement.

\textsuperscript{208} See Crystal, supra note 56, at 71. However, if the executive quits before the limitation period is up or is fired for just cause, then she forfeits the stock. See id. at 72.

\textsuperscript{209} See id. at 71.

\textsuperscript{210} See Murphy, supra note 24, at 2516. These grants accounted for 22\% of the compensation of the executives that received grants. See id.

\textsuperscript{211} See Ruxton, supra note 2, at 3. These figures dropped to 23\% and $410,000, respectively, for sample companies in the S&P 400 MidCap Index, while only 13.6\% of the companies in the S&P 600 SmallCap gave such awards with a median value of $229,550. See id.

\textsuperscript{212} See id. at 20. Ruxton reported that \textquotedblleft CEOs in the S&P 500 saw a 33 percent increase in the median value of restricted stock holdings, reaching more than $2.5 million, while SmallCap chiefs enjoyed an even more impressive 54 percent rise in their holdings.\textquotedblright Id. at 21.

\textsuperscript{213} See Ruxton, supra note 10, at 21.

\textsuperscript{214} See id.
continue to increase.\textsuperscript{215}

Mechanically, the reload option works as follows. Suppose that one of the company’s executives exercises some of her stock options by selling shares of the company’s stock that she already holds to pay for the stock. If the executive is entitled to receive reload options, then the company will subsequently issue her a new stock option at the then prevailing current market price in an amount equal to the number of shares that she sold when she exercised her stock option.

Shareholder critics claim that reload options permit executives to realize all of the increase in the company's stock price, while being protected from any later declines in the stock's value.\textsuperscript{216} Companies respond that reload options encourage executives to exercise their options early and thereby become shareholders faster.\textsuperscript{217} This leads to greater stock ownership by executives, which better aligns managers' interests with those of shareholders. Despite these justifications, a significant number of institutional investors automatically vote against plans containing this type of option provision.\textsuperscript{218}

In the 1998 proxy season, only 63 of the 637 proposals (10%) contained a reload option feature. The average vote against plans with the feature (20.4%) was not significantly higher than the average vote for plans without the feature (18.4%).

\textbf{g. Change in control provisions.} Many proposals (77% of the sample) contain provisions that allow the options to immediately vest upon a change in control of the company. These provisions are generally uncontroversial because they give executives the incentive to maximize the value of the company even if it means selling the company and potentially losing employment with the acquiring company.\textsuperscript{219} However, the univariate results in Table 2 indicate a significantly higher vote against plans with a change in control provision (19.7%) than for plans without this provision (14.9%, \textit{t}-statistic = 4.07).

\textbf{h. Methods of payment.} Companies have come up with a variety of methods by which executives can pay the exercise price for their stock options. Some of these schemes have become controversial because they sometimes give executives below-market rate loans with which to purchase their shares, while others permit executives to exercise their options without any cash outlay, so-called

\textsuperscript{215} See id.
\textsuperscript{216} See id.
\textsuperscript{217} See id.
\textsuperscript{218} Twelve percent of institutional investors have such policies according to IRRC, while another 50% stated that they would consider voting against plans containing these provisions. See id.
\textsuperscript{219} See id. at 20.
“pyramiding” options.220

When loans are used as a method of payment, especially below-market rate loans, shareholders complain that executives are receiving preferential treatment that is not available to them.221 Roughly 22% of the institutional investors surveyed by IRRC had voting policies that led them to vote no on these proposals automatically.222

A total of 169 proposals (27%) in our sample include the possibility of using loans to pay the exercise price. Stockholders appear to disapprove of this practice, as the average vote against proposals including the loan provision is 24.8%, while it is just 16.4% in proposals without the provision. The difference is statistically significant, with a t-statistic of 7.32.

Pyramiding of stock options occurs when the plan permits executives to exercise their options in a rapid series of transactions designed to generate cash for the executive equal to the difference between the stock option’s exercise price and the market price of the stock without the executive being required to put up money to purchase the stock.223 IRRC “defines pyramiding as any plan that allows executives to exercise stock options using stock that has not been held for a minimum holding period.”224 A significant number of institutional investors vote against plans containing these provisions, probably because these plans reduce the risks to executives of owning company stock and undermine the goal of increasing management’s level of stock ownership.225

A total of 412 (65%) of the proposals in our sample allow pyramiding. No significant difference exists in the average vote against proposals permitting pyramiding (18.7%) compared to those that do not allow it (18.4%).

i. Acceleration of vesting. These provisions entitle all outstanding options to become fully vested upon some defined event.226 A total of 339 proposals (53%) in our sample contain acceleration provisions. Like change in control provisions, stockholders disapprove of these provisions. Average AGAINST is 21.2% for plans that include acceleration provisions compared to 15.7% for plans that do not include these provisions. The difference is statistically significant (t-statistic = 5.40).

220. See id. at 23.
221. See id.
222. See id.
223. See id.
224. Id.
225. See id.
226. See id. at 20.
C. Multivariate Tests on Determinants of Shareholder Voting

Table 3 presents the results of four regression estimations based on different specifications of dilution and a series of dummy variables to account for the widespread availability of the options to employees in the firm, whether the plan was new or not, and various other features of the plans. The dependent variable in the regression, AGAINST, and the dilution variables, TOTALDIL and DILPROP, have been defined above. The remaining dummy explanatory variables are defined below:

- \( \text{ALLEMPLOYEES} = 1 \) if all employees are eligible to receive options, 0 if only executives or outside directors are eligible.
- \( \text{ADDSHARES} = 1 \) if the proposal is to add shares to existing plan, 0 if the proposal is to adopt new plan.
- \( \text{EVERGREEN} = 1 \) if the plan has an evergreen or quasi-evergreen provision, 0 otherwise.
- \( \text{DISCOUNT} = 1 \) if the company can award discounted options, 0 otherwise.
- \( \text{REPRICE} = 1 \) if the company can reprice underwater options, 0 otherwise.
- \( \text{OMNIBUS} = 1 \) if the plan includes more than five types of awards, 0 otherwise.
- \( \text{RESTRICT} = 1 \) if time lapsing restricted stock is included in the plan, 0 otherwise.
- \( \text{RELOAD} = 1 \) if the plan contains a reload option, 0 otherwise.
- \( \text{CONTROL} = 1 \) if the plan contains a change in control provision, 0 otherwise.
- \( \text{PYRAMID} = 1 \) if pyramiding is allowed to pay the exercise price, 0 otherwise.
- \( \text{LOANS} = 1 \) if the company gives loans to participants to pay exercise price, 0 otherwise.
- \( \text{ACCELERATE} = 1 \) if company can accelerate the vesting time for options, 0 otherwise.

In regressions 1 and 3, TOTALDIL is positively related to AGAINST, and the coefficient is strongly significantly different from zero (e.g., t-statistic = 9.38 in regression 1). However, as indicated earlier, many institutional shareholders will seriously consider voting against a plan when total dilution is greater than 10%. This statement suggests that, holding all else equal, there may be no relation between TOTALDIL and AGAINST when TOTALDIL is less than 10%, but the relationship would be positive when dilution exceeds 10%. Regressions 2 and 4 estimate the regression coefficient

227. Because AGAINST is bounded from below by 0.0 and from above by 100.0, we test the residuals from the regression equations to determine whether they meet the conditions of normality. Our tests reject the null hypothesis of normality. We therefore transform AGAINST by computing its square root and re-estimate the regressions. Our results are unaffected by this transformation, and we therefore report them using AGAINST as the dependent variable.
for TOTALDIL over two separate segments: TOTALDIL less than 10% and TOTALDIL greater than 10%. The two segments are estimated as follows:

TOTALDIL < 10% = TOTALDIL if TOTALDIL < 10%
    = 10% if TOTALDIL ≥ 10%

TOTALDIL > 10% = 0 if TOTALDIL < 10%
                = TOTALDIL - 10% if TOTALDIL ≥ 10%

However, regressions 2 and 4 show that both segments are positively and significantly related to AGAINST. Thus, as total dilution increases, even over smaller levels of total dilution, the votes against stock option proposals increase.

For the reasons outlined above, a 5% threshold for DILPROP may be important in determining the level of shareholder opposition to stock option proposals. Therefore, not only do we enter DILPROP into regressions 1 and 2 as one variable, we also estimate the relationship between DILPROP and AGAINST over two different segments of DILPROP as shown below:

DILPROP < 5% = DILPROP if DILPROP < 5%
    = 5% if DILPROP ≥ 5%

DILPROP > 5% = 0 if DILPROP < 5%
              = DILPROP - 5% if DILPROP ≥ 5%

Regressions 1 and 2 show that DILPROP is positive and significantly related to AGAINST. Regressions 3 and 4 show that, no matter whether DILPROP is less than 5% or greater than 5%, the coefficient is positive and significant.

In addition to the individual effects of TOTALDIL and DILPROP, Panel A of Table 1 suggests that an interaction effect may be present. In Table 1, average AGAINST is significantly different between the high TOTALDIL/high DILPROP combination compared to the high TOTALDIL/low DILPROP combination, whereas no significant difference is found when comparing average AGAINST between the low TOTALDIL/high DILPROP and low TOTALDIL/low DILPROP combinations. To take this possibility into account, we model an interaction effect in the regressions by multiplying TOTALDIL by DILPROP. The sign on the interaction coefficient is negative and significantly different from zero in all regressions.

The interpretation of this coefficient is illustrated in Figure 1. In this figure, a simple model was estimated using only TOTALDIL, DILPROP, and the interaction variable. The predicted value of AGAINST is calculated using the results of the regression assuming TOTALDIL takes on various values ranging from 0% to 25%. Within each category of TOTALDIL, DILPROP is allowed to vary from 0% to 10% in one percentage point increments. The figure shows that the slope of the predicted AGAINST line is flatter when TOTALDIL is higher than when TOTALDIL is lower. Thus, the relationship between DILPROP and AGAINST is more pronounced at lower levels of TOTALDIL. We interpret these findings to mean
that shareholders are very concerned about the amount of dilution created by stock option plans, but that at low levels of total company dilution, we will see higher levels of negative votes for individual plans with significant dilutive effects.

Panel C of Table 1 indicates that stock option plans for which all employees are eligible are met with significantly more no votes than plans in which executives or outside directors are eligible. However, the results in Table 3 are not consistent with this hypothesis as none of the coefficients on ALLEMPLOYEES are significant.

Panel B of Table 1 shows that proposals to add shares to existing plans are met with more opposition, on average, than are proposals to adopt new plans, even if the new plans simply replace already existing plans. However, as we earlier noted, Panel C of Table 1 shows that average TOTALDIL for proposals to add shares is also significantly greater than it is for proposals to adopt new plans. The results of Table 3 show that the variable ADDSHARES is positive and significantly related to AGAINST in all four regressions. Thus, stockholders cast more no votes for proposals to add shares than they do for proposals to adopt new plans. This result may occur because stockholders are not expecting the additional dilution that will occur with adding shares to existing plans. In other words, when a plan is originally adopted, stockholders form an expectation about the potential dilution that can occur with the plan and vote accordingly. However, later, when the firm wants to expand the number of shares that can be issued in the plan, stockholders become concerned about the amount of compensation being awarded to employees. This concern may precipitate a stronger negative vote.

With respect to the features of stock option plans, the regression estimates of Table 3 show some similarities with the univariate results of Table 2. In particular, there is strong support for positive and significant relationships between AGAINST and REPRICE, RESTRICT, and LOANS. Stockholders strongly disapprove of the practice of repricing underwater options, the ability to issue time lapsing restricted stock, and the company’s ability to loan money to executives or employees to exercise options. Some support is shown in the regressions for a positive and significant relationship between AGAINST and EVERGREEN as well as DISCOUNT. Stockholders do not approve of the practice of replenishing option coffers with evergreen provisions, nor do they approve of the inclusion of below the money option awards. However, the multi-variance analysis does not show any significant relationships between AGAINST and OMNIBUS, RELOAD, CONTROL, PYRAMID, or ACCELERATE.

In Table 4, we replicate regression 1 of Table 3 with the addition of variables MARET1YR, MARET3YR, and MARET5YR, the one, three, and five-year, respectively, market-adjusted stock returns. The sign on all three variables is positive and significantly related to AGAINST. One explanation for this result might be that,
as firm performance worsens, stockholders desire to see managers' and employees' interests become more aligned with their interests, namely, to increase the value of the firm's stock price. Therefore, in a cross-sectional regression, poorly performing firms receive more votes in favor of their incentive compensation schemes. Many of the other variables in Table 4 retain their sign and significance. The exceptions occur when, as observations are dropped from the regression due to missing stock returns, ADDSHARES, EVERGREEN, and DISCOUNT tend to lose their significance. Nevertheless, the results on TOTALDIL, DILPROP, the interaction term, REPRICE, and LOANS remain robust throughout both Tables 3 and 4.

D. Sensitivity Analysis

1. Technology Firms Versus Non-Technology Firms

We re-estimate regression 1 of Table 3 by separating out firms that are classified as being in the technology sector from those that are not in the technology sector. We do this because technology firms tend to exhibit more widespread use of stock options than do non-technology firms. Therefore, the determinants of voting behavior may differ between these two groups of firms. Though we do not provide a table, the results indicate that dilution is important regardless of sector classification. TOTALDIL, DILPROP, and the interaction between TOTALDIL and DILPROP all have the same sign as regression 1 of Table 3 and are all highly significant. In addition, REPRICE is positive and is also highly significant for both groups of companies.

Some variables, however, do exhibit different statistical results depending on sector classification. For example, ALLEMPLOYEES is positive and significant for technology companies but is not significant for non-technology firms. This result may reflect the widespread use of options in technology firms, and investors' apparent growing dislike of the practice. Several variables, EVERGREEN, RESTRICT, and LOANS, are positive and significant for non-technology firms, but they are not significant for technology companies. While we do not have a ready explanation for these results, we simply note the difference in voting behavior between the two groups of companies.

Finally, we note that DISCOUNT is negative and significant for technology firms but is positive and significant for non-technology firms. The result may reflect differences in competition in the markets for human capital that exist in the different sectors. Investors of technology firms recognize that the competition for talent is

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228. See Joann S. Lublin & Leslie Scism, Stock Options at Firms Irk Some Investors, WALL ST. J., Jan. 12, 1999, at C1. Of the ten companies cited in the Article, six of them were technology firms. See id.
fierce. The ability to issue options at a discount is another way of attracting and retaining valuable employees. If the option plan does not allow for discount options, it could be damaging to a technology firm's ability to compete. However, the competition for high level talent may not be as intense for non-technology firms. Thus, investors of non-technology firms may view discount options as an unnecessary perk and increase their votes against stock option plans.

2. Effect of Management Ownership of Stock on Results

To test whether management stock ownership affects our results, we adjusted AGAINST for ownership by all officers and directors. Our assumption is that these shareholders would always vote for the management stock option plan proposals. The adjustment formula is as follows: AGAINST / (100.0 - OFFDIR), where OFFDIR is the percentage ownership of all officers and directors. Of the 605 observations with ownership data, the average adjusted AGAINST is 20.9%, whereas the unadjusted AGAINST is 18.8%. The Pearson correlation coefficient between the two variables is 0.97.

We then re-estimated regression 1 of Table 3. The results are very similar to those reported in Table 3, except that DISCOUNT is now significant and RESTRICT is not. We conclude that management stock ownership levels do not significantly affect our results.

3. Caveats

There are two additional tests that we would have run if we had the data available to do so. First, our data set contains only one year of cross-sectional information, which means that we are unable to follow stockholder voting on stock option plans over time. Ideally, we would like to see how voting patterns change over a period of several years to determine how stable our results are.

Second, we lack data in our sample on institutional investor stock ownership at individual companies. If institutions are more informed voters and act according to set voting policies, it would be interesting to see if they react differently than other investors to management proposals. We would anticipate that companies with higher levels of institutional stock ownership would experience higher levels of opposition to their plans. Unfortunately, we are unable to test this hypothesis with the data that we have available.

CONCLUSION

This Article represents only the first step in understanding the interaction between boards and shareholders over stock option plans. Its principal finding is that, while shareholders generally vote to approve stock option plans, they are sensitive to several aspects of stock option plans' design and their effect on the shareholders' stake in the company. Dilution, measured in terms of total company dilution or of individual plan dilution, emerges consistently
as a critical factor in how shareholders vote on stock option plans. This result suggests that shareholders are concerned about the relative costs and benefits of stock option plans. While the benefits of stock option plans as a form of performance incentive, and as a method of aligning management and shareholder interests, have been subject to exhaustive research by finance and legal scholars, little work has been done on their costs. We view this as an important area for further exploration.

Plan design is another important determinant of shareholder opposition. Several key features of management proposals appear to provoke strong responses from shareholders. Option repricings, payments in restricted stock, and the provision of loans to executives for the purchase of shares appear to be the most significant factors leading to increased shareholder opposition. We also find an increase in the level of negative votes when plans contain evergreen features or offer executives discount options. Boards of directors should reconsider whether they should propose plans that contain these features or at least offer shareholders stronger evidence that these features are in their best interests. In our future work, we intend to examine how boards respond to shareholder opposition to their stock option plan proposals.
**Appendix**

Table 1

**Average Vote Against Management Sponsored Stock Option Proposals by Total Dilution, Proposal Dilution, and Eligibility for Plans Based on Proposals During 1998 Proxy Season**

### Panel A: Average AGAINST by measures of dilution

<table>
<thead>
<tr>
<th>DILPROP</th>
<th>N</th>
<th>AGAINST</th>
<th>N</th>
<th>AGAINST</th>
<th>t-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTALDIL &lt; 10.00%</td>
<td>152</td>
<td>11.7%</td>
<td>16</td>
<td>9.2%</td>
<td>0.93</td>
</tr>
<tr>
<td>TOTALDIL &gt; 10.00%</td>
<td>304</td>
<td>18.3%</td>
<td>185</td>
<td>24.8%</td>
<td>5.07***</td>
</tr>
<tr>
<td>t-statistic</td>
<td>5.85***</td>
<td>6.55***</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Panel B: Average AGAINST and dilution by whether plan is adoption of new plan or addition of shares to existing plan**

<table>
<thead>
<tr>
<th>Plan Type</th>
<th>N</th>
<th>AGAINST</th>
<th>TOTALDIL</th>
<th>DILPROP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adopt new plan</td>
<td>348</td>
<td>16.6%</td>
<td>15.3%</td>
<td>4.9%</td>
</tr>
<tr>
<td>Add shares to existing plan</td>
<td>289</td>
<td>21.0%</td>
<td>17.8%</td>
<td>4.3%</td>
</tr>
<tr>
<td>t-statistic (Adopt vs. Add shares)</td>
<td>-4.21***</td>
<td>-3.67***</td>
<td>1.81</td>
<td></td>
</tr>
</tbody>
</table>

**Panel C: Average AGAINST and dilution by participant eligibility**

<table>
<thead>
<tr>
<th>Group</th>
<th>N</th>
<th>AGAINST</th>
<th>TOTALDIL</th>
<th>DILPROP</th>
</tr>
</thead>
<tbody>
<tr>
<td>All employees</td>
<td>268</td>
<td>22.1%</td>
<td>18.1%</td>
<td>5.7%</td>
</tr>
<tr>
<td>Executives</td>
<td>251</td>
<td>18.1%</td>
<td>15.2%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Outside directors</td>
<td>118</td>
<td>11.9%</td>
<td>15.1%</td>
<td>0.6%</td>
</tr>
<tr>
<td>t-statistic (All employees vs. Executives)</td>
<td>3.41***</td>
<td>3.65***</td>
<td>0.99</td>
<td></td>
</tr>
<tr>
<td>t-statistic (All employees vs. Outside directors)</td>
<td>8.27***</td>
<td>3.13***</td>
<td>17.7***</td>
<td></td>
</tr>
<tr>
<td>t-statistic (Executives vs. Outside directors)</td>
<td>5.28***</td>
<td>0.07</td>
<td>19.8***</td>
<td></td>
</tr>
</tbody>
</table>

**Panel D: Average vote against proposals by stock market return**

<table>
<thead>
<tr>
<th>Stock Market Return</th>
<th>N</th>
<th>AGAINST</th>
<th>TOTALDIL</th>
<th>DILPROP</th>
</tr>
</thead>
<tbody>
<tr>
<td>MARETIYR &lt; -6.74%</td>
<td>208</td>
<td>17.8%</td>
<td>15.5%</td>
<td>4.0%</td>
</tr>
<tr>
<td>MARETIYR &gt; -6.74%</td>
<td>207</td>
<td>18.1%</td>
<td>15.7%</td>
<td>4.9%</td>
</tr>
<tr>
<td>t-statistic for difference in MARETIYR</td>
<td>0.78</td>
<td>0.15</td>
<td>2.58***</td>
<td></td>
</tr>
<tr>
<td>MARET3YR &lt; -1.87%</td>
<td>202</td>
<td>16.1%</td>
<td>14.4%</td>
<td>4.0%</td>
</tr>
<tr>
<td>MARET3YR &gt; -1.87%</td>
<td>202</td>
<td>19.5%</td>
<td>16.7%</td>
<td>4.9%</td>
</tr>
<tr>
<td>t-statistic for difference in MARET3YR</td>
<td>2.63***</td>
<td>2.64***</td>
<td>2.49***</td>
<td></td>
</tr>
<tr>
<td>MARETSYR &lt; -1.55%</td>
<td>186</td>
<td>16.1%</td>
<td>14.5%</td>
<td>4.3%</td>
</tr>
<tr>
<td>MARETSYR &gt; -1.55%</td>
<td>186</td>
<td>19.1%</td>
<td>16.4%</td>
<td>4.5%</td>
</tr>
<tr>
<td>t-statistic for difference in MARETSYR</td>
<td>2.23**</td>
<td>2.05**</td>
<td>0.51</td>
<td></td>
</tr>
</tbody>
</table>

***, ** Statistically significant at the .01 and .05 level

**Definitions:**

AGAINST: Percent of shares voted that are cast against management-sponsored stock option proposals, including abstentions.

DILPROP: Shares reserved for stock options based on each proposal divided by the total number of voting securities.

TOTALDIL: All shares reserved for stock options or granted as stock options divided by the total number of voting securities.

MARETIYR = Market-adjusted return 1 year = Company stock return over previous fiscal year minus Average return on S&P 1500 firms for same period.

MARET3YR = Market-adjusted return 3 year = Company stock return over previous three fiscal years minus Average return on S&P 1500 firms for same period.

MARETSYR = Market-adjusted return 5 year = Company stock return over previous five fiscal years minus Average return on S&P 1500 firms for same period.
### Table 2
Average Votes Against Management-Sponsored Stock Option Plans by Various Plan Features
Based on Proposals During 1998 Proxy Season

<table>
<thead>
<tr>
<th>Plan Feature</th>
<th>Plans With Feature</th>
<th>Plans Without Feature</th>
<th>t-statistic With vs. Without Feature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evergreen provision or Quasi-evergreen provision</td>
<td>28.2% (36)</td>
<td>18.0% (601)</td>
<td>3.77***</td>
</tr>
<tr>
<td>Discount options</td>
<td>24.2% (169)</td>
<td>16.6% (468)</td>
<td>5.97***</td>
</tr>
<tr>
<td>Reprice underwater options</td>
<td>25.1% (179)</td>
<td>16.1% (458)</td>
<td>7.71***</td>
</tr>
<tr>
<td>Omnibus awards</td>
<td>21.1% (241)</td>
<td>17.1% (396)</td>
<td>3.64***</td>
</tr>
<tr>
<td>Time lapsing restricted stock</td>
<td>20.8% (281)</td>
<td>16.9% (356)</td>
<td>3.74***</td>
</tr>
<tr>
<td>Reload option</td>
<td>20.4% (63)</td>
<td>18.4% (574)</td>
<td>1.10</td>
</tr>
<tr>
<td>Change in control provision</td>
<td>19.7% (493)</td>
<td>14.9% (144)</td>
<td>4.07***</td>
</tr>
<tr>
<td>Pyramiding allowed to pay exercise price</td>
<td>18.7% (412)</td>
<td>18.4% (225)</td>
<td>0.30</td>
</tr>
<tr>
<td>Loans given to pay exercise price</td>
<td>24.8% (169)</td>
<td>16.4% (468)</td>
<td>7.32***</td>
</tr>
<tr>
<td>Accelerate vesting time for options</td>
<td>21.2% (339)</td>
<td>15.7% (298)</td>
<td>5.40***</td>
</tr>
</tbody>
</table>

*** Statistically significant at the .01 level.
### Table 3
Regression Coefficients of Voting Results on Dilution and Features of Stock Option Plans  
1998 Proxy Season  
(t-statistics in parentheses)

<table>
<thead>
<tr>
<th>Dependent Variable: AGAINST</th>
<th>Variable</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
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<tbody>
<tr>
<td></td>
<td>Intercept</td>
<td>-0.52</td>
<td>-1.54</td>
<td>-0.58</td>
<td>-1.53</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(-0.34)</td>
<td>(-0.63)</td>
<td>(-0.37)</td>
<td>(-0.62)</td>
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<tr>
<td></td>
<td>TOTALDIL</td>
<td>0.62</td>
<td>0.62</td>
<td>0.62</td>
<td>0.62</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(9.38***)</td>
<td>(9.21***)</td>
<td>(9.21***)</td>
<td>(9.21***)</td>
</tr>
<tr>
<td></td>
<td>TOTALDIL&lt;10%</td>
<td>0.75</td>
<td>0.75</td>
<td>0.75</td>
<td>0.75</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2.87***)</td>
<td>(2.77***)</td>
<td>(2.77***)</td>
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</tr>
<tr>
<td></td>
<td>TOTALDIL&gt;10%</td>
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<td>0.60</td>
<td>0.60</td>
<td>0.60</td>
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<tr>
<td></td>
<td></td>
<td>(7.46***)</td>
<td>(7.45***)</td>
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</tr>
<tr>
<td></td>
<td>DILPROP</td>
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<tr>
<td></td>
<td></td>
<td>(3.67***)</td>
<td>(3.45***)</td>
<td>(3.45***)</td>
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<tr>
<td></td>
<td>DILPROP&lt;5%</td>
<td>0.81</td>
<td>0.71</td>
<td>0.71</td>
<td>0.71</td>
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<tr>
<td></td>
<td></td>
<td>(2.74***)</td>
<td>(2.14***)</td>
<td>(2.14***)</td>
<td>(2.14***)</td>
</tr>
<tr>
<td></td>
<td>DILPROP&gt;5%</td>
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<td>-0.02</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(-3.49***)</td>
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<td>(-2.87***)</td>
</tr>
<tr>
<td></td>
<td>TOTALDIL x DILPROP</td>
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<td>-0.02</td>
<td>-0.02</td>
<td>-0.02</td>
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<tr>
<td></td>
<td></td>
<td>(-3.49***)</td>
<td>(-3.00***)</td>
<td>(-3.00***)</td>
<td>(-2.87***)</td>
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<tr>
<td></td>
<td>ALLEmployees</td>
<td>1.42</td>
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<td></td>
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<td>(1.52)</td>
<td>(1.43)</td>
<td>(1.46)</td>
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<td>ADDSHARES</td>
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<td>2.18</td>
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<tr>
<td></td>
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<td>(2.35***)</td>
<td>(2.35***)</td>
<td>(2.33***)</td>
</tr>
<tr>
<td></td>
<td>EVERGREEN</td>
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<td>(1.92)</td>
<td>(1.92)</td>
<td>(1.92)</td>
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<tr>
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<td>DISCOUNT</td>
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<td>1.86</td>
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<td>1.85</td>
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<td></td>
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<td>(1.69)</td>
<td>(1.71)</td>
<td>(1.67)</td>
<td>(1.69)</td>
</tr>
<tr>
<td></td>
<td>REPRICE</td>
<td>4.62</td>
<td>4.68</td>
<td>4.63</td>
<td>4.68</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(4.10***)</td>
<td>(4.13***)</td>
<td>(4.10***)</td>
<td>(4.13***)</td>
</tr>
<tr>
<td></td>
<td>OMNIBUS</td>
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<td>1.58</td>
<td>1.55</td>
<td>1.58</td>
</tr>
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<td></td>
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<td>(1.19)</td>
<td>(1.21)</td>
<td>(1.19)</td>
<td>(1.21)</td>
</tr>
<tr>
<td></td>
<td>RESTRICT</td>
<td>2.54</td>
<td>2.51</td>
<td>2.51</td>
<td>2.49</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2.09***)</td>
<td>(2.06***)</td>
<td>(2.05***)</td>
<td>(2.04***)</td>
</tr>
</tbody>
</table>
Table 3, continued

Regression Coefficients of Voting Results on Dilution and Features of Stock Option Plans

<table>
<thead>
<tr>
<th>Variable</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>RELOAD</td>
<td>-0.67</td>
<td>-0.72</td>
<td>-0.69</td>
<td>-0.73</td>
</tr>
<tr>
<td></td>
<td>(-0.43)</td>
<td>(-0.46)</td>
<td>(-0.44)</td>
<td>(-0.47)</td>
</tr>
<tr>
<td>CONTROL</td>
<td>1.46</td>
<td>1.43</td>
<td>1.46</td>
<td>1.44</td>
</tr>
<tr>
<td></td>
<td>(1.34)</td>
<td>(1.32)</td>
<td>(1.34)</td>
<td>(1.32)</td>
</tr>
<tr>
<td>PYRAMID</td>
<td>-0.29</td>
<td>-0.30</td>
<td>-0.30</td>
<td>-0.30</td>
</tr>
<tr>
<td></td>
<td>(-0.31)</td>
<td>(-0.32)</td>
<td>(-0.32)</td>
<td>(-0.32)</td>
</tr>
<tr>
<td>LOANS</td>
<td>2.66</td>
<td>2.64</td>
<td>2.64</td>
<td>2.63</td>
</tr>
<tr>
<td></td>
<td>(2.45**)</td>
<td>(2.44**)</td>
<td>(2.43**)</td>
<td>(2.42**)</td>
</tr>
<tr>
<td>ACCELERATE</td>
<td>0.59</td>
<td>0.58</td>
<td>0.57</td>
<td>0.57</td>
</tr>
<tr>
<td></td>
<td>(0.59)</td>
<td>(0.58)</td>
<td>(0.56)</td>
<td>(0.56)</td>
</tr>
<tr>
<td>Number of observations</td>
<td>637</td>
<td>637</td>
<td>637</td>
<td>637</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.3314</td>
<td>0.3306</td>
<td>0.3304</td>
<td>0.3296</td>
</tr>
<tr>
<td>F-statistic</td>
<td>22.015</td>
<td>20.633</td>
<td>20.610</td>
<td>19.389</td>
</tr>
<tr>
<td>(p-value)</td>
<td>(0.0001)</td>
<td>(0.0001)</td>
<td>(0.0001)</td>
<td>(0.0001)</td>
</tr>
</tbody>
</table>

***, ** Statistically significant at the .01 and .05 levels, respectively.

Variable Definitions:

See Table 1 for the definitions of AGAINST, TOTALDIL, and DILPROP
TOTALDIL<10% = TOTALDIL if TOTALDIL < 10%
= 10% if TOTALDIL ≥ 10%
TOTALDIL>10% = 0 if TOTALDIL < 10%
= TOTALDIL - 10% if TOTALDIL ≥ 10%
DILPROP<5% = DILPROP if DILPROP < 5%
= 5% if DILPROP ≥ 5%
DILPROP>5% = 0 if DILPROP < 5%
= DILPROP - 5% if DILPROP ≥ 5%
ALLEMPLOYEES = 1 if all employees are eligible to receive options, 0 if only executives or outside directors are eligible.
ADDSHARES = 1 if proposal is to add shares to existing plan, 0 if proposal is to adopt new plan.
EVERGREEN = 1 if plan has an evergreen or quasi-evergreen provision, 0 otherwise.
DISCOUNT = 1 if company can award discounted options, 0 otherwise.
REPRICE = 1 if company can re-price underwater options, 0 otherwise.
OMNIBUS = 1 if plan includes more than five types of awards, 0 otherwise.
RESTRICT = 1 if time lapsing restricted stock is included in the plan, 0 otherwise.
RELOAD = 1 if plan contains a reload option, 0 otherwise.
CONTROL = 1 if plan contains a change in control provision, 0 otherwise.
PYRAMID = 1 if pyramiding is allowed to pay exercise price, 0 otherwise.
LOANS = 1 if company gives loans to participants to pay exercise price, 0 otherwise.
ACCELERATE = 1 if company can accelerate the vesting time for options, 0 otherwise.
Table 4
Regression Coefficients of Voting Results on Dilution, Features of Stock Option Plans, and Firm Performance
1998 Proxy Season
(t-statistics in parentheses)

<table>
<thead>
<tr>
<th>Variable</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>-2.17 (-1.03)</td>
<td>-1.92 (-0.91)</td>
<td>-1.71 (-0.82)</td>
</tr>
<tr>
<td>TOTALDIL</td>
<td>0.70 (7.18***)</td>
<td>0.69 (7.17***)</td>
<td>0.73 (7.65***)</td>
</tr>
<tr>
<td>DILPROP</td>
<td>1.14 (3.43***)</td>
<td>1.12 (3.39***)</td>
<td>1.05 (3.20***)</td>
</tr>
<tr>
<td>TOTALDIL x DILPROP</td>
<td>-0.04 (-3.35***)</td>
<td>-0.04 (-3.22***)</td>
<td>-0.03 (-3.01***)</td>
</tr>
<tr>
<td>ALLEmployees</td>
<td>0.83 (0.48)</td>
<td>0.27 (0.23)</td>
<td>0.21 (0.18)</td>
</tr>
<tr>
<td>ADDSHARES</td>
<td>2.42 (2.09**)</td>
<td>2.20 (1.50)</td>
<td>1.52 (1.12)</td>
</tr>
<tr>
<td>EVERGREEN</td>
<td>4.48 (1.81)</td>
<td>3.66 (1.49)</td>
<td>1.08 (0.45)</td>
</tr>
<tr>
<td>DISCOUNT</td>
<td>2.56 (1.87)</td>
<td>2.92 (2.12***)</td>
<td>2.11 (1.51)</td>
</tr>
<tr>
<td>REPRICE</td>
<td>5.36 (3.82***)</td>
<td>4.58 (3.25***)</td>
<td>5.31 (3.70***)</td>
</tr>
<tr>
<td>OMNIBUS</td>
<td>0.75 (0.48)</td>
<td>0.77 (0.48)</td>
<td>1.88 (1.17)</td>
</tr>
<tr>
<td>RESTRICT</td>
<td>2.45 (1.65)</td>
<td>2.39 (1.59)</td>
<td>2.01 (1.33)</td>
</tr>
</tbody>
</table>
Table 4, continued

Regression Coefficients of Voting Results on Dilution, Features of Stock Option Plans, and Firm Performance

<table>
<thead>
<tr>
<th>Variable</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>RELOAD</td>
<td>-1.12</td>
<td>-1.67</td>
<td>-2.36</td>
</tr>
<tr>
<td></td>
<td>(-0.60)</td>
<td>(-0.88)</td>
<td>(-1.24)</td>
</tr>
<tr>
<td>CONTROL</td>
<td>1.28</td>
<td>1.34</td>
<td>0.67</td>
</tr>
<tr>
<td></td>
<td>(0.93)</td>
<td>(0.99)</td>
<td>(0.49)</td>
</tr>
<tr>
<td>PYRAMID</td>
<td>-0.23</td>
<td>-0.17</td>
<td>0.32</td>
</tr>
<tr>
<td></td>
<td>(-0.19)</td>
<td>(-0.14)</td>
<td>(0.28)</td>
</tr>
<tr>
<td>LOANS</td>
<td>3.38</td>
<td>3.60</td>
<td>3.74</td>
</tr>
<tr>
<td></td>
<td>(2.42**)</td>
<td>(2.54**)</td>
<td>(2.65***)</td>
</tr>
<tr>
<td>ACCELERATE</td>
<td>1.97</td>
<td>2.10</td>
<td>1.42</td>
</tr>
<tr>
<td></td>
<td>(1.60)</td>
<td>(1.71)</td>
<td>(1.16)</td>
</tr>
<tr>
<td>MARET1YR</td>
<td>0.02</td>
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<td></td>
<td>(2.16**)</td>
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<tr>
<td>MARET3YR</td>
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<td>0.07</td>
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<td></td>
<td></td>
<td>(3.33***)</td>
<td></td>
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<tr>
<td>MARET5YR</td>
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<td></td>
<td>0.07</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(2.28**)</td>
</tr>
<tr>
<td>Number of observations</td>
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<td>404</td>
<td>372</td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>0.3228</td>
<td>0.3265</td>
<td>0.3445</td>
</tr>
<tr>
<td>F-statistic</td>
<td>13.335</td>
<td>13.209</td>
<td>13.188</td>
</tr>
<tr>
<td>(p-value)</td>
<td>(0.0001)</td>
<td>(0.0001)</td>
<td>(0.0001)</td>
</tr>
</tbody>
</table>

***, ** Statistically significant at the .01 and .05 levels, respectively.

Variable Definitions:
See Tables 1 and 3 for all variable definitions.