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Corporate Meltdowns Caused by Compensatory Stock Options

By Calvin H. Johnson

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Tax contributes to high-risk investments that cause meltdowns when the high risk turns into losses. This proposal would end the exemption of compensatory stock options from the section 162(m) $1 million limit on compensation deductions. A CEO with stock options has an incentive to increase the volatility of corporate assets, because an option holder participates in gains but does not share in the losses from volatile corporate assets. However, high-risk investments hurt outside parties when they collapse. In some cases, the government has had to pay bailouts to prevent further economic meltdown. It is far better not to induce high risk in the first place.

This proposal is the second of a two-part series on the contribution of tax to corporate meltdowns. The first proposal was published as "Corporate Meltdowns and the Deduction of Credit-Risk Interest," *Tax Notes*, May 2, 2011, p. 513, *Doc 2011-7312*, *2011 TNT 86-7*.

This proposal is made as a part of the Shelf Project, a collaboration among tax professionals to develop proposals to raise revenue by defending the tax base. It is intended to raise revenue without a VAT or a rate increase in ways that would improve the fairness, efficiency, and rationality of the tax system. The hard work needs to be done now to develop viable proposals. Shelf projects are intended to foreclose both 85 percent income tax rates and 60 percent federal sales taxes.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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Current tax law increases the risk of corporate meltdowns by favoring compensation using stock options. With stock options, the CEO or other managers who control corporate assets avoid losses but profit from gains. Given the loss protection, their position becomes more valuable if they shift corporate assets from stable investments, with no chance of significant gains or losses, to very volatile investments, with suicidal risks. Indeed, with compensatory options, managers can profit privately by shifting to volatile investments, even when the move reduces total probability-discounted value, considering everyone affected.

Section 162(m) favors the use of stock options to compensate top officers. Section 162(m) imposes a $1 million limit on the amount that can be deducted by a publicly traded corporation for compensation for a top officer, but it allows an exemption for compensatory stock options if there is no initial bargain when the option is granted. This project would take away the exemption for stock options and other asymmetrical compensation plans so as to remove the tax incentives for meltdown risks.

Tax law should not encourage risk because risk hurts when it turns into losses. Volatility is usually asymmetrical in its effect because losses hurt more than equal-dollar gains help. And a corporate meltdown hurts people beyond the parties that created the situation. When a corporation fails, it fires employees and devalues their skills. Corporate failure destroys a valuable network of suppliers and customers. For meltdowns that are big enough, American taxpayers have sometimes bailed out the corporation, at the cost of billions, just to maintain economic stability. The United States has a system cynically described as "privatization of gains, and socialization of losses."[1] Public policy should not just be neutral to corporate risk, but hostile to it. At the very least, the tax incentives for increased volatility need to end.

A. Current Law

Under section 162(m), a public company may deduct no more than $1 million a year per person for compensation paid to the CEO and the four most highly paid officers. The limitation is rationalized by a model in which corporate compensation

[1]*See, e.g.*, New York City Mayor Michael Bloomberg, "Bloomberg Addresses Pending Financial Job Losses" (Sept. 15, 2008), *available at* http://www.observer.com/2008/real-estate/bloomberg-addresses-pending-financial-job-loses.

will be excessive for the top officers of the corporation. The top officers of the corporation *are* the corporation, and there is no arm's-length negotiation with an adverse employer when the officers deal with their own compensation. Because the top officers hold the controlling positions, they are able to impose an excessive level of compensation on a generally compliant board of directors, as long as the compensation is not egregiously out of line with compensation at comparable corporations. Economists call a payment in excess of that needed to motivate the services a ''rent,'' and when compensation arises from the officer's strategic position, the compensation appears to be a rent.[2] When all comparable corporations are similarly inflating compensation, the comparability standard as applied is not a meaningful restriction.[3] The corporate return from its cost of compensation packages is well below the normal rate of return on corporate investments.[4] The section 162(m) limitation was adopted in 1993 to limit the growth of excessive compensation.[5]

The section 162(m) $l million cap on compensation deductions has an exception, however, for performance-based compensation. To qualify for the performance-based exemption from the limit, the performance goals must be established by a committee of outside directors before a quarter of the work has been performed,[6] and the committee must certify that the goals have been met before payment is made.[7] The pre-established goals must be ascertainable objectively without the application of discretion.[8] The shareholders must approve the plan before the compensation is paid.[9]

Stock options can qualify as performance based if there is no bargain on the option when granted. To qualify for the performance-based exemption, the bargain to the officer must be ''based solely on an increase in the value of the stock after the date of the grant or award.''[10] An outright grant of stock or a stock option with a bargain built in at the outset will not qualify as performance based, even though the employee's fortunes are thereby tied to the fortunes of the company, because the ''the employee would receive all or part of the compensation regardless of whether the performance goal is attained.''[11] For stock compensation, for instance, an officer who ran his corporation into the ground and reduced stock value by half would still get stock worth half its initial value.

B. Reasons for Change

1. Exemption from compensation cap. Section 162(m), as noted, disallows the deductions of compensation in excess of $1 million paid by publicly traded corporations to top officers but exempts compensatory stock options from the $1 million cap because they are considered performance based. Top officers who run the corporation shape their own compensation to stock options to avoid the $l million cap.

An officer with stock options has an incentive to move corporate assets from stable, low-volatility investments into high-risk investments because that enhances the value of his options. An option holder does not participate in losses, although the underlying assets of the corporation collapse. A corporation that has given its managers substantial options has given them incentives to invest in highly volatile, even suicidal, investments, which should scare the pants off shareholders.[12]

[2]Lucian A. Bebchuk et al., ''Managerial Power and Rent Extraction in the Design of Executive Compensation,'' 69 *U. Chi. L. Rev.* 751, 755 (2002); John E. Core et al., ''Corporate Governance, Chief Executive Officer Compensation, and Firm Performance,'' 51 *J. Fin. Econ.* 371 (1999) (finding that economic rents arising from CEO positions are significant and persistent).

[3]*See, e.g.*, Bebchuk and Jesse M. Fried, ''Pay Without Performance: Overview of the Issues,'' 30 *J. Corp. L.* 647, 654-658 (2005); Graef Crystal, ''In Search of Excess: The Overcompensation of American Executives,'' 48-50 (1991) (every executive strives to get the compensation committee to approve compensation at the 75th percentile); Richard A. Posner, ''Are American CEOs Overpaid, and, if So, What if Anything Should Be Done About It?'' 58 *Duke L.J.* 1013, 1024-1025 (2009) (arguing that the old 75th percentile becomes the new 50th percentile). *Compare* Gregg D. Polsky, ''Controlling Executive Compensation Through the Tax Code,'' 64 *Wash. & Lee L. Rev.* 872 (2007) (arguing that section 162(m) punishes shareholders who are the victims of excessive compensation and that section 162(m) channels compensation into forms harmful to the corporation).

[4]*See, e.g.*, Dennis Michaud and Yunwei Gai, ''CEO Compensation and Firm Performance,'' Dec. 20, 2009, *available at* http://ssrn.com/abstract=1531673 (finding that only cash bonuses were correlated with subsequent increase in shareholder wealth, and cash bonuses might be a response to, not a cause of, increase).

[5]Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, section 13211(b).

[6]Reg. section 1.162-27(e)(2).

[7]Section 162(m)(4)(C).

[8]Reg. section 1.162-27(e).

[9]Section 162(m)(4)(C)(ii).

[10]Reg. section 1.162-27(e)(2)(vi).

[11]Reg. section 1.162-27(e)(2)(v); H.R. Rep. No. 213 (Conf. Rep. 1993).

[12]Jouahn Nam et al., ''The Effect of Managerial Incentives to Bear Risk on Corporate Capital Structure and R&D Investment,'' 38 *Fin. Rev.* 77 (2003) (showing that management stock options incentives for more risk yield increased leverage and research and development investment); Sonja Rego and Ryan J. Wilson, ''Executive Compensation, Equity Risk Incentives, and Corporate Tax Aggressiveness,'' SSRN-id1697683 (working paper 2010) (finding more aggressive anti-government tax sheltering with officer stock options); Richard DeFusco et al., ''The Effect of Executive Stock Option Plans on Stockholders and

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Assume for example a corporation with $500 million in assets invested in some staid, mature business for which fluctuations in value can be expected to be modest. The corporation gives its new CEO an option to acquire 1 percent of its stock at any time over the next 10 years at a price of $5 million, which is the current quoted fair market value of the stock on an established stock market. An option on a property with modest fluctuations is not very valuable. On one end of the spectrum, for example, an option to buy a $100 bank account for $100 is not worth anything because bank accounts vary in interest rates, but not in value. But if the assets of the corporation were invested in currency swaps, currency default swaps, or some derivatives with high volatility, the option can be made into something of worth, even with investments that have negative expected value for the company.

The new CEO, therefore, sells all $500 million in company assets to move into a position that will give higher risk. He pays $500 million for a bet with currency options that will pay $10 billion if the value of some foreign currency reaches a strike price well above current value vis-à-vis the dollar. The option will lose all its value if the strike price is not met. Assume there is a slightly *less* than 5 percent chance of the foreign currency reaching the strike price and under that assumption, the switch in investment will reduce the expected value of the company.[13] There is a better than 95 percent chance of the options expiring to become worthless.

Still, the CEO's option does not participate in losses, so that option has positive value. The up-leg of the currency position is worth 1 percent of $10 billion, or $100 million to the CEO with 1 percent of the stock. The CEO has to pay $5 million for stock under the option worth $100 million, for a $95 million bargain. The bargain happens 5 percent of the time for an expected value to the CEO of $4.75 million. The company is destroyed, but the CEO just walks away on the options. On the down leg of the currency speculation, the company, by giving its CEO significant stock options, has given him a very tempting incentive to undertake risks that will kill the company in 95 percent of the cases in which the currency position is worthless.[14]

The example is extreme. It looks at what finance slang calls a Hail Mary or Gamble on Resurrection investment. Not all companies can make a $10-billion-or-nothing bet. The CEO may have offsetting incentives to be risk adverse.[15] The externalities from too much risk of corporate failure seem more serious than the externalities from too little risk of meltdown. In more than 95 percent of the cases in this investment, the firm will fail and be worthless. All employees will lose their jobs, all suppliers will lose their established networks, and all investors will lose their nest eggs. And if the failure is large enough, federal taxpayers will have to socialize the losses with another bailout. And the tax system contributes to the calamity by allowing large compensation only by the use of compensatory stock options. Perhaps the offset to risk aversion is a good reason not to penalize stock options but only to take away the tax incentive, as this proposal would do.

If the CEO had been given stock instead of stock options, then he would suffer losses when the currency position expires worthlessly. Without the loss protection or an option, the CEO would then not have a financial motive to increase volatility of corporate assets. Stock compensation, however, does not qualify as performance based, under the rationale that the CEO will keep the remaining value of the stock even if his performance causes a decline in value or value remains the same.[16] Even the appreciation of the stock is not performance based because the stock cannot be split into merit-based and non-merit-based segments.[17] For example, if the corporation gives compensatory stock worth $4.75 million, the corporation would lose the deduction in excess of $1 million. The deduction would be worth as much as 35 percent * ($4.75 million - $1 million), or $1.3 million. The tax law thus has given the corporation a $1.3 million relative advantage in paying the CEO with suicidal-risk-generating stock options instead of with stock or even cash.

Bondholders,'' 45 *J. Fin.* 617 (1990) (finding that management stock options increase risk, resulting in a decrease of bond value but an increase in stock value).

[13]A 5 percent chance of making $10 billion has an expect value of 5 percent * $10 billion, that is, to the $500 million cost. Anything less than 5 percent chance of success will mean the investment is worth less than its cost.

[14]The hypothetical bears some resemblance to Corning Glass, which went from $20 a share in a mature industry to $113 and then down to $1.45 as a fiber optics manufacturer, although I have not tried to determine the contribution of stock options to the shift. *See* http://www.shareholder.com/corning/stocklooku.cfm (stock prices at June 25, 1999; Sept. 1, 2000; and Oct. 12, 2002, respectively).

[15]A CEO, for example, should not kill the company in one crapshoot if he wants to continue his job. CEOs also are said to be too risk averse so that increasing risks might improve the company's financial position. M. Andrew Filds and Phyllis Y. Keys, ''The Emergence of Corporate Governance From Wall St. to Main St.,'' 38 *Fin. Rev.* 1 (2003) (reviewing the literature with an emphasis on cases in which decreasing management risk aversion *improves* firm financial position).

[16]Reg. section 1.162-27(e)(2)(v). *Accord* Conf. Rep. 1993, *supra* note 11.

[17]*Id.*

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The risks increased by top-officer options yield losses that are borne beyond the parties to the contract. The officer with an option does not bear losses in his role as option holder, but if the corporation collapses, the officer is out of a job. Employees of the corporation, who were not responsible for the risks that led to the failure of the corporation, are also out of a job, and in losing their jobs, they lose value on their specialized skills. Suppliers and customers have to find alternative networks. If the failure is large enough, American taxpayers have to bail out the corporation to maintain national economic stability.

C. Explanation of the Proposal

This Shelf Project proposes to end the exemption from the section 162(m) $1 million cap on compensation deductions for options on corporate employer stock. The proposal assumes (without separately defending) the model underlying section 162(m): that the $1 million cap appropriately limits excessive top officer compensation. It assumes (without separately defending the proposition) that excessive salaries have an element of rent, achieved by reason of the tactical position of the officers, and not because the salary is the minimum amount necessary to induce the officer to work effectively. The proposal would end the exemption for other compensation plans that give officers only gain, but not loss, because those plans similarly induce higher risk.

The proposal does not recommend extending section 162(m) principles beyond the four most highly paid officers or beyond public corporations. If an employee is unlikely to be able to move corporate assets to high-risk investments, the compensatory options cannot be expected to induce higher risk. Nonpublic corporations that are not traded on an established stock market can fail without calling for a public bailout. If the failed corporation is small, then suppliers, non-officer employees, and customers will have more alternatives and substitution will entail fewer losses. If a partnership is publicly traded, however, the proposal would extend the section 162(m) limitation to the partnership because the external victims of high-risk investment become more serious when the partnership is large enough to be publicly traded.

The proposal would liberalize the law in allowing the performance-based part of a compensation package to qualify as exempt from the $1 million compensation limit, as long as the executive can suffer gains and losses symmetrically. Thus, if the executive is given restricted stock that may appreciate or decline in value based on market forces on an established market, and the decline in value will hurt the value of the executive's compensatory stock as much as the gain helps, then the proposal would allow the subsequent appreciation to be considered performance based.

An added improvement in the efficiency of performance-based compensation would be to filter out market fluctuations caused by industry-wide or stock-market-wide variations. Much of stock appreciation is luck — or, at least beyond the control of the CEO and other top officers. If the stock appreciation has an element of luck or unjust punishment because it depends on economy-wide or industry-wide factors, then the compensation plan does not reward merit or punish non-merit.[18] The proposal would therefore allow the exemption from the compensation cap only if the performance of the employer stock is measured vis-à-vis a base line that includes industry-wide and market-wide fluctuation.

A prior Shelf Project recommended with that corporate tax be replaced with a 20-basis-point quarterly tax on market valuation of publicly traded corporations.[19] This proposal is made only on the assumption that the recommendation for the replacement of corporation tax is not taken.

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[18]There have been several suggestions to filter out market-wide volatility. *See* Rick Antle and Abbie Smith, ''An Empirical Investigation of the Relative Performance of Corporate Executives,'' 24 *J. Acct. Res.* 1, 32-35 (1986) (arguing that taking systematic risk out of stock volatility reduces risk to executives without reducing incentives); Bebchuk et al., *supra* note 2.

[19]*See* Calvin H. Johnson, ''Replace the Corporate Tax With a Market Capitalization Tax,'' *Tax Notes*, Dec. 10, 2007, p. 1082, *Doc 2007-26347*, or *2007 TNT 238-36*.

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