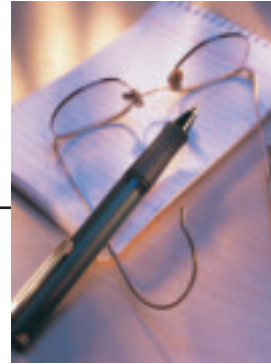


The right to vote

Molson-Coors merger puts options to the test

FIELD NOTES

BY GEORGE ATHANASSAKOS



An employee stock option is a right granted to an employee which allows them to purchase a particular number of shares for a fixed price over a defined period of time.

Because the fixed price does not change, the employee has effectively been given the ability to share in the company's growth during the life of the option. *Business Week* (Sept. 13, 1999, p.28) reported that 40% of the large U.S. companies had option plans for at least half of their employees. *The New York Times* (April 4, 1999, p. BU9) reported that options accounted for about half the total compensation paid to executives of 428 large companies. In Canada, *Investment Executive* (Sept. 1998, p.43) reported that executives are now getting more than three-and-a-half times their annual salary in option value.

Companies use employee stock options as an incentive to draw more productivity out of their employees by giving them an equity stake in the success of the company. Stock options provide a strong incentive to employees and, they lower worker-related compensation expenses, since companies can offer lower cash salaries by making up the balance with stock options. In the wake of recent corporate scandals, policymakers have moved to have stock options treated as an expense on the income statement, citing their potentially harmful impact on companies' future profits and valuations, as well as the temptation such options provide to executives to manipulate earnings and take advantage of investors. This article argues that, once we have accepted the expensing of stock options, there may be side effects which have to be accepted for consistency's sake.

One such side effect has recently become apparent. On September 17, 2004 Molson Inc. announced in a regulatory filing that its executives and employees will be allowed to use their stock options to cast votes on the fate of the company's merger with The Adolph Coors

Co.—admittedly a very controversial and unusual practice. The Ontario Securities Commission, in its Staff Notice 55-308 (under Rules and Regulations), responds to questions on insider reporting by stating: "A stock option is the right to buy or sell a specific security at a predetermined price within a specified period. A common share is a security which represents ownership in a company and carries voting privileges." In other words, stock options represent no ownership in a company and hence carry no voting rights, whereas common stocks do. However, the latter is not always true.

Many corporations have issued non-voting common stock, including Molson Inc., which had both Class A non-voting shares and Class B voting shares. But non-voting shareholders normally are allowed to vote in a merger situation as was the case with the merger of Molson and Coors. A logical extension of this argument might then be to ask why we do not also allow stock option holders to vote.⁴

According to the entity approach to equity valuation, the market value of a company is first calculated as the present value of the company's free cash flows (FCFs). The market value of that equity is then derived residually by subtracting the market value of all claims against the company's assets—i.e., preferred stock, and executive or employee stock options—from the estimated market value of the company. The purpose of the exercise is to estimate the current shareholders' value. Any shares issued when stock options are exercised in the future represent shares of future shareholders, not current ones. In general, we view common equity and stock options as part of total equity and then we sub-divide total equity into current equity and future equity. To find current equity, we subtract future equity from total equity.

In arriving at the value of the firm's FCFs, whose

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present value we estimated above, we do not incorporate any financing-related cash flows, such as interest expenses or dividends. In other words, they reflect the cash flows generated by the company that are available to all providers of the company's capital—by accepting a lower salary due to option-granting by the company, stock option holders (employees) can also be considered one of the firm's capital providers. At the same time, and to be consistent, the discount rate applied to any estimation of the present value of the FCFs should reflect the opportunity cost to all capital providers, including the cost of stock options.

CAPITAL PROVIDERS

Here is where the argument becomes interesting: executive stock option holders are indirect providers of capital to the corporation. They are unlike regular stock option holders who have bought stock options without any interference by the company as a means of speculating. For executives and employees, stock options are received as part of their compensation, as they have accepted a lower salary and thus have indirectly financed the company's operations. In this way, they look like other providers of capital such as bondholders or equity holders. However, bondholders have a fixed claim and priority over all other claim holders, and provide capital on the understanding that the maximum they can get back is their bonds' face value. If the company goes bankrupt they have first claim on the company's assets; when the company is involved in a takeover the new company normally takes on the responsibility to pay off the debt outstanding at maturity. In short, bondholders, when they lend money to the company, have no expectation of being current or future shareholders.

In contrast, executive and employee stock option holders are future shareholders and have given up salary for the privilege. If the company goes bankrupt, they stand to lose everything along with other equity holders. In most cases, outstanding executive stock options are part of any merger negotiations, and executive stock option holders

are generally allowed to convert their options into either stock or reprised or revised options in the new company, effectively becoming current or future shareholders. The probability of becoming shareholders in this case is quite high, so they must have an interest in the future of the company. In addition, their options are not trading and no market exists for them: the only way out is to eventually convert them into equity or new option, effectively making them shareholders. Executive stock options holders, in this sense, are not unlike non-voting shareholders.

Moreover, by requiring stock options to be deducted as an expense in income statements, regulatory authorities admit that stock options are a means of financing the company's operation, the same as any other source of capital. Stock option holders may not be current shareholders, but they have been made an implicit promise to become future shareholders and thus have a direct interest in the outcome of any merger. Having forgone capital, the outcome of the merger is of just as great an interest to them as it is for non-voting shareholders.

To be symmetric and fair, then, we should also allow executive (employee) stock option holders to vote in a merger situation. The only innovation here is that we should treat equity as total equity and add shares outstanding to shares option holders are eligible for in order for the percentages of the vote to add up to 100%.

While it is true that, in general, management's interests may not align with those of the other shareholders, this is a different issue which has to be addressed by the shareholders at a different point in time. In the meantime, executive stock option holders of Molson Inc. had a valid argument to be included in the decision regarding the merger with Coors.

Postscript: Molson's Inc. intention to allow executive stock option holders to vote in the impending merger with Coors raised the ire of the investment community and threats of challenging the decision in courts by larger institutional investors ensued. Eventually, Molson Inc. succumbed to the pressure and disallowed executive stock option holders from voting. ■