



Valuing executive compensation and executive stock options

How much would a person pay for the right to purchase the employer's stock at some point in the next 10 years?

In some injury, wrongful death, and employment cases, the individual may have been in a job position that awarded employee stock options (ESOs) prior to the incident in question. Other employees may have been enrolled in plans that made them eligible for participation in the employer's stock purchase plans. This article discusses the basics of how to value employee stock option grants.

The Basics of ESOs

When a person is granted ESOs by an employer, that employee receives the right to purchase a set number of shares of the employer's stock at a predetermined price. The predetermined price at which the employee can purchase the employer's stock is called the grant price. The employee generally must meet certain conditions before he or she can exercise the options.

The employee usually must be with the employer for a certain amount of time, called a vesting period. Additionally, the employee's stock option rights expire within a set time period, usually within 10 years. The employee's stock purchase rights also expire after the person leaves the employment of the issuing company.

Subject to these restrictions, the employee may choose to purchase the employer's stock at his or her discretion. The employee makes money if he or she is able to exercise the stock option—purchase the stock, at the agreed upon price, and then sell the employer's stock at a higher market price. The employee does not have to exercise the option. As a result, employees are not at risk of losing money if the stock price does not exceed the agreed-upon purchase price.

The damage issue in a case involving an ESO is how to determine the value to the employee of having the right to purchase the company's stock. That is, how much would a hypothetical person pay the employee with the ESO grant for that grant?

Keep in mind when valuing the ESO that the goal is not the value of the underlying stock, but instead, it is the value of the employee stock option. Clearly, the two are related, but are not the same. The value of an employee's ESO is a function of a number of factors. These factors include the employer's stock price, the price at which the

When valuing an ESO, the goal is not to calculate the value of the underlying stock, but of the employee stock option.

company has agreed to sell the stock to the employee, and the exercise restrictions that the employer has placed upon the ESO grants. The value of an employee's stock option grant is affected by economic variables, such as the interest rate in the economy, the employee

turnover rate of the company, and the anticipated variability of the stock price.

The value of the ESO will almost always be less than the market value of the stock option. This reduction in value is because of the exercise

restrictions placed on

the employee's ownership of the option. In essence, the valuation of an ESO implicitly considers all the possible stock price outcomes that could occur and places a value on the ESO based on these possible stock price outcomes.

The key thing to remember is that the valuation of the ESO includes all possible values and not just the highest possible value. In other words, the value of an ESO is not simply the investment return derived from the difference between the grant price and the price of the employer stock price as of the day of the valuation. Instead, the valuation takes into account the range of likely investment returns given the stock price's volatility.

For instance, consider a hypothetical firm whose stock presently trades at \$10 per share. Further, the stock option grant price is \$5 and may be exercised at anytime within the next eight years. The value of the ESO, based on standard mathematical models of stock option prices, would be \$6.61. This valuation takes into account the fact that if the person purchases the ESO, the employer's stock may or may not exceed the grant price over the next eight years that remain on the

ESO. Intuitively, the lower the grant price, or predetermined purchase price set by the employer, the higher the price the hypothetical person would pay for the ESO.

Employee Stock Purchase Plans

In addition to ESOs, it is also possible that the injured or deceased was eligible for or participated in an employee stock purchase plan. Employee stock purchase plans allow the employee to purchase the employer's stock at a discounted rate. Employee stock purchase plans are valued in a similar fashion as ESOs since there is no guarantee that the stock price will remain at this level. Most employee stock purchase plans impose restrictions on reselling the stock purchased under the plan.

The discount on the stock price varies by employer, but it tends to be in the area of around 15 percent to 20 percent of the market price. With employee stock purchase plans, the employee makes money if he or she is able to sell the discounted stock in the future at a price higher than the purchase price. In most employee stock purchase plans, there are usually certain restrictions on how soon and/or how much the employee can sell the purchased stocks. There are valuation models for stock purchase plans. However, since participation in the plan requires a purchase on the part of the employee, the potential value associated with participation tends to be lower than that associated with employee stock option plans.

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Guidelines on employee stock options and employee stock purchase plans

Six easy to follow steps to introduce you to the valuation of employee stock options and employee stock purchase plans.

- 1 Valuations based on the best case scenario of the employer's stock price are not very informative. Although the employee will not lose money, he or she may not necessarily make money, as the employer stock price may not exceed the grant price during the allotted time in the option.
- 2 An employee stock option that is currently 'underwater', (the grant price is higher than the market price) is not necessarily valueless. The option may still be valuable if there is sufficient probability that the stock price will increase in the future.
- 3 All other factors remaining equal, the higher the volatility, (the more the employer's stock price fluctuates) the higher the value of the employee stock option. This is because a naturally larger range of stock price values makes larger gains more likely.
- 4 Most employee stock option plans will only vest a certain percentage of options per year. This is important to take account when performing any valuation.
- 5 Most employee stock option plans will have a provision that terminates the option automatically within a set period, commonly 90 days, of a not-for-cause employment termination.
- 6 Although grant prices are typically set at the end of a fiscal or calendar year, some employers have been known to use special rules for setting grant prices, such as backdating to the lowest price over a given window of time.



We calculate alleged losses related to employee stock options and ESOs. Contact us to learn more.

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