

Navigating Underwater OPTIONS

Examining Option Exchanges & Alternatives

The current market downturn is especially challenging for companies that rely on stock options as a key component of their rewards strategy. Boatloads of grants made prior to the downturn have plunged “underwater” — that is, option exercise prices are below current share prices. As unexercisable shares continue to be charged against earnings and inflate overhang, it becomes increasingly difficult for companies to garner investor support for new share requests. That puts organizations at a disadvantage in trying to attract and retain the talented and driven workforce needed to execute a successful turnaround.

QUICK LOOK

- Option exchanges are a complex process in which out-of-the-money grants are cancelled and replaced with awards of new options, restricted stock or cash.
- The primary reasons cited for option exchanges are to renew motivational and retention power for executives and employees and to restore the alignment of interest between shareholders and executives/employees.
- After considering critical issues associated with option exchanges, many companies conclude that the benefits do not outweigh the costs.

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The compensation and governance environment has changed dramatically since the last wave of **option exchanges**, which followed the collapse of the technology bubble in 2001.

To address the problem of underwater options, many companies are taking a closer look at option exchanges. Given the level of interest in such exchanges, it's important that businesses understand how they work and how to decide if they are the correct course of action. To that end, this article explores the basics of option exchanges, as well as outlines alternatives for companies that determine such exchanges are not feasible at their organization.

The Option-Exchange Lifeboat

Option exchange is a complex process in which an out-of-the-money grant — this is, a grant with an exercise price that is greater than the market price of the underlying stock — is cancelled and replaced with an award of new options, restricted stock or cash. Our own research indicates that between January 2008 and mid-March 2009, 86 companies — including employee stock option strategy bellwethers Google and Starbucks — submitted proposals to their shareholders or filed a tender offer for an option exchange.

Such interest is further highlighted in Pearl Meyer & Partners' latest *Executive Pay in the New Economy* survey, completed in February 2009. More than 7 percent of survey respondents with stock option programs said that

they recently implemented an option exchange or were planning to do so within the next six months. Roughly 46 percent of these companies had just completed or were contemplating a swap for full-value shares, while 59 percent were considering issuing new options (totals exceed 100 percent because some firms are considering a mix of stock options and full-value shares).

The primary reasons cited for the option exchange were to renew motivational and retention power for executives, to renew motivation and retention for employees, and to restore the alignment of interest between shareholders and executives/employees.

Obstacles at Sea

The compensation and governance environment has changed dramatically since the last wave of option exchanges, which followed the collapse of the technology bubble in 2001. The current conditions are decidedly less favorable. Along with heightened shareholder activism and scrutiny of compensation programs, there are changes in accounting rules and proxy advisory firms' standards, including:

- stricter New York Stock Exchange and Nasdaq listing standards that require shareholder approval of any

option exchange, other than for cash, unless specifically permitted by the company's equity plan

- opposition by many institutional shareholders and proxy voting advisory services (including Risk-Metrics Group, the most influential proxy advisory service) to any option exchange program that includes executive officers or directors
- FAS 123(R) accounting regulations that treat exchanges as a modification to the original grant, requiring that any additional value provided be recognized as an incremental expense. In response, many companies conducting an option exchange have:
 - moved away from a 1-for-1 exchange ratio in favor of providing only one new option for every five, 10 or even 20 significantly underwater options, depending on the estimated value of forfeited options relative to new awards
 - opted to replace cancelled underwater grants with full-value shares, particularly restricted stock units.

Is an Exchange Appropriate for Your Company?

Before committing to an exchange program, companies should carefully consider whether it is the most effective and appropriate means of dealing with

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their underwater options. There are four critical issues:

- Is the timing right?
- Is your company experiencing or concerned about the potential for high turnover?
- Does the exchange address investor concerns?
- Is it worth it?

Is the timing right? Depending on market conditions, an option exchange can end up reducing the motivational and retention value of the equity award. That can occur if the company's share price drops significantly after the exchange, plunging the newly issued options underwater and leaving employees back at square one. Conversely, if the stock price unexpectedly bounces back to a point where forfeited options would have been "in the money," it would render the exchange pointless.

Is your company experiencing or concerned about the potential for high turnover? Let's face it: The economic downturn has affected nearly every industry, and very few companies appear immune. Anyone reading financial headlines knows that companies are laying off employees, freezing base salaries, not paying out bonuses and

experiencing stock price declines. As a result, knowledgeable employees may be frustrated that potential stock option gains have been lost, but may be more concerned about the prospect of job loss. Even so, we are not suggesting that companies be cavalier about the economy's dampening effect on their compensation programs, as it is important for companies to continue to incent and motivate employees, and we recognize that top performers in critical positions will continue to be a retention concern. However, an option exchange should only be considered if the company expects to experience significant turnover and lost motivation in the absence of drastic action, and after other alternatives have also been explored.

Does the exchange address investor concerns? Option-exchange proposals put to shareholder vote may include "shareholder friendly" design features in order to increase the likelihood of gaining a majority vote and to avoid negative sentiment from investors. These features can include:

- exclusion of executives and board members
- exclusion of any options granted within the past 18 months to two years

- resetting or extension of the vesting term of the replacement options
- exclusion from the exchange of any options with an exercise price lower than the stock's 52-week high
- the use of value-neutral cash payments or share-for-share exchange rates (i.e., using Black-Scholes or binomial pricing models to determine how many replacement options to grant for each forfeited underwater option, based on current value)
- a prohibition on adding any surplus shares from the exchange back to the plan for future grants.

Is it worth it? Option exchanges entail a significant time commitment to prepare employee communications and multiple SEC filings and disclosures (e.g., the shareholder proposal, tender offer and Compensation Discussion & Analysis (CD&A) disclosure in the proxy statement). Additionally, there may be substantial incremental expense for the new options, restricted stock or cash awards, as well as consultation fees for services rendered by accounting, legal, valuation and compensation experts. (An extreme example of substantial incremental expenses is when Google anticipated a modification charge of \$460 million during the vesting periods of new options offered in its March 2009 exchange.)

Alternatives to Exchanges

At the end of the day, companies must ask if the administrative burden, associated fees and potential negative shareholder response to an option exchange outweigh the advantages. If not, there are a number of alternative approaches to consider.

If you haven't already done so, consider migrating to an annual award schedule rather than limiting awards to new hires, promotions and special events. Annual grants will essentially reload employees each year with

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at-the-money options and trigger a fresh vesting schedule that promotes retention. This approach also helps avoid the risks involved in over-weighting a new-hire grant.

Consider a supplemental grant of new options, with appreciation capped at the exercise price of the underwater options. Like annual grants, this approach reloads employees with at-the-money equity, providing a motivation and retention “bridge” between the current share price and the exercise price of the underwater options. However, this approach should only be considered if there are no immediate constraints on shares available for grant.

Migrate to increased use of restricted stock or performance-based restricted stock in lieu of options. Because they are immediately in the money, full-value shares can be an effective way to increase morale and retention. The award value can be set to competitive market rates or — more conservatively — to the underlying economic (Black-Scholes) value of the underwater options an employee holds. (Yes, underwater options may still have economic value because there is always a chance that the underlying share price may increase to a point where the option is no longer underwater during the remaining option life.)


Offer a choice of equity vehicles going forward, such as a menu of stock options, restricted stock or performance-based restricted stock.

Trade-offs could be made in terms of the equity value provided based on the particular instrument selected by the employee. Employees who choose a relatively less risky award, such as restricted stock, would receive less value than those selecting stock options. Note that this approach may be very well received and effective for a non-executive population, but less appropriate for executives. There is a risk that shareholders might interpret an executive’s decision to choose restricted stock over stock options as signaling a lack of confidence in the company’s future.

Increase the target cash-incentive opportunity and decrease (or eliminate) the equity award value for non-executive populations. Studies have shown that once options vest, employees are more likely to exercise and sell their shares for immediate gains than to hold those shares over the long term, as many executives do. If the intent of the option grant program is to foster employee ownership, employee stock purchase plans may be a better answer. (Clearly, increasing cash-incentive targets is less practical for companies that are cash constrained.)

Conclusion

Out of every crisis comes opportunity, and today’s crisis is no exception. The current market downturn presents a chance for companies to address the pain associated with underwater stock

options through alternatives including option exchanges. A potential outcome is a better-designed long-term incentive strategy that not only boosts investor support but also increases the organization’s ability to attract and retain talent key to company success. 

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