

Exchanging Underwater Stock Options

by Gerry Miller and Takis Makridis

Despite 2009's modest market recovery, many of your employees' stock options remain "underwater." With little incentive value, and fading hopes for their ultimate worth, these options remain a drag on your accounting, do little to spark performance, and make it easier for competitors to lure top talent. Some major corporations are looking at option exchange programs—but you should tread carefully.

Are your company's stock options considerably underwater? Is the company stock price a fraction of the exercise price of previously granted stock options? Does your company face the grim prospect that most employee options will likely never be worth anything? Does your board also worry about being in the headlines if you modify (reprice) your underwater stock options? Many companies have already or are considering stock option exchanges to re-establish broken incentives and retention benefits.

Changes in the corporate governance landscape, accounting rules, and investor sentiment have driven equity pay professionals to innovate the ways they modify underwater stock options. Many companies have chosen a "value-for-value" exchange, trading employees' underwater options for an equal value of at-the-money stock options, restricted stock, or cash. This avoids any additional compensation expense as a result of the transaction.

The prolonged market downturn has sparked significant interest in exchanging underwater options. However, many key questions remain unanswered for the compensation committee.

Yet why would an employee accept the same value of replacement awards as the value they give up?

Research clearly shows that even if the accounting values of the new options are the same as the old values, employees tend to disproportionately discount the value of an option that is deeply underwater and will see the old options as essentially worthless.

The current prolonged market downturn has sparked significant interest in exchanging underwater options. However, many questions remain unanswered: Of the 100 plus companies that have conducted an exchange in the last four years, for example, why do employee participation rates range from 40 percent to 100 percent? What are the characteristics of companies that successfully obtain shareholder approval? What are the potential risks of conducting an option exchange?

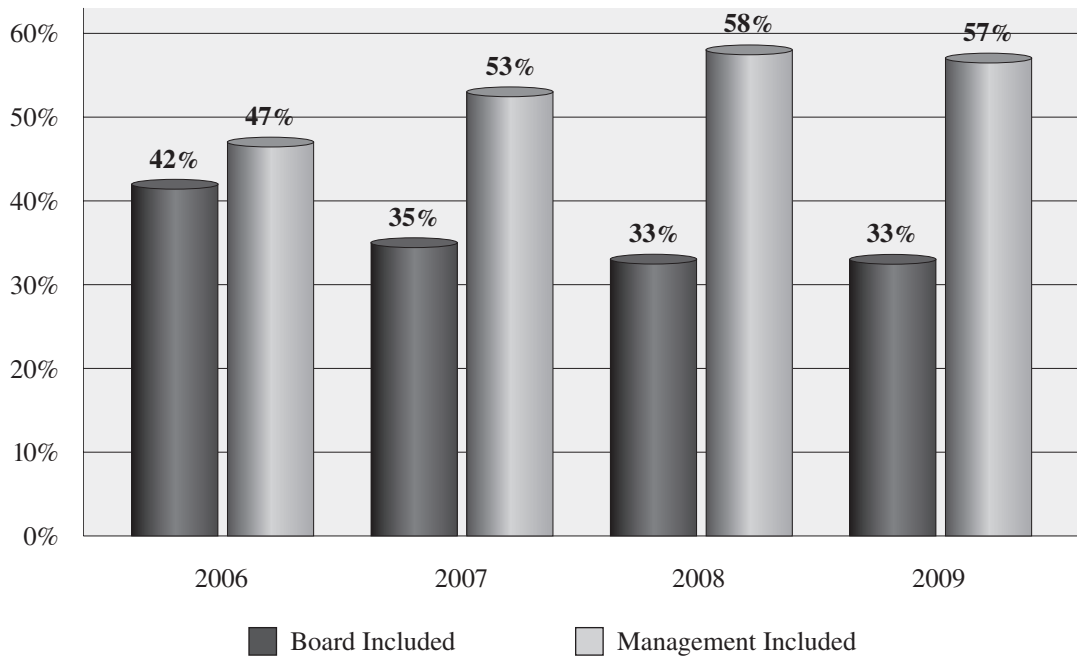
Companies consider option exchanges because they view their underwater options as lacking retention and incentive value for employees. Sometimes, exchanges allow for recapturing shares if the pool of shares for future grants is dwindling. With a long-term decline in stock prices, replacement options (that are at-the-money) can form a very direct link between key employees' rewards and increases in shareholder value.

Compensation committees must consider several questions before proceeding with an exchange:

- Could stock market speculation or a general short-term rise in a major stock index (such as the S&P 500) eliminate the current underwater condition?
- How far has the company stock declined?
- Does the employee equity plan allow for stock option exchanges? Is shareholder approval necessary, and likely? Even if shareholder approval is not required, what are the negative consequences in not

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Fewer Directors, More CEOs
Board And Top Executive Participation



seeking approval?

- Are there adequate shares remaining in the employee equity pool to allow for future grants?
- Are most underwater stock inordinately held by Named Executive Officers (NEOs) in the company’s proxy statement? Should they be allowed to participate in the exchange?
- Do executives and other key employees have competitive levels of equity participation?
- What portion of outstanding stock awards are in options?
- What is the current overall investor relations climate?
- How would a stock option exchange be explained in your Compensation Discussion & Analysis disclosures?
- Is the board’s compensation committee certain that shareholders and employees would benefit from correcting the underwater option situation?
- Would correcting the underwater options be viewed as “one more” incident in a series of negative events about the company?
- Will RiskMetrics or other shareholder advocacy

groups provide a favorable voting recommendation? If not, are there enough votes controlled by favorable shareholders to overcome a negative vote recommendation?

The process of an exchange generally takes between three and six months. It requires consideration of governance implications, detailed analyses, and employee participation. The process can be thought of in three phases:

- Phase 1: Initial consideration.
- Phase 2: Analyses and strategy.
- Phase 3: Implementation.

Start by discussing why an underwater option exchange makes sense for your company. Why has your share price performed poorly?

Phase 1: Initial consideration and assessment. Start by discussing and answering the questions outlined above. In particular, why is an exchange the right deal to strike with employees, especially if the intent is to allow NEOs to participate? The board and

management should ask why the company's share price has performed poorly. The more firm-specific the reason (key customers have gone bankrupt, etc.), the better the reasoning will stand up to scrutiny. Ensure that an exchange will not send a signal to employees that their pay contracts can be renegotiated whenever things do not go their way.

The compensation committee should also develop a discussion document to summarize important accounting, tax, securities law, shareholders' views and governance issues. An exchange today is much more complicated than a repricing was in 2002, and committee members should be aware of this.

Model the option exchange to determine which older options are to be considered for exchange and the preliminary exchange ratios. The key advisors here are compensation consultants and outside legal counsel.

□ *Phase 2: Analyses and strategy.* Once it is determined that an option exchange is desirable, a much more rigorous analysis is required with strict focus on the details. The goal is to engineer a transaction that shareholders approve, benefits the company's business strategy, and employees find advantageous. Will every option be eligible for exchange? What will the terms of a value-for-value exchange look like? Will the "juice be worth the squeeze"—that is, will the exchange be worth the effort of the process?

Understanding the key requirements of the exchange, ranging from securities law to FAS 123R accounting procedures, is also essential. Your initial design should answer two key questions: whether value-for-value exchange ratios should be used (versus more favorable ratios) and how well the design adheres to proxy advisor voting guidelines.

In a "value-for-value" exchange, the rationale is to incur no additional compensation cost (beyond that of the initial grant), while granting employees an instrument they view as more valuable.

Depending on how far your options are underwater, a value-for-value exchange may or may not appeal to employees. With deeply underwater options, a value-for-value exchange may simply not be appetizing to employees (would you participate if you had to give up 50 underwater options just to receive

one at-the-money option?).

With deeply underwater options, the incremental cost of departing from a value-for-value ratio may not be great. The more a company "needs" to depart from value-for-value in favor of the employee, the less of a financial statement impact this should create.

So if value-for-value is not required, how much incremental cost can be absorbed? Google represents one side of the spectrum. Its exchange was conducted on a 1:1 basis (one underwater option will be exchanged for one at-the-money option). The estimated incremental accounting cost exceeds \$400 million.

Most companies pursuing a non-value-for-value exchange, however, determine the exchange ratios of a value-for-value design and then set a discount that meets a maximum amount of incremental cost. The goal is to balance shareholder interests with the expected reaction from employees to the exchange terms.

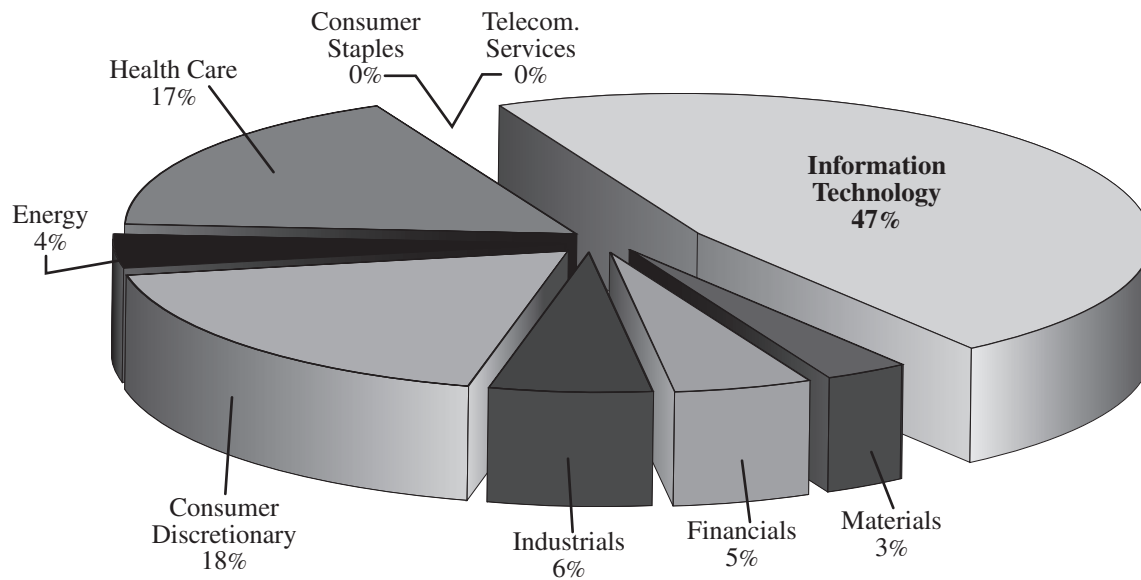
Valuing an underwater option that is midway into its contractual life differs from valuing those that are at-the-money. Standard option-pricing methodology (usually the Black-Scholes formula) is not fit for the task.

Companies cannot apply the usual Black-Scholes methods to set exchange ratios because a FAS 123R-compliant valuation may yield very different results. The company may face incremental accounting charges because what they thought was value-for-value actually turns out *not* to be value-for-value according to a FAS 123R.

The major proxy advisory firms, of which RiskMetrics is the largest, have published annual voting guidelines related to an exchange. Institutional investors turn to these proxy advisory firms in casting their votes on shareholder proposals in a company's proxy.

RiskMetrics has stated that it will evaluate each exchange on a case-by-case basis. However, the record suggests that when NEOs or board members are included in an exchange, RiskMetrics will vote against the transaction. RiskMetrics will also vote against exchanges involving option eligibility where options with an exercise price below the

Who Is Swapping Options? IT Stock Has The Most Urgent Need



company's 52-week-high stock price are eligible for exchange.

In an exchange, the goal is to address shareholder and employee needs—and proxy advisory firms are neither shareholders nor employees. However, they are an influencer to shareholders. Understand who the company's shareholders are, the exchange terms they will find appropriate (and inappropriate), and whether it may be necessary to depart from proxy advisory voting guidelines to drive employee retention and motivation.

Even when shareholder approval is not required, it is recommended. Bypassing shareholder approval may result in “against” or “withhold” votes for directors.

□ *Phase 3: Implementation.* NASDAQ and NYSE rules require companies to obtain shareholder approval for option exchanges, unless company equity plans expressly permit a repricing. The main exception is an exchange of options for cash, which both NASDAQ and NYSE rules do not classify as a “repricing.” Thus, option exchanges for cash have

been implemented without shareholder approval.

However, even when shareholder approval is not required, it is recommended. It improves the perception of the transaction, and bypassing shareholder approval may result in proxy advisory firms recommending an “against” or “withhold” vote for compensation committee members.

Companies seeking shareholder approval need to consider the nature of their shareholder base. As a rule, the more institutional shareholders a company has, the more likely those shareholders are to follow the voting recommendations of proxy advisory firms or initially oppose an option exchange proposal. The nature of ties with institutional shareholders also matters. Can phone calls be made to explain the transaction to key investors? The more uphill the battle, the more important it is to hire a proxy solicitation firm.

Finally, record-keeping and accounting systems must be adjusted to reflect the transaction. Although the ease of reporting on an exchange should not drive how it is structured, not all exchanges are equally simple to administer and account for. These challenges should be understood in the beginning of the process, although the focus should be on designing

an optimal deal for shareholders and employees.

An upsurge in option exchanges came in the latter half of 2008 in response to the rapid deterioration in the capital markets. As of March 2009, approximately 20 companies have either completed an option exchange or have stated an intention to do so. Many are large, recognizable brands, such as Intel, eBay, Starbucks, and NetApp.

These companies are primarily in the technology, health care, and consumer sectors, those particularly affected by the economic decline. These sectors also tend to employ niche talent, in which retention is critical to innovation, ability to hit milestones, and product delivery.

Current trends suggest an increased prevalence in options-for-options exchanges. One possible explanation is that companies feel granting replacement options will provide added leverage to employees by increasing upside price potential.

One of the most important decisions facing the board is whether named executive officers should participate. While RiskMetrics opposes all exchanges including NEOs, it is surprising that in almost 60 percent of the cases, NEOs are eligible. Smaller companies are more likely to include executives, as are those that choose not to seek shareholder approval. Compensation committees need to think carefully about the implications of allowing NEOs to participate in any exchange.

The goal of most exchanges is to minimize cost and maximize value. By doing so, the company keeps the incremental cost as close to zero as possible while maximizing the perceived value by employees. The data, however, suggest that not all companies have successfully driven high rates of employee participation. The average participation rate is around 70 percent of employees.

Certainly, a key driver of employee participation is how favorable the exchange ratios are. Most com-

panies have a threshold amount of incremental accounting cost they are willing to incur. Compensation committees should task management with exploring multiple options to ensure the most appropriate design is selected. They should also confirm that a thoughtful communication strategy is in place.

The compensation committee must require a good rationale for a stock option exchange. Clarify that performance targets will not be reset any time things do not go as planned.

Many companies may have already contemplated a stock option exchange program, but only a select few have gone so far as to implement one. Should the overall stock market remain low or decline further, there may be many more completed.

In those cases where an exchange program is warranted, there is no universal formula on how it should be designed. At the outset, however, the compensation committee must demand a good rationale for an exchange, and clarify that performance targets will not be reset any time things do not go as planned.

From there, explicit consideration of who the key shareholders are and the type of exchange they would find reasonable is necessary. With this in mind, the task is then to design terms that employees would find meaningful and communicate them clearly and succinctly via the tender offer.

Exchange programs to deal with underwater stock options require careful oversight by a compensation committee, and active management to ensure the program achieves its stated objectives. If appropriate, and implemented thoughtfully, an exchange program could score a win with employees during a challenging time where boosts to morale are integral to a company's strategy. ■

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