McLagan Alert

Addressing Underwater Options

Measured responses to a contentious problem

By Brett Harsen and Brian Flume
January 28, 2009

The credit crisis of 2007 and 2008 has resulted in severely depressed stock prices for the majority of large financial services firms, leaving their executives and employees holding underwater options (an employee stock option with an exercise price greater than the fair market value of the underlying company stock). Many executives have lost a significant portion of net worth based on the decline in the value of their holdings.

In the quest for creative alternatives to address long-term compensation issues, some firms are researching approaches to replace the significantly out of the money options. They are well aware that such an exchange program may pique shareholders and the business press in the process if handled poorly. Nevertheless, shareholders will support responsible underwater exchange proposals and some firms are willing to run this gauntlet to achieve important objectives:

- Reduce overhang of outstanding options
- Provide value and motivation to key executives and employees who are in position to drive growth and a return to profitability

The primary focus must be on balancing interests of both employees and shareholders. The days of one-sided repricings that only benefit the option holder to the detriment of shareholders are over.

The current business, shareholder, and regulatory environment have a very real impact on the approach that companies are able to take in order to address the problem:

- SFAS 123(R) is mandatory, changing the accounting treatment for underwater option exchange programs (in general, the accounting consequences are less punitive)
- NYSE and NASDAQ exchanges have rules requiring shareholder approval for underwater option exchange programs
- Shareholders have become more sophisticated and vocal in recent years in making known what types of option exchange programs are acceptable – and which are not
- The SEC requires underwater option exchanges to be treated as tender offers, exposing programs to greater public disclosure and more restrictive offer rules
- Plan documents often require approval of shareholders

History has shown us that aggressive or egregious repricings (lowering of the option strike price) that only benefit option holders are certain to raise the ire of shareholders, regulators and the media.

CHICAGO
Aon Center
200 East Randolph Street
Tenth Floor
Chicago, IL 60601-6421
Tel: 312.381.9700
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Dubai International Financial Center
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P.O. Box 506706
Dubai
United Arab Emirates
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Suite 601
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2nd Floor
22-15, Akasaka 2-chome
Minato-ku, Tokyo 107-0052
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But as it stands today, there is precedence for executing an underwater option exchange that is beneficial and acceptable to each of three primary stakeholders:

- Employees (Restore equity value, Maintain ownership)
- Company (Reduce unproductive overhang, Increase employee morale and retention, Restore employee alignment with shareholder interests)
- Shareholders (Increase return on investment, Reduced dilution)

This McLagan Alert will explore the three most common underwater exchange approaches and discuss the implications of each major design consideration. We will also provide advice on program rollout, communication and administration.

UNDERWATER EXCHANGE PROGRAM APPROACHES

Three basic approaches have emerged for addressing underwater options in today's business environment: Options-for-Options, Options-for-Stock, and Options-for-Cash. The form of consideration offered by the company in return for the employees' participation is the primary difference between the alternatives. The table below provides a general description and outlines the advantages and disadvantages of each approach.

APPROACH	DESCRIPTION	ADVANTAGES	DISADVANTAGES
Options-For-Options	Cancellation of underwater options followed by an immediate re-grant of (typically fewer) new options	▪ Ease of communications (employees generally understand options) ▪ Employees maintain control of taxable event (options taxed at exercise) ▪ Some reduction in issued stock overhang	▪ Potential remains for newly issued options to go underwater in the future ▪ May not be received positively by employees if stock options have not provided value historically ▪ Public scrutiny and adverse media reaction
Options-For-Stock (restricted stock or RSUs)	Cancellation of underwater options followed by an immediate re-grant of (significantly fewer) new shares of restricted stock/units	▪ Eliminates potential additional future underwater options (restricted stock cannot fall underwater) ▪ Greater reduction in issued equity overhang due to higher exchange ratios ▪ High perceived value by employees	▪ Employees lose control of timing of taxable event (shares taxed at vest/receipt) ▪ Number of shares returned to employee typically reduces future upside leverage compared to using stock options ▪ Public scrutiny and adverse media reaction ▪ Reduction in alignment to shareholder interests
Options-For-Cash	Cancellation of underwater options for a (typically immediate) cash payment	▪ Greatest possible reduction in issued equity overhang (no new equity shares are issued) ▪ Eliminates additional future underwater options ▪ Typically provides immediate value to participants when no additional vesting required for payment	▪ Requires a cash outlay by the company ▪ Employees lose control of timing of taxable event (taxed upon payment) ▪ Employees lose opportunity to participate in future upside stock price growth ▪ Lacks retention features if no additional vesting added ▪ Public scrutiny and adverse media reaction ▪ Elimination of alignment to shareholder interests

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Aon Center
200 East Randolph Street
Tenth Floor
Chicago, IL 60601-6421
Tel: 312.381.9700
Fax: 312.381.9920

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Gate Village, 2nd Floor, Unit 9
P.O. Box 506706
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The primary factors driving program choice are:

EQUITY INCENTIVE PHILOSOPHY

The use of restricted stock in lieu of options for ongoing equity awards has increased substantially in recent years. If an organization has already undergone such a philosophical shift to restricted stock, the options-for-options approach may deliver conflicting messages to employees.

RESOURCE LIMITATIONS

Cash is often a scarce resource, making the options-for-cash approach infeasible. Conversely, if shares available for grant under existing plans are not sufficient to cover the expected re-grant obligation, using cash may be the only course of action.

EMPHASIS ON OVERHANG REDUCTION OBJECTIVE

In some cases, issued overhang reduction is of paramount importance (either to the company or shareholders), driving companies away from the options-for-options approach that requires the largest number of new shares granted in the exchange and is the most dilutive.

EMPLOYEE PERCEPTION

It is important to remember that employee participation in an exchange is voluntary. To maximize program success, employee demand for one form of consideration over another must be factored in the decision.

PROGRAM DESIGN CONSIDERATIONS

Regardless of the approach used, the majority of design considerations remain the same. Since shareholder approval is often required, we will touch on typical strategies for maximizing likelihood of investor approval at each step.

OPTION HOLDER ELIGIBILITY

The first decision is whether certain option holders should be excluded from the program, namely members of the Board of Directors and executive officers of the company. Shareholder groups consistently want these senior level individuals excluded, arguing that accountability for performance and direct linkage between stock price improvement and pay is essential. Shareholders reason that unlike broad-based employees for which morale and retention is the focus, directors and officers should not get a second chance if the stock price declined on their watch.

However these individuals often hold substantial amounts of the troubled options in question, and excluding them can undermine other important program objectives such as overhang reduction. If it is determined that directors and/or officers must be included, consider:

- Allowing their participation only under terms less favorable than those provided for broad-based employees
- Separating the shareholder approval process into multiple proposals so that investors can decide on directors and/or officers without jeopardizing the program for broad-based employees

GRANT ELIGIBILITY

The next decision is which outstanding stock options to allow employees to exchange. Do we allow any underwater option to be turned in, or only those that are 'significantly' underwater? There are three primary reasons for putting some space between stock options eligible for exchange and the current stock price:

- Allowing those options that are still priced relatively close to the current market value of the stock may send the message to investors and employees that the company's leaders have little faith in stock price recovery
- Options only slightly underwater still provide an achievable incentive to increase stock price
- For those using the options-for-options approach, the new awards could be struck with a higher exercise price than those surrendered if the stock price spikes during the program enrollment period (tender offer rules, discussed later, require the offer remain open for at least 20 business days)

EXCHANGE RATIOS OR CASH AMOUNTS OFFERED

The most important element of an underwater exchange program is usually the amount of consideration being offered to the stock option holder. Remember, these are voluntary offers in which employees typically fixate on the number of shares they will be holding before and after the exchange. If an employee perceives a bad deal, participation will be below expectations and the program will fail to meet its stated objectives. On the other hand, if employees perceive the options to be so far underwater that they are worthless, then getting anything in exchange for them will be viewed positively.

Many factors are at play when dealing with employee perceptions, but a common starting point is the "value-neutral" exchange rate. This is determined by using a fair value model, such as Black-Scholes, to calculate the value of underwater options. If using cash, this represents your offering amount and you stop here. If using new options or restricted stock in the exchange, the number of underwater options equal in value to one new award in your exchange rate. Because restricted stock has a higher per-share value than an option, options-for-restricted stock program typically have higher exchange ratios than options-for-option offers.

- Companies may round the calculated value-neutral rate to make it easier to administer and communicate to employees, or they may dismiss it altogether if the Black-Scholes valuation is dubious. It is important to note that if the new award has greater value than the surrendered underwater options, an incremental accounting charge will be generated under SFAS 123(R). An offer that is value-neutral, or returns less value to the employee, avoids such charges.
- Many exchange programs attempt to address multiple underwater option grants with a range of strike prices. Offering only one exchange rate in these cases would make it very attractive to exchange certain awards and much less attractive for others. Conversely, establishing a unique exchange rate for every outstanding grant is complex and usually not necessary.

VESTING OF NEW AWARDS

In options-for-options and options-for-stock programs, the second most critical factor affecting employees' willingness to participate is the vesting treatment for new awards. There are three basic ways to approach vesting of new equity awards in an underwater exchange program.

- MAP VESTING: Mapping is the most employee-friendly approach that simply transfers the vested portion of the underwater award to the new award. For example, if the underwater award tendered for exchange was 50 percent vested

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with one year to vest on the remainder, the new award will be 50 percent vested when it is granted, with the balance vesting over a one-year period.

- FULL VESTING PERIOD: A full reset is the least employee-friendly approach. It disregards the vested position of the tendered underwater options and introduces a fresh vesting schedule to the new award based on typical practices (e.g. four years).

- PARTIAL VESTING RESET: The partial reset is a middle ground between mapping and full reset. Typically, the new award is reset to zero vested at grant, but uses a shorter schedule than is typically used for equity awards (e.g., two years instead of the normal four year requirement). This approach adds additional retention to the new grant – a key objective of most option exchange programs – while still recognizing some of the vesting already earned by the employee.

In most cases, the underwater options being considered for exchange are substantially vested. Failing to recognize this past service by requiring the employees to vest from scratch in the new awards may hurt program participation. Because retention is often a key objective for the company, McLagan typically recommends using a partial vesting reset. This approach recognizes some of the vesting earned on the old awards, while adding retention value to the plan.

TREATMENT OF NET RECAPTURES

Unless a 1:1 ratio is used, underwater exchanges will cancel a greater number of underwater shares than are re-granted as new awards. Most employee equity plans allow these recaptured shares to be returned to plan pools and made available for future issuance. However, in order to make the program more palatable to investors, some companies commit to permanently retiring net shares so they cannot create any further shareholder dilution.

PROGRAM IMPLEMENTATION

Underwater option exchange offers are complex programs that require a well-defined communication and administration strategy. Some have compared the effort required to execute these programs to an open enrollment campaign for health and welfare benefits. In both cases, program details have to be explained and incumbent-by-incumbent elections must be tracked. It is important that the company not recommend to employees a course of action or try to influence their decision to participate. To remain at arms length, some organizations choose to use a third party to communicate plan terms and administer elections.

Making the process even more burdensome is the requirement that it be treated as a tender offer under SEC rules. In a tender offer, any information that is material to the employee's decision to participate must be publicly filed. Due to the logistics and costs associated with making SEC filings, this means that all information that is intended to be shared with employees should be finalized before the program begins (legal offer description, employee presentations, e-mail announcements, enrollment forms, frequently asked questions). Employees must be given at least 20 business days to consider program participation and the company cannot recommend any course of action to option holders.

Any introduction of new material information after the program has started, or a change to the information originally provided, may require the company to file a tender offer amendment and restart the required 20 day election period.

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Finally, eligibility for employees outside the United States must be examined on a country-by-country basis to avoid creating unnecessary tax and securities burdens for the company and program participants. Advice from local tax and securities experts should be obtained before deciding whether to include these locations in such programs.

The costs and complexities of implementing a stock option exchange in a country without critical headcount and limited underwater option shares may mean such an approach is infeasible. In such circumstances, underwater options outside the United States can be addressed with supplemental equity awards that do not require the tender offer process.

CONCLUSION

Stock options will continue to play an important role in compensation delivery well into the future. For various reasons, and from time to time, options will fall underwater and companies will have to take action to address the associated employee morale issues.

While regulatory and shareholder scrutiny has made underwater option solutions more onerous, companies can take advantage of responsible strategies for addressing the problem while meeting the objectives of all three stakeholders – the employees, the company and shareholders.

For more information and results from research conducted on actual exchange programs filed with the SEC, visit our Underwater Options Portal at www.UnderwaterExchange.com. ■

Brett Harsen is a Vice President. Brett leads the Analytic Services group, providing customized analytics and services that improve survey data analyses and compensation program design. In addition to managing the strategic direction, he directs a team conducting special research into equity practices, underwater option strategies and Board of Directors compensation practices and trends for publicly-traded companies. Brett can be reached at (312) 381-3685 or bharsen@radford.com.

Brian Flume is an Associate within McLagan’s Executive Compensation Consulting practice. Brian can be reached at (212) 479-4229 or bflume@mclagan.com.