



# Executive Remuneration Perspective

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## Weathering the storm – part III: Revisiting underwater options

Unprecedented volatility has been wreaking havoc on equity programs. With the US stock markets at levels not seen for over a decade, many companies have a substantial percentage, if not all, of their stock options underwater – that is, the exercise price is greater than the current stock price – with no hope of being back in the money any time soon. Companies question whether these awards have any power to motivate and retain employees, yet they are still taking accounting charges for these awards that likely will produce no ultimate value.

On the other hand, the employment market is softening in most sectors, so retention may not be as pressing a concern for all but the highest-performing employees. Plus, shareholders have incurred significant losses, making them unsympathetic to concerns about equity compensation. Against this backdrop, many companies are considering whether it is appropriate to take action on their underwater options. All should proceed with caution – these unprecedented times call for ensuring that shareholder interests are carefully considered. Although many companies will decide to take no action, some ultimately will conclude that an exchange is an appropriate step.

### In this issue:

*When determining whether an underwater option exchange is appropriate, how can companies balance both shareholder and employee interests?*

*If an underwater option exchange is an appropriate course of action, what are the potential alternative replacement vehicles for underwater options?*

*What shareholder, securities, accounting, tax and communications considerations and requirements need to be examined when considering any underwater option exchange program?*





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In this *Perspective*, the third in our “Weathering the Storm” series, we provide a framework for evaluating underwater options and determining if actions are appropriate. The first article in the series addressed equity compensation actions for 2009, and the second one examined broader executive program strategies to consider in the current environment. In this article, we explore the following topics regarding underwater option exchanges and repricings (in this article, for simplicity, exchanges and repricings are referred to as “exchanges,” and options and stock settled stock appreciation rights are referred to as “options”):

- How to assess whether an underwater option exchange is appropriate
- Alternative strategies for exchanging underwater options
- Implementation requirements, including legal, shareholder approval and communication considerations

Mercer has examined about 50 option exchanges that have been announced since mid-2008. We include highlights of that review throughout this *Perspective*.

### **Assessing whether an underwater option exchange is appropriate**

A balance of company, shareholder and employee interests should be carefully considered when determining whether an underwater option exchange is appropriate.

- **Reliance on stock options in the LTI program** – Understand the extent to which long-term incentive (LTI) awards are tied to the stock option component. Many companies have moved to a portfolio approach of LTI awards, where stock options are used in conjunction with full-value shares or performance awards. Assess the degree to which stock options and the entire LTI portfolio have been affected by the downturn. Where options are a minority component of the total portfolio and other devices exist to motivate and retain employees, an exchange may not be warranted.
- **Impact on retention** – Analyze the extent of underwater options. Assess the proportion of awards that are underwater and the degree to which they are underwater. It may be more appropriate to consider an exchange if a large proportion of awards is underwater and the current stock price is well below the exercise price. Also, if the options have been underwater for a significant period of time – say, at least a year – they may have less motivation power. Evaluate this in the context of the retention power of other rewards for employees to ascertain the degree of risk the company has for retaining its workforce in the current environment or when circumstances improve.

- **Dilution and share plan capacity** – Assess the current levels of share dilution and shares remaining for grant. If dilution is high and shares reserved for future grant are limited, the ability to strengthen retention hooks through new LTI annual grants will be constrained and receiving shareholder approval for additional share capacity may be difficult. Thus, depending on the terms of the plan document and shareholder approval, an exchange program may be an opportunity to free up capacity.
- **Rewards program context** – Consider the impact of other rewards elements on the appropriateness of an exchange. Understanding how base salaries, annual incentives and benefit programs are holding up relative to those of the company’s peers provides additional context. For example, if your company has provided base salary increases and annual incentive awards, while other competitors in your industry have not, an exchange may not be needed since the total rewards package may compare favorably to that of the external market. Also, grants under the ongoing LTI program may provide sufficient motivation to mitigate the need for an exchange.
- **Company performance** – Examine how the company has performed in the current environment to gauge what shareholder perception might be of an exchange program. A company that has had stable performance in a down industry may find shareholders are more receptive to an exchange and are more prone to ensuring that employee rewards are appropriate. Ongoing stock price performance is another consideration; if a company’s stock price is still in decline or is highly volatile, implementing an underwater option exchange at this point in time may be premature.
- **Regulatory and shareholder approval hurdles** – Determine the potential hurdles for implementing an exchange program, including shareholder approval, securities, accounting and tax considerations. Shareholder approval may be a particularly high hurdle to overcome in today’s environment, based on the significant losses that shareholders may have incurred. Recipients of funds from the Troubled Assets Relief Program need to be particularly sensitive to these issues and potential limitations on replacement compensation. We discuss these considerations for the US below; companies will also need to address the implications for other countries.
- **The relative costs and benefits of a potential exchange** – Implementing an underwater option exchange can be a costly undertaking, and both the administrative costs and potential accounting charges must be weighed against the ability of the program to improve employee retention and reduce share dilution. In many cases, the restrictions that arise from designing a “shareholder-friendly” plan (for example, deciding to exclude executives and directors) can limit the impact of the program to the point that the potential benefits may not justify the likely costs.

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## Potential exchange strategies

After examining these issues thoroughly, many companies will choose to stay the course and not undertake an option exchange. However, others may conclude that an underwater option exchange is an appropriate course of action. There are three potential alternative replacement vehicles for underwater options.

Exchange approach	Description and implications
Exchange options for options	<ul style="list-style-type: none"> <li>■ Replaces options with new grant of stock options (usually a reduced number)</li> <li>■ Maintains the same form of award, making it easy to communicate</li> <li>■ Maintains leverage inherent in stock option compensation</li> <li>■ May not have desired retention effect – risk remains that replacement options will be underwater if stock price continues to decline</li> <li>■ A large majority of the option exchanges since mid-2008 have been option-for-option programs</li> </ul>
Exchange options for restricted stock or restricted stock units	<ul style="list-style-type: none"> <li>■ Replaces options with new grant of restricted stock (since restricted stock is a full value award, fewer shares are used than in an option-for-option exchange)</li> <li>■ Typically results in a greater reduction in share dilution</li> <li>■ May have perceived higher value to participants, since denominated in full value shares, although this does not have same upside leverage as options</li> <li>■ Can promote retention if value is meaningful</li> <li>■ May be viewed less favorably by shareholders since there is less downside risk for participants</li> <li>■ Could include performance conditions on restricted shares if desired</li> <li>■ About 10 percent of option exchanges to date fall into this category</li> </ul>
Exchange options for cash	<ul style="list-style-type: none"> <li>■ Replaces options with a cash award, which may or may not have vesting conditions</li> <li>■ No dilutive impact of new award, since cash is used instead of equity</li> <li>■ Most tangible value for participants</li> <li>■ May not require shareholder approval</li> <li>■ Typically least favored by shareholders because this eliminates employee alignment with shareholder interests (unless dilution is a primary concern)</li> <li>■ Requires cash outlay, instead of equity, for the company</li> <li>■ Least common of exchange approaches – less than 10 percent of option exchanges fall into this category</li> </ul>

Companies will need to consider the following design attributes as the program is developed in detail:

- **Options to include in the program** – Determine which options will be included in the program. Newly issued options or those that are not too far underwater are typically not included in the exchange. Some shareholders or proxy advisory groups consider the stock’s 52-week high to be a “best practice” cutoff point – of recent option exchange proposals, about 40 percent use the 52-week high price (or higher) as a cutoff.

- **Exchange ratio** – Calculate the exchange ratio of the number of underwater options to be surrendered for each replacement award – for example, 10 underwater options for each replacement share of restricted stock. Shareholders generally expect that the exchange ratio will be calculated so that there is no incremental accounting expense from the exchange (see discussion below). Of recent exchange proposals, about two-thirds are structured to avoid an additional accounting expense.
- **Eligible participants** – Identify who will be eligible to participate in the exchange program. It is common for board members and some or all executive officers or other senior executives to be excluded from participation to make the exchange shareholder friendly. Plus, since Named Executive Officer compensation actions must be disclosed in the Compensation Discussion and Analysis, excluding those individuals from participation mitigates a disclosure obligation. About 50 percent of option exchange proposals exclude officers and directors, while another 20 percent exclude directors only.
- **Vesting period of new awards** – To promote retention, a vesting period is usually attached to the replacement awards. Most commonly, the remaining vesting period of the exchanged awards is used with a minimum or additional vesting period applied in order to promote retention.
- **If the exchange is for stock options, consider:**
  - *Exercise price* – The exercise price is typically the stock price at the date of the exchange, although some companies use premium options to promote further alignment with the shareholder perspective.
  - *Option term* – The replaced award could be structured to have either the remaining term of the exchanged award or a new term. An examination of recent option exchange programs indicates that practices vary. Extending the term of the replacement option increases the value of the replacement awards. Companies also need to be aware of equity plan limitations (such as a provision that prohibits extending the option life beyond 10 years).
  - *Treatment of recaptured shares* – The plan document should be reviewed to verify the treatment of exchanged awards. The language of the plan will dictate whether they are added back to the plan to be available for future grant. In most cases, recaptured shares are returned to the share pool to be available for future grants. An examination of institutional shareholder and proxy advisor perspectives on the recapture provisions should be considered as the design is finalized.

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*“Organizations should examine the parameters of their institutional shareholders as they consider an exchange program.”*

## Implementing an exchange

Several important shareholder, securities, accounting, tax and communications considerations and requirements need to be examined when implementing any underwater option exchange program.

### Shareholder approval requirements

An option exchange program may require shareholder approval. There are two sources of requirements for potential shareholder approval:

- *Exchange rules* – The New York Stock Exchange requires that all option exchanges for equity be shareholder approved unless the company’s stock plan includes a provision permitting exchanges without shareholder approval. NASDAQ indicates that if the plan is intended to permit option exchange without shareholder approval, the plan language should be explicit. NASDAQ interpretations of the rules suggest it has a view that is similar to that of the NYSE, although each company’s situation needs to be evaluated. Exchanges for cash do not require shareholder approval under the exchange rules.
- *Plan document* – The plan document language should be reviewed to assess whether exchanges for equity or cash are permitted without shareholder approval.

Even if shareholder approval is not required, it still may be in the company’s interest to secure shareholder approval of the exchange to facilitate an open dialogue. Institutional shareholders and proxy advisory firms apply a range of criteria to assess if they will support a proposed exchange. For example, RiskMetrics Group (formerly Institutional Shareholder Services) outlines a series of criteria that it considers when deciding if it will recommend a vote in favor of an exchange. RiskMetrics also considers not getting shareholder approval to be a “poor pay practice,” which may lead it to recommend withholding votes from directors. Organizations should examine the parameters of their institutional shareholders as they consider an exchange program.

### SEC tender offer rules

Option exchanges, other than 1-for-1 repricings, are generally subject to the tender offer rules of the Securities Exchange Act of 1934, since an exchange is considered an investment decision. These rules require the company to comply with specific disclosure and information dissemination requirements, and to keep the exchange offer open for at least 20 days.

### Accounting considerations

Most exchanges can be structured to avoid an incremental accounting charge under FAS 123(R). An exchange of options results in an incremental charge only if the value of the replacement award (such as options, restricted shares or cash) is greater than the value of the underwater options immediately before the exchange. For that reason, most organizations structure the exchange ratio so that no incremental expense is

incurred as a result of the exchange. Both the remaining initial value of the underwater options that has not yet been expensed and any incremental expense (if applicable) must be recognized over the vesting period of the replacement award.

### **Tax considerations**

An option exchange is generally considered a nontaxable event in the US, but a range of tax considerations should be closely examined. These include the impact of 162(m) (\$1 million deductibility cap), 409A (deferred compensation), the incentive stock option rules (if applicable) and the participant's tax impact.

### **Administration and election tracking**

Stock plan administrators should be engaged early in the process. Many outside vendors require time to implement an exchange program – or may require companies to handle the arrangements directly.

### **Participant communication**

Once the decision is made to effectuate an exchange, a key to the successful implementation of the program is appropriate communication to participants. Effective communication can increase the proportion of employees who agree to exchange their options in return for replacement awards. Due to the tender offer rules, the communication plan and supporting materials (legal documents, FAQs, modeling tools, etc.) must be finalized before the program begins, as the introduction of new materials could require companies to extend the offering period.

Communicating an exchange offer to employees can be complicated, especially if multiple grants are eligible and a range of exchange ratios is used. Not only must employees understand how the exchange works, but they must also be able to weigh how participation in the exchange will affect their individual rewards. If communicated well, an option exchange can significantly enhance the retention and motivational value of the equity program, but if done poorly, companies may not realize the intended return on the investment. The total implementation costs of an exchange program, including legal, accounting and communication, can be significant – \$250,000 or more is not unusual – so companies will want to ensure that employees fully understand the value that is being delivered to them.

### **Conclusion**

Determining whether to undertake an option exchange is complex and requires careful consideration of shareholder, company and employee issues. After this in-depth review, many companies will determine that an exchange program is not the best course of action, while others will decide to delay implementing an exchange until the equity markets become less volatile. Regardless of whether companies decide to proceed with an option exchange, the current environment invites taking a closer look at the role of stock options in the equity program. As we discussed in **Part II** (<http://www.mercer.com/referencecontent.htm?idContent=1335825>) of this

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article series, the downturn in the equity markets has exposed potential shortcomings in programs that overemphasize one element of compensation. Stock options undoubtedly will continue to play an important role in executive compensation. However, today's environment underscores the importance of taking a step back to validate that the executive rewards are optimized to balance attraction, retention, motivation and risk.

#### Additional resources

For more information, please see our *Executive Remuneration Perspective* library of articles at [www.mercer.com/perspective](http://www.mercer.com/perspective) for the other articles in our *Weathering the storm* series – part I: *Equity compensation actions for 2009* and part II: *Executive compensation reconsidered*. For more general information, visit Mercer's *Leading through unprecedented times* website at [www.mercer.com/unprecedentedtimes](http://www.mercer.com/unprecedentedtimes).

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