

Dealing With Underwater Stock Options

Some New Twists on a Timeless Quandary

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The quandary posed by underwater options isn't new. Companies face it whenever stock prices tumble for a prolonged period, whether the decline cuts across the market as a whole or falls only on certain hard-hit sectors. The issue attracts the most widespread attention during and after major market downturns such as the 1987 market crash, the 1992-1993 recession, the dot-com meltdown, the 9/11 aftermath in 2001 and again today, especially among financial services firms.

Many of the issues companies face with regard to underwater options are timeless. Most companies feel they must take action to:

- restore the options' ability to provide a meaningful performance and retention incentive to holders who view out-of-the-money options quite negatively
- promote fairness between holders of underwater options and new hires who receive at-the-money options with far lower exercise prices
- limit the negative effect of underwater options when there are low levels of share reserves available under shareholder-approved plans.

At the same time, companies understand that shareholders tend to view repricings of underwater options (in their various forms) as an unfair "do over" that wasn't available to investors who suffer real losses. That perception isn't new and isn't likely to change.

Recent Technical Developments

There are, however, some significant technical developments that have occurred since the last broad market downturn in 2001 that should be carefully factored into today's decisions. These affect:

- the accounting treatment under FAS 123(R) for repriced awards
- the need for shareholders to approve many repricings and whether proxy advisors such as RiskMetrics/ISS will support such actions
- the need to treat repricings as a tender offer and publicly file Schedule TO (along with requiring additional time and filing fees)
- whether and how repricings will have to be shown in a proxy statement and/or Form 8-K
- whether any adverse Section 409A (deferred compensation) implications will result.

Towers Watson's Guiding Principles

For more than a decade, Towers Watson has followed these guiding principles for evaluating how to address underwater options:

- **Decisions to reprice should be made with a very long-term perspective.** Repricings should not be used to bail out underwater options resulting from what is likely to be a temporary market decline. Repricings should not be viewed as a routine event.
- **Those most directly responsible for the stock price decline should not be held harmless.** Repricings and related actions are more appropriate for lower-level managers and other employees than for senior managers and directors who have the most direct obligation to shareholders.

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- **There should be a quid pro quo connected with receiving repriced options, requiring recipients to give up something in return.** As a general rule, option holders should not be enriched in an economic sense by a repricing transaction. Generally, this can be accomplished by replacing options on less than a share-for-share basis so that the Black-Scholes (or other) value of the replacement grant is equivalent. In many instances, the company may justifiably give less than equal value for the canceled options. For example, unvested options may be converted on less than a dollar-for-dollar basis.
- **A solution shouldn't simply correct past problems.** Unfortunately, it often takes a poorly performing stock price to identify structural flaws in a program, which should be corrected to steer clear of future problems.

Applying the Guiding Principles to a Company's Unique Situation

In applying these principles, there are a number of specific issues companies should consider in deciding whether and how to deal with underwater options:

- the number of options that are underwater (and by how much), as well as the underlying expiration date(s) of the underwater options
- reasons why the options are underwater
- historical precedents (including any that a current repricing might set for the future)
- the extent of any accounting consequences
- the extent to which shareholders in particular are likely to react negatively to news of a repricing or a similar action — and whether any commitments have been made not to reprice

- how employees who don't hold options may react, particularly if they have shares under employee stock ownership, stock purchase or 401(k) plans
- what the company can do to prevent windfalls if the stock price rebounds to its former level soon after the repricing
- the risk of turnover among key executives or groups of employees
- any 8-K and proxy disclosure requirements.

Beyond these issues, where new options are to replace existing underwater options, there are some design issues that must be considered:

- **Term.** Would the new options expire on the same date as the options they replace, or would a new 10-year (or other) term be started?
- **Vesting.** Would the replacement options follow the original vesting schedule, or would a new vesting schedule begin?
- **Replacement level.** What would be the relationship between the Black-Scholes or other value of options given up and the value of replacement options?

Decisions on these and similar issues will directly affect whether RiskMetrics/ISS and other proxy advisors will recommend a favorable vote for the repricing. These questions have to be answered with an understanding of exactly which option holders would be eligible for relief and the extent to which their overall compensation packages are changed. Who gets what, and how much? What about former employees who hold underwater options?

Clearly, evaluating situations involving large numbers of underwater options and considering whether to reprice requires companies to weigh a variety of complex factors. Coming up with the right answers is no easy task. What is more important, however, is that these issues may play out in different ways depending on the approach, or strategy, that the organization is considering.

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For example, a straightforward “do nothing” strategy may be appropriate if there is a long term remaining on the options in question and the stock price is expected to recover over time. Or, if the share reserve allows, a company might opt to leave its underwater options alone, but grant some additional at-the-money options or accelerate the next grant (either across the board or selectively) to promote retention and provide an ongoing incentive. At the other end of the spectrum, a repricing that cancels existing underwater options and replaces them with an equivalent value of at-the-money options, restricted stock or even cash may be appropriate for certain employees if the stock price is not expected to rebound, the company wants to minimize the amount of any additional accounting expense and a limited number of shares are available to make additional grants.

Looking Longer Term

In keeping with the fourth guiding principle, it's also important for companies to address any fundamental flaws in their stock option programs that are likely to give rise to future incentive and retention problems resulting from underwater options. A number of fundamental questions should be considered in this regard:

- Is the degree of risk inherent in stock options appropriate for all of the individuals currently eligible, especially for key business-unit employees and individuals below the executive ranks whose performance may not be fully reflected in the parent company's stock price?

- Are other forms of compensation or a lessened role for stock options more appropriate, at least for some participants?
- Are there better ways to structure your stock option program? For example, would more frequent grants of fewer shares each time facilitate some dollar-cost averaging in exercise prices? Are there more appropriate vesting schedules and option terms that could be put in place? Remember, though, that a change aimed at reducing risk and volatility comes at the cost of reducing the incentive value of the option program. Well-designed programs strike the appropriate balance.
- Are there better ways to communicate to employees the structure of your stock option program and make sure that they understand the risks as well as potential rewards?

With the scrutiny currently given to compensation decisions, the evaluation of any potential option repricing must carefully balance the unique perspectives of employees (including those who participate in the plan), shareholders who must approve the repricing and directors who may face difficult questions about the decision to reprice. In light of the volatility of today's markets, companies need a comprehensive approach to stock options, and to rewards in general, that prepares the organization for times of turbulence.

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