

CORPORATE BOARD MEMBER.

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Are These Great Times to Reprice Stock Options or What?

Myrna Hellerman, senior vice president and regional manager at the HR firm Sibson Consulting in Chicago, says that beyond considering what value will be gained from a repricing and by whom, directors should ask whether there might be better ways to improve the executive compensation plan. "Boards should want to see all the alternatives," she says, "and the economics of each one, both from the company's perspective and the shareholder's perspective, before making a decision."

Assuming you decide to reprice, be prepared for a backlash. Minow isn't the only one who casts a jaundiced eye on the practice. "I think it undermines the theoretical underpinnings of option usage in the first place," says Patrick McGurn, special counsel to the consulting firm RiskMetrics Group, whose influential Institutional Shareholder Services unit advises big investors on how to vote. "You can sometimes say it might be a necessary thing to do, or even the economically right thing to do, but that doesn't make it a good thing." Hellerman agrees. "Repricing programs have seemed rather egregious to shareholders," she says. "They've said, 'Why should you get a repricing? I'm the investor and I don't get any relief.' It is clearly viewed as bad practice, manipulative, and perhaps unfair."

Many board members are well aware that repricing can annoy shareholders. "We still use options, but we will not reprice," says Roy Herberger Jr., 66, president emeritus of the Thunderbird School of Global Management and compensation committee chairman at the Apollo Group, which runs the online University of Phoenix, among other Web-based educational businesses. "The chips will fall where they may. It's very difficult to reward insiders when your own shareholders don't get the same opportunity." Adds John Fluke Jr., 66, chairman of Fluke Capital Management LP in Bellevue, Washington, and a director of Paccar Inc., which manufactures heavy-duty trucks such as Kenworth, Leyland, and Peterbilt: "Our attitude is, we can't undo broad damage done to the markets." Fluke notes that Paccar, like most companies with option programs, grants executives a new batch of options each year, whatever the state of the markets. This means the executives will almost always have at least some options with significant upsides.

"You have to acknowledge the fact that your management needs to maintain equity types of incentives and compensation so that their interests are aligned with the shareholders' interests," says Gregory Corona, 54, general partner of Atlanta's Paladin Capital Partners LP, a private equity firm. There are other ways to do this than options, of course. Corona sits on the board of

CompuCredit Corp., a payday-loan, financing, and debt-collection company in Atlanta that, he says, includes restricted stock rather than stock options in its executive compensation packages.

Still, Corona appreciates the appeal that repricing might have for some companies. Says Steven Hall: "What you want to look at is how badly underwater the options are. If the exercise price is \$40 and the stock is at \$4, there's not much chance it's going to come roaring back. If you look at your executive team and employees and find that almost everything they hold is underwater, that their options are offering very little retention value and will be hanging around for quite a while contributing to the overhang on your stock, then repricing is probably something to think about." Hall also challenges critics who argue that with the economy in a recession, the retention value offered by stock options isn't as important as it might be at other times. "If you have employees who are well recognized in their industry and their options are underwater, your competitors may view this as an opportunity to steal them away," he says. "And while you may be able to say that people aren't jumping to new jobs today, you can't know whether that will be true in six or nine months or a year."

Convincing shareholders come proxy season that this is the right strategy is a board's big challenge. To win them over, many companies are making significant changes in how they structure repricing programs. In the past, companies simply invited executives to turn in their underwater options in a direct one-for-one exchange. Any accrued vesting typically carried over. Now many companies limit repricing to lower management ranks and exclude the CEO, other top officers, and directors from the offer, the theory being that they are more directly responsible for the stock's decline. Companies are also drastically reducing the number of repriced options and at least partly restarting the vesting clock.

The goal of all this is a "value-neutral" exchange in which the total value of all the newly issued options equals the total value of those that were surrendered. Because the new options with the lower exercise price are more valuable than the underwater options being surrendered, a one-for-one exchange usually won't work. "Companies have been forced into these more shareholder-friendly terms," says Brett Harsen of Radford Analytic Services, "in part because shareholder advisory groups like ISS are more focused on this."

At Equilar, research manager Alexander Cwirko-Godycki says that 62% of the repricing programs completed in 2008 excluded independent directors and 40% excluded CEOs and other executive officers. He expects a higher percentage of companies to exclude top officers and directors in 2009. "The first companies out of the box were the more aggressive ones, and some either had a provision in their plan that didn't require them to go to shareholders or were closely held and could predict their shareholders' voting patterns," he says. "Now that the market downturn has been prolonged, more mature companies are coming down off the fence and realizing they need to do something. We expect the vast majority of programs put to shareholders come April and May will be very shareholder-balanced—more balanced than the programs we've seen thus far."

Boards that decide to reprice are less likely to be skewered by shareholders at the annual meeting if they know what the proxy-adviser firms are looking for. ISS has a long list of wishes, one of which is that directors and top executives be excluded from repricing. It also asks that the repricing program cover only options that have been significantly underwater for more than a year, that the exercise price of the surrendered options be above the stock's 52-week high, that the term of the new options be the same as the term of those being replaced, that the new exercise price be set at fair market value or a premium to the market value, and that the new options not vest immediately.

"These aren't hard-and-fast rules," says McGurn. "We will look at these programs on a case-by-case basis, and we're interested in the whole story. What is the economic situation? How profound is the drop in the company's stock, how likely is it to recover, and within what time frame? Also, is the price collapse a very recent event? Was it tied to some mistaken strategy or

business decision, or was it more due to the macroeconomic environment in the marketplace as a whole? What problems is the company having related to retention? And why can't this be done on a more surgical basis, taking care, for example, of the key employees, the true value creators, without spreading it over the entire compensation structure? The company's management has to tell you why this is going to be a helpful event in the life span of the corporation. To the extent they can make that case and do the repricing on an economically neutral basis, I think you'll see more often than not that shareholders will approve these programs." In fact, while ISS didn't endorse every exchange program last year, McGurn notes that "to the best of my knowledge, not a single one failed to get shareholder support if it was needed."

In addition to selling shareholders on the need to reprice, boards must also be sure the company gets the right message across to employees. "If you're going through all the effort to conduct one of these exchanges, which is expensive and complex and burns political capital with shareholders, it would be a failure if you didn't make the program attractive enough for employees to turn in their underwater options," says Brett Harsen. "Among other things, you wouldn't have met your goal of removing these inefficient options from your overhang."

Clearly, repricing options is something you need to get right the first time.