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Companies breathe life into options

Governance specialists sound alarm over exchange programs

By Sara Hansard
December 7, 2008, 6:01 AM EST

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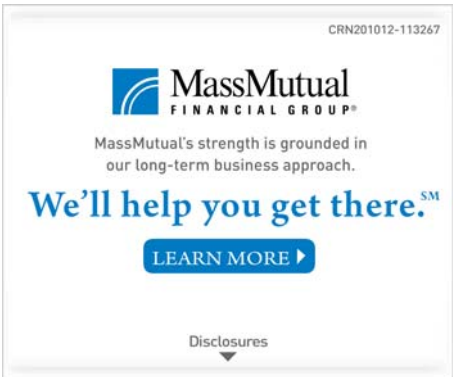

With the stock market in Palookaville, more companies are quietly bailing out executives holding "underwater" stock options. The moves are aimed at keeping executives motivated and their pay packages from being dinged.

Maxim Integrated Products Inc., a technology company in Sunnyvale, Calif., for example, recently filed plans with regulators to exchange employees' underwater stock options for cash. Meanwhile, casino operator MGM Mirage of Las Vegas recently exchanged underwater options for restricted stock, and United Therapeutics Corp. of Silver Spring, Md., re-priced underwater options for a more favorable price for its executive officers.

Patrick McGurn: Option re-pricing ranks high among compensation issues.

"The big comp issue for this proxy season is not say on pay; it's R&R — re-pricings and re-setting the bar," said Patrick McGurn, special counsel at New York shareholder advisory firm RiskMetrics Group. "Those are the twin plagues of an economic downturn."

Executives at scores of companies are holding stock options — which give them the right to buy shares at a preset price — that are essentially worthless. The problem with underwater stock options is that they provide little in the way of incentive for executives to meet performance goals or even to stay with the company.

CREATIVE RE-PRICING

To change that, many companies are replacing those options with new ones at a lower exercise price or with restricted stock, or simply exchanging them for cash.

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So far, 38 companies have exercised options exchange programs, compared with 14 for all of 2007, according to Equilar Inc. of Redwood Shores, Calif., and Radford Surveys + Consulting of San Jose, Calif., both of which specialize in tracking compensation.

"The big thing that a lot of people are thinking about right now is option exchanges," said Alexander Cwirko-Godycki, research manager for Equilar. "The biggest issue facing a lot of companies is underwater stock options and the loss of retention value."

To be sure, corporate-governance specialists are sounding alarms about the practice. By fiddling with stock options, companies essentially are rewarding executives for poor performance. What's more, they are lowering the bar on future performance, they said.

"Performance pay is supposed to be just that," said Amy Borrus, deputy director of the Council of Institutional Investors in Washington, which represents public, corporate and union pension funds. "What's the point if you're just going to be lowering the bar at will when performance doesn't measure up? It sends a terrible message."

Not to mention what it says to ordinary investors.

"Millions of ordinary American investors have seen their retirement savings decimated by the financial crisis, and they're not getting any sort of cushion," Ms. Borrus said. "Except in unusual and extraordinary situations, the compensation committee should not lower the bar by changing performance targets in the middle of performance cycles."

However, in some cases, re-pricing stock options may be justified, some executive compensation experts said.

A BALANCING ACT

"Companies are struggling to balance a bunch of competing objectives — the commitments they've already made and the fiscal issues that they're facing right now," said Paula Todd, a managing principal with Towers Perrin Forster & Crosby Inc., an employee benefits and human resources consulting firm in Stamford, Conn.

A survey of more than 450 companies released in November by Towers Perrin found that companies are focused on targeted work force reductions and spending cuts rather than on massive layoffs. That has led to an emphasis on retaining key talent, the survey said.

"Stock option re-pricing in particular is an area where you may be able to take a stock option that you're going to have to charge an expense for — and one the participant may view as worthless — and turn it into something that the participant perceives value from," Ms. Todd said.

Indeed, accounting rules require companies to recognize options expenses based on the original value of the stock when the option was issued, whether or not it is exercised.

Companies may be able to issue fewer new options to employees in exchange for underwater options, Ms. Todd said. "Those options motivate people more" if they are still in the money, she suggested.

"I understand investors are saying, 'The stock price is down. Nobody is bailing me out. Nobody is restructuring my investing,'" Ms. Todd said. "But the point is, we are where we are. You're stuck with the expense whether you get value out of it or not."

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