StockSense

Your Quarterly Newsletter from Fidelity Stock Plan Services

December 2008

Is Your Stock Option Plan Underwater?

Get tips on the best way to structure an underwater options exchange program

Many publicly traded companies with broad-based stock option plans have been dealing with underwater options for some time now. In recent months, a severe global economic downturn and a painful drop in stock market valuations have exacerbated the situation. As a result, many companies are urgently looking into whether they should approach shareholders with a program to address underwater options.

StockSense recently spoke with Brett Harsen and Terry Adamson, equity compensation experts with Radford Surveys + Consulting, an Aon Company, for their insights into how companies should go about structuring an underwater options exchange program.

StockSense: What is different about today's underwater option problem compared to the 2001/2002 downturn?


Brett Harsen

Brett Harsen: In a word, everything. The business environment has changed in just about every area that affects how underwater options can be addressed. Many of us at Radford were advising technology companies after the tech bubble burst in 2001/2002 and we dealt with similar underwater option problems. But it's no exaggeration to say that this time around the problem is broader. We're getting calls every day from not only the technology sector, but from financial services organizations, retailers, housing sector companies - nobody seems immune. We've also seen an uptick in the number of exchanges executed in 2008 versus previous years, which we track on our free Web site, Underwater Exchange.

Since 2002, we have seen many changes, including new equity compensation accounting standards, increased public SEC disclosure requirements, required shareholder approval of equity programs (including most underwater exchanges) from the NYSE and NASDAQ exchanges, new governance reforms passed by Congress, and much greater scrutiny of compensation practices overall. Every one of these factors influences what we can and can't do to "fix" underwater options.

StockSense: What are the alternatives?

Harsen: Some advisors like to address this question broadly - talking about counterbalancing decreased equity effectiveness with cash incentives or increased benefits, or by granting "supplemental" equity awards on top of the underwater options. But let's be realistic: Companies that have a significant underwater option problem typically don't have resources to increase compensation in other areas, nor do they have equity plan reserves to just keep granting more stock. Further, none of these actions directly addresses the outstanding underwater award - only an underwater exchange program does.

Historically, some companies have practiced aggressive repricings that rightfully earned the indignation of shareholders and criticism from the business press. An aggressive repricing is a modification of only the exercise price of the award for any option holder, (including executives or Board members) that leaves the number of shares held and vesting unchanged. These actions clearly benefited only the employee to the detriment of shareholders. We don't recommend anyone attempt these aggressive repricings.

Instead, we recommend a responsible underwater option exchange program that balances the interests of all major stakeholders - the shareholders, the employees, and the company. We find companies have been equally split between options-for-options and options-for-restricted stock exchanges with very few choosing options-for-cash. The type of exchange matters as much as the terms of the program and can make or break the good corporate governance test.

Approach	Description	Advantages	Disadvantages
Options-for-Options	Cancellation of underwater options followed by an immediate regrant of (*typically* fewer) new options	• Ease of communication (employees generally understand options) • Employees maintain control of taxable event (options taxed at exercise) • Some reduction in issued stock overhang (assuming fewer new options are granted than were cancelled)	• 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
Options-for-Stock (restricted stock or restricted stock units, RSUs)	Cancellation of underwater options followed by an immediate regrant of (*significantly* fewer) new shares of restricted stock/units	• Eliminates additional future underwater options (restricted stock cannot fall underwater) • Greater reduction in issued equity overhang due to higher exchange ratios	• Employees lose control of taxable event (shares taxed at vest/receipt) • Number of shares returned to employee typically reduces future upside leverage compared to using stock options
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 taxable event (taxed upon payment) • Employees lose opportunity to participate in future upside stock price growth • Lacks retention features if no additional vesting added

StockSense: What are the rules for a balanced underwater option exchange program that passes the good corporate governance test?

Harsen: First, the program should be brought to shareholders for approval prior to execution. Even if a company's equity plan technically allows for an exchange without additional shareholder approval, doing so will draw fire from shareholders that will very likely have a collateral impact on future proxy issues.

When it comes to designing the terms of a balanced exchange offer, there are four primary guidelines: 1) Exclude senior leaders of the company, including board members and top officers; 2) Allow only options that are significantly underwater to be exchanged; 3) Require multiple underwater shares to be tendered for each new award of options or restricted stock using an accounting value-neutral ratio (discussed in detail later); 4) Reset the vesting on the new awards.

StockSense: How important is employee perception with any given program?

Harsen: Assuring that employees perceive the offer as a fair deal is crucial because option holder participation in the exchange is entirely voluntary. This is why balance is so important. The terms of the offer must follow the corporate governance and fiscally responsible guidelines for shareholders to approve, yet remain attractive enough to employees to accept the exchange terms.

Option holders are going to make their decisions based on many factors, but we've found the common thread in all successful programs is trust between the employees and the employer. Programs that avoid complexity, are clearly communicated, and provide fair terms usually have the highest participation rates. But if we had to pick the most important feature employees use to gauge fairness, it would have to be the exchange ratios offered.

StockSense: How are exchange ratios determined?

> **Terry Adamson:** There are no explicit regulatory restrictions on determining exchange ratios. However, shareholder advocates strongly recommend the use of "cost-neutral" or "value-for-value" exchange ratios. Cost-neutral or value-for-value refer to exchange ratios such that the FAS123(R) fair value *immediately before* the exchange is at least equal to the fair value *immediately after* the exchange. FAS123(R) does not provide explicit guidance on how to perform the valuations immediately before and after, however, the


Terry Adamson

guidance requires the use of an option pricing model (Black-Scholes, binomial, or Monte Carlo simulation). Note that the examples in the guidance use a binomial model for these valuations.

StockSense: How should a company pick an expected life for the option-pricing model to value the awards immediately before an exchange?

Adamson: The valuation of the awards immediately before an exchange is one of the most challenging aspects of underwater exchanges. Since the awards are not "plain vanilla" or at-the-money, SAB107 and SAB110 preclude the use of a simplified assumption of the midpoint of the future remaining term. Further, it's likely that the underwater options will be held longer than traditional at-the-money awards, as they need time for the stock to appreciate before coming into-the-money. Some may believe that the full remaining contractual term of the award should be used for the holding term assumption. However, that approach incorrectly ignores the probability of a post-vesting cancellation due to a termination. Therefore, the use of the full remaining term will over-estimate fair value, minimizing exchange ratios, and could possibly lead to unexpected FAS123(R) compensation expenses upon a rigorous audit review.

The most appropriate methodology makes use of Monte Carlo simulations, applying a termination rate (consistent with a forfeiture rate) when awards are underwater, and applying exercise behaviors (either based on actual historical data or a simplified assumption) when an award is in the money. The examples in FAS123(R) (Paragraphs A149-A155) use a binomial model that considers the "moneyness" (stock price divided by strike price) of an option.

StockSense: What happens to the unamortized FAS123(R) compensation cost of the original underwater awards?

Adamson: Even though the original awards are cancelled, companies are required to continue to recognize the original compensation cost over the remaining service period. If vesting has been accelerated, then the original compensation cost should be accelerated, and if vesting has been extended, then the unamortized compensation cost should be recognized over the new service period. An underwater exchange is not an opportunity to reverse compensation expense, it is, however, an opportunity to better utilize that expense by converting underwater options to new awards that employees perceive to have greater value.

StockSense: Even if companies develop cost-neutral exchange ratios, is there a risk of a FAS123(R) expense charge due to volatility during the tender offer period?

Adamson: Yes. Exchange ratios are typically fixed during the legal tender offer (TO) period, and the ultimate accounting charge will be based on economic assumptions at the end of the TO. The offer must remain open to employees for at least 20 business days, during which the company is at risk of incurring unexpected charges if the stock price changes during the TO period. It is often prudent to build in some buffer (higher exchange ratios than theoretically cost neutral) to offset the probability of an incremental expense. The chart below illustrates the sensitivity to stock price changes during the TO period (assuming ratios are fixed at the start of the offer).

Stock Price Change During Tender Offer Period	Accounting Impact
Stock Price Drops During TO Period	Increase in Incremental FAS123(R) Charges Incurred
Stock Price Increases During TO Period	No Increase in Incremental FAS123(R) Charges Incurred

StockSense: How are these offers typically communicated to employees?

Harsen: Unlike other Human Resources programs, communication of these exchanges is dictated by legal tender offer rules. The primary communications vehicle will be the offer document filed with the SEC, which describes the terms of the offer, purpose, background, and material terms and conditions. Since legal documents aren't always the warmest way to explain a program to employees, some companies present the terms in a summary presentation either in town hall settings or via webcasts. If you intend to provide supplemental communication, we strongly recommend that it is carefully scripted and you consider having a third party expert deliver the message. This will minimize the risk of accidentally disclosing any material information that is not included in the legal offer document. Further, a third party will help avoid the perception the issuing company is endorsing a course of action for the employees.

StockSense: How does a company get started on analyzing the viability of an underwater exchange program?

Harsen: The first step is to assess the timing/urgency of the issue, keeping in mind that shareholder approval, and preparation of a proxy proposal, is a time-consuming task. Modeling design scenarios and finalizing program terms with senior management and the Board often requires up to two months of analysis. Proxies are typically filed one to two months prior to a shareholder meeting. Therefore, companies should begin analysis at least four

months prior to a shareholder meeting.

The second step is to assemble a cross-functional team for the project. Because these exchanges affect so many stakeholders, we recommend having HR, Finance, Legal, and Investor Relations represented on the internal team. At the outset, engaging an experienced compensation consultant to walk you through the design alternatives and implications is valuable. As it becomes more evident that an exchange will actually be executed, external SEC counsel and independent auditors will need to be brought into the process. For those companies with eligible option holders outside the US, international tax and securities experts will be a valuable addition to the team.

For more information about this topic, you can reach Brett and Terry at the following phone numbers:

- Terry Adamson. Phone#: 215-255-1802 Email: tadamson@radford.com.
- Brett Harsen. Phone#: 312-381-3685 Email: bharsen@radford.com.

Professional Bios:

Terry Adamson has nearly fifteen years of benefit and compensation consulting experience. Terry is involved with all phases of equity compensation valuations including design of executive packages; valuation of compensatory arrangements for purposes of a change in control under IRC 280G; sabbatical valuations under FAS 43/EITF 06-2; and Employee Stock Option (ESO) valuations and Employee Stock Purchase Plans under FAS 123(R). Additionally, Terry consults on issues involving all aspects of a company's benefit and equity programs in mergers, acquisitions and divestitures. Terry was on the FASB Round Table on Employee Share Options and is the Chairperson of the Society of Actuaries Taskforce on stock option valuation. Terry is a Certified Equity Professional (CEP) and serves on the Curriculum Committee of the CEP.

Brett Harsen has more than 10 years of compensation consulting experience on a range of issues, including broad-based employee pay, short- and long-term incentive design, executive and Board of Directors compensation. He specializes in equity compensation design and delivery. Brett consults organizations in a variety of industries, with a focus on high technology and life sciences. Brett holds designations from WorldatWork as a Certified Compensation Professional (CCP), and the Society for HR Management as a Professional in Human Resources (PHR).