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Firms Jump to Salvage 'Underwater' Stock Options

By PHRED DVORAK

More companies are executing their own bailouts -- for holders of worthless stock options.

Thirty-five companies, including MGM Mirage and Toll Brothers Inc., have swapped options that are "underwater" -- meaning they can be exercised only at prices above today's levels -- for other securities or cash this year. That's roughly twice as many as in each of the past three years, according to compensation trackers Equilar Inc. and Radford Surveys & Consulting.

Twelve other companies lowered, or are planning to lower, the exercise price of some options. And 15 others are proposing to exchange underwater options for cash or stock. Many more exchanges are coming next year, experts say.

"We're going to see them go through the roof," says Brett Harsen, a Radford Surveys vice president. He has advised 44 companies on option-exchange deals this year, compared with about three a year for the past few years.

Companies issue stock options, which give holders the right to buy stock at a set exercise price, as an incentive for employees. Big option grants can swell the compensation of top brass, but nonexecutives typically hold most of a company's options.

Companies say they're considering the swaps to bolster employee morale because so many options are now worthless. Equilar estimates that at 72% of Fortune 500 companies, the typical option is underwater. Some 93% of options held by Fortune 500 CEOs have no value at current prices, it says.

Option exchanges can rankle shareholders, who complain that they don't get relief when share prices fall. Shareholders rebelled when many tech companies repriced options after the Internet-stock bubble crashed. That led to accounting and regulatory changes that made option grants more costly and mandated shareholder approval for most exchanges.

Rescuing underwater-option holders "is not good behavior," says Edward Durkin, who oversees governance issues for the pension fund of the United Brotherhood of Carpenters and Joiners. Options are supposed to have value only if shares rise, so if prices fall, "they're done," he says. The Carpenters this year voted against option-exchange plans at Toll Brothers, R.H. Donnelley Corp., Beazer Homes USA Inc. and VMware Inc., among others, Mr. Durkin says.

Executives at Advanced Medical Optics Inc., a maker of medical devices for the eye, rejected option exchanges when they pondered in October how to motivate employees amid a 67% plunge in the company's share price since June. Fifty of the top officers elected instead to give up around 785,000 underwater options, freeing the shares attached for new equity grants. The move will also save the company $5 million to $10 million in future expenses, says Aimee Weisner, executive vice president of administration.

Some companies craft option exchanges to reduce shareholder opposition. Beazer shares fell around 50% to roughly $7 in the year before it put an exchange plan before investors in August. The plan applied only to options and similar securities called stock-appreciation rights with exercise prices of $26 and above, and it excluded executives and directors. Investors approved the plan, which would swap options for fewer restricted shares, but the company hasn't implemented it yet.

Beazer's plan won the blessing of the Florida State Board of Administration, which manages around $124 billion in assets, most in the state's pension fund. The Florida agency typically opposes option exchanges, but stocks have dropped so precipitously this year that it's willing to consider them, says Michael McCauley, its senior corporate governance officer.

"We'd rather have some incentive framework in place than nothing," says Mr. McCauley. His agency recently revised its guidelines so that it can support an option exchange if executives aren't eligible to participate and it believes management isn't responsible for the share-price drop.

Proxy advisers RiskMetrics Group and Glass, Lewis & Co., whose recommendations are influential with institutional investors, also say they will consider blessing option exchanges under some conditions.

But option exchanges can also be tricky for companies and employees, as the experience of Yellow Pages publisher R.H. Donnelley shows. Donnelley's stock price fell 94% to around $5 in the year to April 2008, rendering worthless nearly all of its options and stock-appreciation rights.

"The options had lost their primary employee-retention value," says Chief Financial Officer Steve Blondy. He also says the company no longer had enough shares for new grants, so it was hoping to recycle shares attached to the cancelled options.

Donnelley proposed letting employees with options whose exercise prices exceeded $10 exchange them for new stock-appreciation rights that would vest over three years. Executives and senior managers were included, but they could only exercise the new rights if the company's shares topped $20. Donnelly added that provision to help win investors over.

Florida's pension-fund agency voted against the proposed exchange because executives were included. Mr. McCauley says Donnelley was also more generous to its option holders than he liked.

The proposal passed anyway. In July, Donnelly cancelled 4.6 million underwater options and appreciation rights with exercise prices ranging from $10.78 to $78.01. It issued 1.2 million new appreciation rights with an exercise price of $1.69, the average of the stock's high and low prices on July 11, the last trading day before the grant.

The new appreciation rights haven't helped employees yet. On Friday, Donnelley's shares closed at 40 cents. Donnelley says it still thinks the exchange was effective.

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