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Feature: Employers Give Underwater Options New Life

Employers Give Underwater Options New Life

Williams-Sonoma is among a growing number of employers that are allowing employees to exchange their underwater options for cash, restricted stock or repriced options.

By Jessica Marquez

Laurel Pies started worrying about her employees' underwater stock options even before the recession.

As director of compensation, benefits HRIM (human resources information management) at Williams-Sonoma, she recalls seeing her company's stock drop to around $31 a share in November 2007, significantly down from grants priced at $40 a share the company gave 500 of its employees in March 2006.

"Our business—being a specialty retailer in the home furnishing sector—was hit first and then things got worse this past September," Pies says. By the end of October, Williams-Sonoma's stock was down to $8 a share.

During the next few months, Pies and her team developed and then received shareholder approval for an options exchange program by which employees could trade in their underwater options and stock-settled stock appreciation rights for a smaller number of restricted shares. Stock-settled stock appreciation rights, or SSARs, provide employees the same compensation value as options, but they don't have to pay the exercise price upon selling their shares.

Williams-Sonoma is among a growing number of employers that are allowing employees to exchange their underwater options for cash, restricted stock or repriced options. Seventy-one companies have executed stock options exchange programs so far this year, up from 50 that offered such programs in 2008, according to Underwaterexchange.com, a Web site created by San Jose, California-based Radford, an Aon Consulting company. On top of that, an additional 70 companies have made public their intentions to conduct such programs this year, says Brett Harsen, a vice president at

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Radford. “We are tracking to triple the number of exchanges in 2009 than we saw in 2008,” Harsen says.

Specifically, companies are worried that if they don’t do anything to address their underwater stock options, they won’t be able to retain their talent, says Steve Van Putten, practice leader, executive compensation at Watson Wyatt Worldwide. “People can just reprice their options by going to the competitor down the street,” he says.

Underwater options also can dampen morale, experts say.

In addition, offering underwater options when companies now have to include the value of those options as an expense on their financial statements doesn’t make business sense, experts say.

But conducting an options exchange program isn’t an easy task; usually it is up to HR and compensation executives to help lead the charge, says Scott Price, a partner in the New York office of Kirkland & Ellis.

“If the company is in peril that some people might leave, it’s up to HR to make sure the program offers the right kinds of incentives,” he says. “They would help structure the program and communicate it to employees.”

Because the programs are complex and require shareholder approval, many companies are taking a wait-and-see approach to offering exchange programs, says Alan Johnson, a New York-based executive compensation consultant.

“What happens if they offer the exchange program and then the stock bounces back?” he says. “That’s not good for morale either.”

Program design and education

The initial decision that companies need to make when conducting an options exchange program is whether to offer employees repriced options, cash or restricted stock for the underwater options.

“There are advantages and disadvantages to each one,” says Seth Rosen, a principal in the executive remuneration business of Mercer.

“Obviously options provide the greatest upside if the company does well. But if it doesn’t, there is no value to them,” he says.

With restricted stock units there is less upside, but they always have some value to them. And cash always has value, but it’s the least popular option among employers given the economic climate, Rosen says.

According to Radford, in 2008 and 2009 there have been 70 options-for-options exchanges, 27 options-for-restricted-stock exchanges, 17 options-for-cash exchanges and seven exchanges that involved trading in options for a combination of these.

Williams-Sonoma, like many employers, decided to give its employees the opportunity to exchange their underwater options and SSARs for a lesser number of restricted stock units. Once the company got shareholder approval, the next challenge was communicating it to employees, Pies says.

“I wanted our associates to see as clearly as possible what the choices were,” she says. “We could not give anyone advice about what to do, so I needed to ensure that they would understand very clearly that if they give up their stock options or SSARs for a lesser number of restricted stock units, there were certain circumstances that would make that less optimal.”

Communication is often the biggest challenge employers face when conducting underwater options exchanges, experts say.

“Often people compared the process of making the election in an exchange program to benefits open enrollment,” Radford’s Harsen says.

Since these exchanges are legal tender offers, the amount of communication a company can do before it gets SEC approval is limited, he says.

Recognizing the communication challenges associated with the exchange program, Williams-Sonoma contacted Mercer for help with the process, Pies says.

“Within 10 days they came up with a basic modeling tool and we went from there,” she says.

Mercer’s equity-choice tool, which Mercer is now selling to all employers, allows employees to log on to a password-protected site and view what options they have, when they vest and what the strike price is, says Shem Asefaw, national partner in the Toronto office of Mercer.

They can then run different scenarios if they exchange their options for whatever the company is offering or if they decide to keep their underwater options. Finally, they can do the actual exchange online through the site.

At Williams-Sonoma, 95 percent of the eligible population logged in to the tool and 97 percent of eligible shares were exchanged, Pies says.

Since Mercer launched its equity-choice tool in January, it has signed on three clients and is in discussions with several more, says Mercer spokesman Bruce Lee.

On top of offering the tool, Williams-Sonoma also did a lot of other communications. The company held a companywide meeting about the tender offer for the program and then did training sessions for employees to make sure they understood how to use it. “Associates could go in and look at their information and ask questions of me or somebody on my team,” Pies says.

Williams-Sonoma also set up a phone line to its compensation team so that employees could call with questions.

Offering tools and support is paramount to conducting a successful options exchange program, Kirkland & Ellis' Price says. But companies need to be wary of inundating their workforce with too much information. "HR needs to be careful that they haven't given so much information to people that some of them say, 'There is too much here for me. I am shutting down and doing nothing.' "

Despite the recession and the current state of most stock options, experts believe they will continue to play a part in employees' compensation, particularly in certain industries such as technology.

Williams-Sonoma plans to keep options and SSARs as part of its compensation package, Pies says.

"I believe there is a value in both forms of equity," Pies says. "Restricted stock units are more secure, and options and SSARs offer more upside potential and directly align employees with shareholders."

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