Implementing an Option Exchange Program – How To Decide Whether It's Right for You

With the recent volatility in the stock market, many technology and life sciences companies find a large number of their outstanding stock options are significantly "underwater" (that is, the options' exercise prices are greater than the current market price of their common stock). In this environment, these stock options are no longer delivering the value that was expected, which can significantly undermine a company's compensation strategy.

Typically, companies take one or more of the following approaches to address underwater stock options:

- Make additional targeted equity grants – this is most effective where only a portion the employee population is affected
- Make enhancements to other compensation programs – In some situations, additional cash bonuses, an enhanced employee stock purchase plan, or other compensation arrangements may be most appropriate
- Wait and see – The stock price may rebound soon – or may not have stopped falling
- Implement an option exchange – Exchange underwater options for new at-the-money stock options, restricted stock, or cash

This year, we have seen a noticeable increase in option exchanges. So far, there have been more than 10 option exchange programs announced for technology and life science companies in 2008, including VMware, Riverbed, and UT Starcom. With the current stock market turmoil, we expect that this pace will pick up over the next year.

Recent option exchange programs have been very successful. Exchanges for new options have had participation rates in excess of 70% and exchanges for restricted stock have had participation rates in excess of 80%. This demonstrates that a well-designed and communicated exchange program can be an effective means of addressing an underwater options problem.

With significant accounting, corporate governance, and disclosure changes since the last major stock market downturn (in 2001-2002), we believe that a new approach is warranted when considering a stock option exchange program. This article provides an overview of key considerations and a roadmap for the process of evaluating whether an option exchange is the appropriate response to an underwater option situation.

The Need for a Deliberate Process

While exchanging stock options will often appear to be an attractive solution from both a compensation and human resources standpoint, because it can substantially "fix" underwater options, historically shareholders have not been receptive to option exchanges, believing that it is unfair that optionees get to "reset" their equity value when they cannot. Given the tension that may arise where an option exchange can be viewed as internally desirable but externally controversial, a Board Compensation Committee should follow a thorough, deliberate process in evaluating the merits of an exchange (as well as other possible alternatives), considering all pertinent information to

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ensure that it is making a reasoned and informed business decision that meets current standards of diligence and due care.

Here is our recommended process for determining if a stock option exchange program is the appropriate response to underwater options.

Step #1: Understand your current situation and gauge the magnitude of the problem

The Compensation Committee's initial task must be to develop a thorough understanding of the current situation. This should include evaluating the degree to which outstanding options are underwater, identifying which employees are specifically affected, reviewing how long the options have been underwater, analyzing the price history and trend for the company's common stock, and determining how direct competitors have fared in addressing their own option situation.

Step #2: Establish your objectives

In our experience, the primary objective of any stock option exchange program is to address concerns arising from the lack of value being delivered by underwater options. These concerns include greater retention risk, morale issues, and the absence of effective incentives to drive company performance. Secondary objectives for undertaking an exchange include reducing equity overhang (that is, the number of outstanding stock options) and making better use of the financial accounting cost associated with the underwater options.

Based on the company's own particular facts and circumstances, the Compensation Committee should identity and agree upon the objectives that it is seeking to achieve.

Step #3: Determine if shareholder approval is needed (or desired). If so, review and assimilate key institutional shareholder policies and guidelines

Whether a stock option exchange program will require shareholder approval is a critical step in evaluating the feasibility of an exchange, because the stock option repricing or exchange policies of the proxy advisory firms and your key institutional shareholders will have significant impact on the program's design. Where a company can conduct an option exchange without shareholder approval, it will have greater flexibility in setting the terms of the exchange as well as potentially reducing the time and expense required to implement the exchange. In our review of over 70 recent stock option exchanges, approximately 70% of the companies did not seek shareholder approval and several of the companies that did seek shareholder approval for their exchange had a controlling shareholder whose ownership level made approval more likely.

Note that conducting an option exchange without shareholder approval may create shareholder (as well as public) relations issues and could lead to "withhold" or "no" votes for the directors that approved the exchange.

Step #4: Determine your accounting expense "budget"

The accounting treatment of a stock option exchange is no longer the impediment that it once was. In fact, under current accounting standards, an option exchange can be structured to avoid any material increase in accounting expense by designing the program as a "value for value" exchange. This is achieved by ensuring that the fair value of the new stock option is equal to the fair value of the replaced option, as measured immediately prior to the exchange. Typically, this will require an exchange ratio that trades several underwater options for each new stock option or share of restricted stock. Where there is a value for value exchange, any remaining unrecognized compensation expense associated with the replaced underwater options is amortized over the vesting period of the new awards.

Consequently, a key decision in designing the program is to determine whether it will involve a value for value exchange and, thus, result in no significant additional accounting expense or if there is a "budget" for any

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additional expense, which can be used to make the exchange ratio more attractive.

Step #5: Understand your time commitment and costs

Between the need for shareholder approval and filing the necessary materials with the appropriate regulatory authorities, a stock option exchange program can be a time-consuming and expensive undertaking

- An exchange may be considered a "tender offer" for purposes of the federal securities laws, and, if so, will require a detailed filing with the Securities and Exchange Commission. This filing will require significant assistance from outside legal counsel and can be both a lengthy and costly process
- The tender offer process usually takes a minimum of three months where shareholder approval is not required and a minimum of five months if shareholder approval is required
- Tender offers must remain open a minimum of 20 business days under SEC rules
- If shareholder approval is required, a special meeting of the company will need to be scheduled. Alternatively, a company may wait until it holds its customary annual meeting of shareholders to seek shareholder approval of the exchange
- There may be significant regulatory requirements for any international employees included in the exchange

Step #6 Establish the preliminary terms and conditions of the exchange

When developing a stock option exchange program to meet your objectives, the following key terms must be decided:

- Form of payment – Generally, about 50% of the exchanges that we have reviewed granted new stock options, 45% granted shares of restricted stock (including restricted stock units (RSUs)), and just a few (5%) made cash payments in exchange for underwater options
- Eligibility – Exchanges are often limited to non-executive employees. In fact, named executive officers are often expressly excluded to satisfy institutional shareholder policies. Typically, directors are excluded both to meet institutional shareholder policies and to address corporate governance concerns. International employees may be excluded where an exchange is not permitted in their home country or has potentially adverse consequences for the employee
- Exchange Ratios – The determination of the exchange ratio must balance making the offer attractive to optionees, the potential accounting expense, and the possible shareholder reaction
- Options Eligible for Exchange – Frequently, the Compensation Committee may establish a "floor" that excludes from the exchange options that are not significantly underwater. This also may be necessary when seeking shareholder approval to satisfy institutional shareholder policies
- Vesting Schedule – A new vesting schedule increases the retention value of the new awards and is an important feature for institutional shareholders evaluating the merits of the exchange

In addition, consideration should be given to whether shareholder approval is required (or desired) and the relevant institutional shareholder policies and guidelines.

Step #7: Model the exchange, assess costs, and compare benefits to your objectives

Once you have set the potential terms of the stock option exchange program, you should model various option exchange alternatives to determine their outcomes, potential costs, and effectiveness at achieving your objectives. Key considerations include the following:

- Will the exchange effectively address your retention, morale, and incentive concerns associated with the underwater options?

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- Do the new awards provide better incentives to create shareholder value than the old awards?
- Do the new awards provide additional retention through greater value and new vesting schedules?
- Will the terms of the exchange be attractive to optionees?

- Is the accounting expense to be incurred as a result of the exchange acceptable?
- Is the exchange's effect on your equity overhang and dilution levels acceptable?
- What is the likely impact of the exchange on shareholder relations?

Step #8: Decide whether an option exchange is the best solution to your current situation

After completing the process outlined above, the Compensation Committee should have the information it needs to make an informed decision as to whether a stock option exchange is the appropriate response to your underwater options. In addition, the Committee will have a well-documented record that evidences the process it used to analyze this question and will demonstrate how it discharged its fiduciary obligations.

Need additional assistance?

Compensia has had significant experience in designing stock option exchange programs. In addition to being one of the most frequently-engaged compensation advisers to technology and life science companies, we have advised more than 20 companies regarding option exchanges. Several of our partners have legal backgrounds and, thus, extensive experience advising companies on all aspects of establishing an exchange program.

If you have any questions on stock option exchanges or the evaluation process outlined above, please feel free to contact us. ■

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