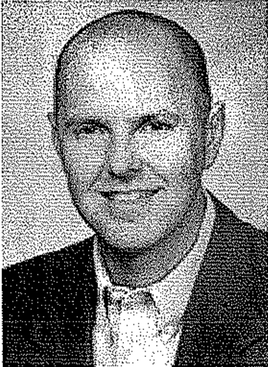
What To Do With Underwater Stock Options



Law360, New York (November 26, 2008) -- As a result of the stock market's plummet in 2008, the executives of many public and private companies now hold stock options that have little retention or incentive value because their exercise price far exceeds the current fair market value of the underlying shares.

These options are commonly referred to as being "out of the money" or "underwater" – and the time is right for attention to them. This is partly because shareholder approval is required or desired for most replacement programs, and it makes sense to start the planning process early in order to assure full consideration of the many issues noted below.

Unfortunately, no one solution will work for all employers. Nevertheless, there are three main choices for employers whose stock options are underwater.

Specifically, an Aon study[1] released on 9/22/2008 reports that, out of 61 companies that have disclosed exchange programs for underwater stock options ("Exchange Programs") since 2005, the methods employed generally involved the following:

- Options-for-shares: 49 percent offered to exchange underwater options for a fewer number of shares of restricted stock or restricted stock units ("RSUs").

- Options-for-options: 46 percent offered the immediate replacement of underwater options with new options having an exercise price equal to the fair market value of the underlying shares on the new grant date.

- Options-for-cash: 5 percent offered cash to cancel underwater options, with the cash paid often being determined by an option valuation formula such as Black-Scholes.

Employers should go further when considering their alternatives – by giving attention to any Exchange Programs or other actions that their competitors and industry segment are pursuing. This diligence not only makes business sense, but reflects the standards that RiskMetrics Group (the former Institutional Shareholder Services, or ISS) applies when evaluating stock compensation plans for its shareholder approval recommendations.

General Considerations

When implementing an Exchange Program, the following issues warrant careful and detailed evaluation:

1. Shareholder Approval. Nasdaq and NYSE listing rules generally require shareholder approval for any program under which underwater options are repriced or replaced with new stock awards.

Approval is not required, however, for programs that shareholders have expressly authorized in a plan that they previously approved. Nor is shareholder approval required when underwater options are cancelled in consideration of a present or future payment of cash.

That noted, an Exchange Program that receives shareholder approval will best suit governance expectations given the longstanding public distaste for these programs.

2. Business and Public Disclosure. As noted above, Exchange Programs are generally lightening rods for criticism by shareholders, institutional investors, and proxy advisors such as RiskMetrics. The best strategies for limiting criticism entail shareholder approval and the following:

- Minimize the number of shares subject to replacement awards in order to establish that the Exchange Program materially decreases the potential dilution that could occur through outstanding awards. The use of a "value-for-value" exchange formula will often help because the replacement awards will almost certainly involve fewer shares. In addition, "whole share" awards such as restricted stock or RSUs will require fewer shares than option or stock appreciation right ("SAR") awards.

- Add provisions to the new (replacement) awards to protect corporate interests, such as claw-back protections and performance goal requirements for vesting.

- Exclude named executive officers from the Exchange Program to establish that the Exchange Program benefits ordinary employees, with executives suffering the downside with shareholders. However, this may discourage retention of valued executives who are left holding worthless awards, and means their individual compensation merits careful re-examination. There are alternatives for handling officers and directors, with full disclosure of any special treatment being required and consequently being important to weigh.

3. Financial Accounting. Exchange Programs after 2005 do not give rise to variable accounting, but instead to treatment of replacement awards as new grants, with expense being incurred only to the extent the new grants value exceeds the value of the options being repriced or cancelled. Such expense, if any, is amortized over the expected future vesting period.

4. Securities Issues. An Exchange Program that extends beyond a small group of directors and up to about five senior officers will implicate the SEC's tender offer rules, and generally requires implementation through a Schedule TO filing with the SEC. Although these SEC filings have become somewhat routine, the disclosure is comprehensive and drives up the implementation costs.

5. Tax Considerations – Capital Gains vs. Deferral. The use of incentive stock options ("ISOs") for replacement awards provides option holders with the potential for capital gain treatment if they hold the shares they purchase not only for at least two years after the grant date, but also for one year after the exercise (purchase) date.

The latter condition often forecloses capital gain treatment because most option holders hold and cash-in at the time of a corporate sale.

For a company whose stock price is depressed, restricted stock is often desirable as a replacement award, because Section 83(b) of the Internal Revenue Code of 1986, as amended (the "Code"), allows individual elections that accelerate income taxation to the award date.

A Section 83(b) election enables all gain after the award date to be capital gain; whether such capital gain is short- or long-term depends on the time between the 83(b) election and the date of the subsequent sale. By contrast, long-term tax deferral is available through RSUs that include a timing-of delivery feature for issuance of shares to the award holder.

6. Tax Considerations – 162(m). The Code Section 162(m) limit of $1 million that applies to each named executive officer (other than the CFO) will include income from replacement awards received through an Exchange Program unless the replacement award is either (i) a stock option or SAR, or (ii) an RSU, restricted stock, or cash-settled award that conditions vesting on the attainment of future corporate performance goals determined under a shareholder-approved plan that is 162(m) compliant.

7. Tax Considerations – 409A. It is possible to structure any awards made through an Exchange Program in a manner that exempts the awards from the nonqualified deferred compensation provisions of Code Section 409A. This is principally done by omitting tax deferral elections for award holders, and by retaining the same expiration date for re-granted options.

Conclusion

Any Exchange Program that employers adopt in response to today's financial downturn should be structured both to address business concerns (from finance to personnel), and to withstand scrutiny when disclosed to shareholders and proxy advisors.

Public companies will need to make SEC 8-K and TO filings, as well as proxy statement disclosures. The spotlight on executive compensation will pressure all decision-makers to carefully design the terms and conditions of any Exchange Program.

Notably for stock-based compensation, there has been an escalating trend for the past five-plus years that finds all industry groups moving away from stock options and toward restricted stock, RSUs, and (even more dramatically) performance awards.

This is primarily because stock options are considered to encourage excessive risk taking in that (i) they have value only if there is stock appreciation, and (ii) there is no sense of "loss" when stock options become underwater (because the holders never had their own money at risk). By contrast, restricted stock and RSUs have inherent value to the extent the underlying shares have value.

Performance awards tend to be even more well received because – whether made in the form of options, RSUs, restricted stock, or cash – vesting will be contingent on both continued employment and the attainment of corporate (or individual) performance goals.

The current bailout legislation drives toward designing awards to reward sustained long-term financial success. Those who authorize awards will be wise to respond to best practices such as this (and claw-backs) – and thereby to protect and advance the long-term interests of their company's shareholders.

--By J. Mark Poerio (pictured) and Sean C. Honeywill, Paul Hastings Janofsky & Walker LLP

Mark Poerio is a partner with Paul Hastings in the firm's Washington, D.C., office. Sean Honeywill is an associate in the firm's Atlanta office.