Option Exchange Considerations

With the stock market down, Financial Week reported in August of 2008 that "options are underwater at nearly 40% of Fortune 500 companies" and "one in every 10 companies now has options that are more than 50% underwater", and with the much more favorable, predictable, and manageable accounting treatment under FAS 123(R), more and more companies are considering an "exchange program" of one sort of another. It seems we and our partners are being approached every day by companies wanting to evaluate solutions and the potential cost of an exchange program.

(We use the term "exchange program" rather than the historically more common term of "repricing" for two reasons: 1) many of these programs are not truly "repricings" since they are an exchange of underwater options for restricted stock or for cash and 2) the term repricing has, for several years now, had often undeserved negative connotations.)

At SOS we firmly believe, along with many of our partners, that an option exchange program can, if properly evaluated and executed, be structured to be beneficial to all concerned parties with a relatively minimal amount of expense to the company. However, these programs are quite complex and challenging to manage and should not be undertaken lightly or without sufficient analysis and planning.

A very high-level sketch of a few of the important issues to keep in mind include:

- **Which type of exchange should your company do?**

Exchanges of options for cash payouts are suddenly getting more attention. Survey data shows that they are historically less frequent, but we are hearing from more and more companies that are considering them. Why? With the market so volatile, some companies and participants seem to have "lost faith" in options and that the market value of their company will go back up in the short- or mid-term. For many companies, accelerating the expense into the current quarter when their financials are already challenging, rather than continuing to expense it over the service period makes a good deal of sense. Also, cancelled shares are generally returned to the plan, conserving them for future use. Wendy Davis, an attorney for Cooley Godward Kronish LLP, says "We have clients approaching us daily about exchange programs. These programs are not one size fits all - increasingly, I'm seeing clients consider value-for-value exchanges (in an endless variety of flavors) and even cash-out programs in lieu of repricings. In short, each company must carefully analyze and work to address its unique needs."

Exchanges for restricted stock were the most popular in 2007, again perhaps due to disillusionment with options and the desire to keep shares in-the-money despite market performance. Shares can also be conserved somewhat since fewer shares are almost invariably issued. However, issuing firms should consider what sort of message this might send to the market.

Option-for-option exchanges have made a bit of a comeback in 2008, based on a recent analysis by Cooley Godward Kronish LLP. These sorts of exchanges are generally easier to explain to participants since most already understand stock options, and more leverage can be retained by the optionee, since more shares are generally granted than in exchanges for restricted stock.

Some companies have even done exchanges of options for executives, who theoretically have the most control over the performance of the company stock price, while allowing rank-and-file employees to exchange options for restricted stock units.

- **International considerations**

While certain types of exchanges may be effective from a US tax/accounting perspective, they may have negative results in non-US jurisdictions. We have assisted several companies in identifying potential issues (e.g. employee is taxed upon cancellation of options for the exchange in a non-US location) in connection with tender offers. It is important to complete such a review prior to implementation.

- **Whom to include and exclude?**

Should you include or exclude directors and officers? Many are choosing to exclude them. The recent analysis by Cooley Godward Kronish LLP found that in 2008 (through July), 33% of exchanges excluded only directors, and an additional 27% excluded officers and directors). However, if you do choose to include them, generally you should ensure that they have little-to-no input over the design of the exchange.

- **Which options should you include and exclude?**

It seems almost moot to point out that including options that are only slightly out-of-the-money sends a negative message to shareholders and the market in general. But how far out-of-the money should they be? A recent survey by Radford Surveys + Consulting found that of companies that have exchanged in the last three years, the median multiple is 1.3 and the average multiple is 1.7. (If you have a current stock price of $10, you'd exchange only grants with prices $13 or $17 or higher, respectively.) In addition, a recent development is that the 2008 Risk Metrics ISS Governance Services Guidelines require that you exchange only options with prices above the 52-week high and options more than one-year old (see page 38 of the guidelines).

• Tender offer process

Exchange programs invariably require that your employees be offered the choice to participate: a tender offer. Tender offers can be extremely challenging to manage if some form of automation is not utilized. Collecting and processing the elections of your participants manually while being prepared to update your executives and other interested parties on the status of the exchange at a moments' notice can tax the patience of even the calmest stock plan manager. "The SOS Tender Offer website made our exchange program so much easier to manage. I'm not sure how I would have survived without it!" says Wendy Jennings, of Riverbed Technology.

• Employee communication

You don't want to put all the time and effort into an exchange program and then not have enough optionees take advantage of the offer. But, at the same time, you can't advise your employees to accept the offer. And any and all communications to employees must also be filed as part of the tender offer on the Schedule TO. We've seen and helped companies put together FAQs, onsite presentations, and even call centers to field participant questions (though care must be taken not to communicate anything not filed as a part of the TO).

• Modification accounting

Exchanges require modification accounting under FAS 123(R), but can be structured to minimize (or even eliminate) the "incremental expense" that must be recognized. You compute the value of the exchanged option and the value of the new grant, and the excess of the new grant over the exchanged grant is the incremental expense. The trickiest part of this, it seems, is computing the "expected term" of the underwater grant. Some companies have used the remaining contractual life of the grant, but that is actually the most aggressive approach (producing the lowest expense) and some audit firms have begun to push back on this approach. Terry Adamson, of Radford Surveys + Consulting, recommends the use of a Monte Carlo simulation to produce a supportable expected term.

If you have questions on any portion of this article, please e-mail us at: xtra@sos-team.com.

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