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Stock Options: Overused and Underwater

HR professionals face major challenges with this once-attractive recruiting and compensation tool. But there are remedies.

By Don Delves

Employees once viewed hefty stock-option grants as a fast lane on the road to riches. Companies embraced the distinct advantages of using options to attract and keep top talent. In today's economy, however, with the market price of many stocks dipping well below the exercise price, millions of options are solidly underwater and unprofitable--at least in the short term.

Human resource professionals face major challenges in coping with the fallout from this weakened compensation and retention strategy. But there are remedial steps that can be taken both to address the current dilemma and to implement more effective solutions for the future.

Attempts to recognize and resolve the option quandary actually began nearly a decade ago. In 1993 and 1994, the Financial Accounting Standards Board launched a quest to require an expense for stock options. The response from corporate America was swift and primarily negative. Clinging to a comfortable status quo, companies claimed that unfettered access to free options would align executive and employee interests with those of shareholders and would propel America's then fledgling tech economy to new heights.

Remember the saying, be careful what you wish for? Bowing to intense public pressure, the FASB backed off. It allowed businesses to continue granting stock options as freely as they wished--without any real checks and balances on the system. Unrestrained, the practice spread and accelerated like wildfire, and option grants expanded in size by more than 400 percent in seven years. Seeing only the upside in the proposition, companies also began to widen the practice, including more lower-level employees in option plans. These enormous and widespread grants definitely helped to drive growth in the tech sector as well as the "old" economy. On the other hand, some argue that lavish option grants were also partially responsible for unrealistically inflating and ultimately puncturing the market bubble.

The result is that our nation's incentive system is seriously broken, with a huge percentage of the options that were intended to attract, retain, and motivate employees now underwater and ineffective.

Where does this leave HR executives? In many cases, they're holding the bag and scrambling for solutions. It's a problem replicated across the corporate landscape, as a growing number of companies find themselves strapped with underwater options and high overhangs, or options as a percentage of shares outstanding. In effect, HR has lost the almighty magnetic field they'd relied on to

attract, retain, and motivate their best people. When stock options lose their lucrative luster amid a downturn in the market, valued managers and executives can quickly start to feel unappreciated and uncompensated--and may consider un-employing themselves with the company.

Given the substantial size of option grant packages within most companies, executives may stand to lose 50 percent or more of their total pay package when the stock price drops significantly. Human resource executives can temporarily reassure themselves that their competitors for talent are in the same boat. But if the boat is sinking, does it really help to know you're not alone in it?

If stock options have been included as part of your pay package, and your stock price has plunged 30 to 50 percent or more, it is imperative that you consider all of the alternatives available to you:

- 1) Do nothing at all.
- 2) Grant additional options.
- 3) Grant restricted shares (may be tied to performance), or replace underwater options with restricted shares on a value-for-value basis.
- 4) Cancel and reissue underwater options, with a six-month window.
- 5) Reprice underwater options.

Creating solid plans for the future

Underwater options are a big problem in part because so many have been granted to so many people. The reason they were granted makes the problem worse. For many employees and executives, options were a primary reason they accepted a job at the company in the first place. And for a great many companies, options were the competitive edge needed to attract people, and

the "glue" used to keep them. So, when a company's options go underwater, the "deal" or "contract" made with its employees and executives begins to crumble. What is worse, the deal was flawed in the first place, based on an implicit promise that couldn't be kept of relatively quick and easy wealth.

Though well intentioned, large option grants didn't succeed in making executives think and act like shareholders. It made them think and act like option holders, with a higher risk and shorter-term perspective than shareholders. On their own, options don't provide balanced incentives, and they're not a valid reason to go to work for a company in the first place. For mutual benefit, employment should be based on a variety of stable and substantive factors such as corporate culture, suitable career path, belief in the product or service, and alignment with the company's vision and philosophy. Joining a company on the basis of the number of options granted (with hopes of getting rich quick and retiring early) creates an ill-conceived contract for all concerned.

Digging ourselves out of today's swamp is only half the battle. Going forward, it's important to decrease our lopsided reliance on options and develop better plans that combine a variety of cogent and creative strategies. We need to consider flexible, tailored compensation vehicles that are clearly aligned with the company's organizational objectives and desired risk profile.

This shift in strategy does not have to dilute executive pay. However, executive pay must become more balanced and directly aligned with the goals and strategy of the company--part of what we call a Balanced Incentive Portfolio. Packages may include a combination of options and long-term cash and stock incentives tied to core financial and non-financial goals. The options that are

granted should be more performance-based, with the exercise price increasing at a given percentage rate or fluctuating with the market. Such provisions would require the company to earn a minimum rate of return for shareholders before providing a return to executives and employees.

While there isn't a magic incantation to make the current problem of underwater stock

options disappear, management can cope through measured actions such as a value-for-value cancel/re-issue, or replacing underwater options with restricted stock (in far fewer numbers). Looking ahead, companies must take prudent steps to avoid this problem in the future by developing and implementing more balanced incentives based on business fundamentals and measurable, controllable performance.