

Strategies for Steering Through Turbulent Times

UNDERWATER STOCK OPTIONS

BY DON DELVES, CPA

While a multitude of companies have seen their stock prices take a nose dive over the past year, they've also faced the difficult issue of sinking employee stock options—and sinking morale. Originally designed to recruit, retain, and motivate key talent, some are now so far underwater they're presenting a net-full of tough challenges and choices for financial managers.

What is an “underwater stock option”? A stock option is considered to be underwater when the exercise price for the company's stock exceeds the current market price. In other words, the value has been effectively neutralized.

Employees holding underwater stock options would actually fare better buying the same stock on the open market than exercising the options they've been granted through their employers.

As various segments of the economy continue to plunge, skid, or maintain precarious holding patterns, companies still need to be able to attract and keep employees if they are to individually thrive and collectively restart the nation's economic engine. In light of sinking stock options, employers must reevaluate their compensation packages and develop new strategies that will satisfy employers, employees, and shareholders at large.

TAKING STOCK OF MARKETPLACE TRENDS

The tidal wave of corporate restructuring and downsizing in the late 1970s transformed the bond between employee and employer. It's now a link wrought more from the sustenance of mutual self-interest than any mutual loyalty. The best and brightest may indeed turn the tide for a company, but they may also be the most likely to turn away toward greener pastures and compensation plans.

Today, the average employee plays job hopscotch every three and a half years, and personal or career commitment has replaced company commitment. Employees no longer see themselves toiling at the same company for 30 years with a modest retirement fund waiting on the horizon. They want and expect to own at least a small slice of the pie. Over the past two decades, as the paradigm has continued to shift in this direction, stock options have become an increasingly important tool in the talent war.

Until the recent and dramatic downturn—particularly in the high-tech sector—the economic boom of the 1990s fueled great expectations on the part of job seekers and employees. Options were regularly granted (and perhaps, taken for granted) as employers sought to reel in a roster of highly skilled workers. This became a common practice throughout many industries, especially in the tech-rich Silicon Valley, where it was raised to a fine art. But significant differences in policy and philosophy still exist between the Old Economy and the New Economy. Larger, well-established organizations obviously bank on the lure of stability outweighing the risky enticement of option-heavy early-growth companies.

Option plans proliferate. How widespread is this issue? According to the National Center for Employee Ownership (NCEO), between eight million and 10 million employees in this country participate in broad stock option plans, representing several hundred billion dollars in value. Employers use such plans to attract, retain, and

NUMBER OF PLANS AND EMPLOYEES; VALUE OF PLAN ASSETS

Type of Plan	Number of Plans (as of 2000)	Number of Participants (as of 2000)	Value of Plan Assets (as of 2000)
ESOPs and stock bonus plans	11,500	8.5 million	\$400 billion+
Broad stock option plans	4,000	8 to 10 million	(several hundred billion; not realistic to estimate)
Stock purchase plans	4,000	15.7 million	(not realistic to estimate)

Source: National Center for Employee Ownership (NCEO)

reward employees and sometimes to balance below-market salaries.

All other things being equal, the opportunity for wealth creation through stock options has been cited by employees as a reason to switch—or stay with—employers within any sector. In 1999, according to iquantic.com, more than 140,000 high-tech millionaires were created—three times the number in the previous year. But as we've been painfully reminded in recent days, situations can change in an instant. Many fortunes have been won and lost in the last few years...often without leaving the paper they were written on. And with today's abundance of underwater options, what began as a win-win situation for employer and employee has in many cases become a lose-lose proposition. Employees hold worthless options, and employers have lost the "glue" needed to retain people.

But despite stock market declines and a number of noticeable layoffs, the labor market is maintaining a remarkably low 4.5% unemployment rate. Given this fact and the continued dearth of technical talent, companies are being forced to deal with the devaluation of stock options as their primary tool for attracting and retaining top talent. Recent figures indicate that roughly 80% of technology companies are towing some portion of their options underwater, while a third of those companies have watched at least half their options sink below sea level. (This is according to iquantic.com, which notes that the market has declined further since this study, so the figures are conservative.) Clearly, this is a widespread issue with a number of significant implications:

Turnover. Despite a weakened economy, competition

THE VALUE OF VESTING

More than 65% of technology companies use a four-year vesting schedule to ensure retention. Some early growth companies are shortening this cycle to three years, while larger corporations are extending it to five years.

for key talent remains stiff; highly skilled employees holding worthless options may pay closer attention to calls from headhunters. Losing key players at a critical stage of growth or economic recovery will make it harder for the company to rebound.

Low morale. Watching anticipated wealth evaporate can have a demoralizing effect on employees. As morale sags along with the stocks, productivity goes down, taking profits with it, and shareholder confidence erodes. Also, as long-time employees see new hires being granted options at the lower price, disgruntlement may increase among the more experienced ranks.

Entitlement Mentality vs. Ownership. Employers have to walk a fine line between feeding a false sense of entitlement among employees and creating a culture of ownership. For this reason, vesting schedules are usually designed to promote retention, and the size and frequency of future grants is based on individual performance.

WEIGHING YOUR OPTIONS...AND THEIRS

So how are companies coping with the situation? Very few, it seems, have decided to discard the notion of granting stock options. The practice has gained in popularity in recent years and would be difficult to eradicate. But companies aren't ignoring the problem, either. Many are responding to the albatross of underwater options by venturing down a variety of strategic paths. Unfortunately, none of the choices is completely without risk or cost, but some are considered more prudent than others, depending on individual circumstances.

Potential solutions can range from taking no action at all to a straightforward repricing that involves canceling existing options and replacing them on a one-for-one basis—along with several intermediary steps. Doing nothing carries retention risks, while repricing should be considered a last resort if the stock is severely

A Look at How Corporate America Is Handling UNDERWATER STOCK OPTIONS

- ◆ Apple Computer, Oracle, Iomega, and Barnes&Noble.com have all used some version of repricing as a strategy to deal with underwater stocks.
- ◆ Cisco Systems has offered supplemental option grants and extended the exercise rope by nine months for workers recently laid off, giving them a chance to recoup underwater stock options if the market rebounds in this period of time.
- ◆ Novell adopted the cancel/reissue approach—affecting 13.6 million shares that will be reissued six months after cancellation on a 1-to-1 basis.
- ◆ MarketWatch.com announced a voluntary stock option exchange program for eligible option holders, giving them the chance to cancel outstanding options in exchange for new options to be granted at a future date. The company doesn't expect to incur accounting charges as a result of this action.
- ◆ Nortel Networks recently announced it would allow thousands of nonexecutive employees to exchange roughly 111 million existing stock options for new options with lower prices.

Table 1: DECISION-MAKING MATRIX

UNDERWATER OPTION STRATEGY	WHEN IT'S APPROPRIATE	PROS	CONS
<p>DO NOTHING</p> <ul style="list-style-type: none"> ◆ Assess turnover risk and market conditions ◆ Be prepared with other alternatives, if necessary 	<ul style="list-style-type: none"> ◆ If stock price drop is 20% to 30% or less ◆ Only a portion of options are underwater ◆ Turnover risk is fairly low 	<ul style="list-style-type: none"> ◆ Avoids accounting charges ◆ Avoids future repercussions of potentially unnecessary action ◆ Does not use additional shares 	<ul style="list-style-type: none"> ◆ Could cause rise in employee dissatisfaction and turnover rates
<p>ACCELERATE FUTURE GRANT</p> <ul style="list-style-type: none"> ◆ Make next scheduled option grant now 	<ul style="list-style-type: none"> ◆ If stock price drop is 25% to 50% ◆ If stock price has likely bottomed out 	<ul style="list-style-type: none"> ◆ Sends positive message to employees ◆ Does not use additional shares ◆ Maintains integrity of existing programs 	<ul style="list-style-type: none"> ◆ If stock price drops further, you should have waited ◆ Cannot grant options at next scheduled time
<p>MAKE SUPPLEMENTAL STOCK OPTION GRANT</p> <ul style="list-style-type: none"> ◆ No effect on existing underwater options ◆ Award could be performance based or geared to value of underwater options 	<ul style="list-style-type: none"> ◆ Stock price drop is 25% to 50% or higher ◆ Company has significant additional shares available for options (This is the key factor. Most companies with enough available shares do this, e.g., Microsoft and Cisco) 	<ul style="list-style-type: none"> ◆ Provides strong incentive if stock price hits previous levels ◆ Can link option grant or accelerated vesting to specific achievements ◆ Avoids compensation expense if option granted at or above FMV 	<ul style="list-style-type: none"> ◆ Depletes available company shares ◆ Only works if a company has sufficient shares available under current plans ◆ Can exacerbate entitlement mentality
<p>CANCEL/REISSUE OPTIONS IN SIX MONTHS</p> <ul style="list-style-type: none"> ◆ New options granted at FMV six months + one day after cancellation, based on quantity or value ◆ Can exchange one for one, or offer fewer number of new options based on valuation formula 	<ul style="list-style-type: none"> ◆ If stock price has dropped more than 50% ◆ All, or almost all, options are severely underwater ◆ Few additional shares are available for option grants ◆ Additional shares cannot be authorized 	<ul style="list-style-type: none"> ◆ Does not result in additional share dilution ◆ No recognition of compensation expense if granted at or above FMV, and no shares are granted within six months before or after the cancellation 	<ul style="list-style-type: none"> ◆ Loss of retention tool during six months between cancellation and new grant (you are "flying naked" for six months, with no hold on your people)
<p>REPURCHASE/REGANT AFTER SIX MONTHS</p> <ul style="list-style-type: none"> ◆ Buy back employees' underwater options based on their economic value ◆ New options granted at FMV six months + one day after repurchase 	<ul style="list-style-type: none"> ◆ Company has the cash and can incur the expense ◆ Company is very concerned about morale and retention (cash payment for options could be contingent on staying with company for 6-12 months) 	<ul style="list-style-type: none"> ◆ Same benefits as cancel and reissue after six months ◆ Aids retention and morale by restoring some option value 	<ul style="list-style-type: none"> ◆ May require major cash expenditure—and expense ◆ Expenditure and expense may be minimized depending on valuation of underwater options—a nominal payment may be adequate

UNDERWATER OPTION STRATEGY	WHEN IT'S APPROPRIATE	PROS	CONS
<p>CANCEL OPTIONS AND GRANT RESTRICTED STOCK</p> <ul style="list-style-type: none"> ◆ Cancel outstanding underwater options ◆ Grant Restricted Stock of equivalent economic value to the options canceled (using Black-Scholes or other option pricing model) 	<ul style="list-style-type: none"> ◆ If stock price has dropped more than 50% ◆ Few shares are available for additional option grants ◆ Continued retention is a major and immediate issue ◆ Company can sustain the charge to earnings 	<ul style="list-style-type: none"> ◆ Good for retention and morale—full-value shares mitigate impact of further stock price depreciation ◆ Expense is fixed at value of restricted shares on date granted—amortized over their vesting period ◆ Otherwise, same benefit as cancel and reissue after six months 	<ul style="list-style-type: none"> ◆ Earnings charge could be significant ◆ Uses scarce incentive shares
<p>CANCEL UNDERWATER OPTIONS/IMMEDIATE REGRANT AT LESS THAN 1-FOR-1 EXCHANGE</p> <ul style="list-style-type: none"> ◆ New options granted at FMV equal to economic value of underwater options <p>For example, may exchange three underwater options for one new FMV option</p>	<ul style="list-style-type: none"> ◆ If stock price drop is greater than 50% ◆ Retention issues are significant and immediate ◆ Few, if any, additional shares are available ◆ Company can either sustain charge to earnings or is losing so much money that it doesn't matter 	<ul style="list-style-type: none"> ◆ Dilution and expense are lower than in full 1-for-1 repricing ◆ Greater shareholder appeal than with full 1-for-1 repricing ◆ Reduces the total shares used for options—allows “room” for future grants 	<ul style="list-style-type: none"> ◆ Incurs variable accounting charge—the spread between market price and exercise price must be expensed, and the expense varies as the stock price varies.
<p>FULL AND IMMEDIATE CANCEL/REISSUE—OR REPRICING</p> <ul style="list-style-type: none"> ◆ Either cancel all underwater options and immediately reissue the same number of new options with a current FMV exercise price, or just lower the exercise price of all underwater options to FMV (depends on what the plan document allows) 	<ul style="list-style-type: none"> ◆ Stock price has dropped more than 50% ◆ Retention issues are severe and immediate ◆ Company needs all outstanding options at FMV for retention purposes ◆ Few, if any, additional shares are available ◆ Company can either sustain charge to earnings or is losing so much money that it doesn't matter 	<ul style="list-style-type: none"> ◆ Replaces full retention capability of option plan ◆ Immediately establishes incentive for recovery of performance and stock price 	<ul style="list-style-type: none"> ◆ Incurs potentially significant variable accounting charge ◆ Possible criticism from shareholders/negative publicity ◆ Employees may lose vesting status or have to completely restart ◆ May exacerbate entitlement mentality

depressed and there are few shares available for additional grants. Once a common way to deal with devalued stock option grants, repricing has become costly for companies since a ruling enacted in March 2000 by the Financial Accounting Standards Board (FASB) tacked an onerous expense onto options that had been repriced at fair market value (FMV).

Financial managers should consider the impact of any

underwater strategy on employee recruitment and retention, the flexibility for future recovery, the potential charge to earnings, and the perception by shareholders. Investors may react negatively to any moves that seem to give executives and managers a better deal than shareholders. To avoid perceived conflicts of interest, employers may decide to exclude top-level management from adjustments to underwater stock options. Also, certain

solutions come with a price tag in the form of fixed or variable accounting charges. To meet the needs of all key stakeholders, companies should carefully consider the ramifications associated with any underwater stock option strategies.

As part of the decision-making process, management should consider questions such as:

- ◆ How many options are currently underwater and by how much?
- ◆ Which employees or groups are most affected?
- ◆ What's the current turnover risk among key talent?
- ◆ What's the relative level of risk and cost associated with unwanted turnover?
- ◆ Are there a sufficient number of remaining shares available for additional grants?
- ◆ Has the stock hit bottom yet?
- ◆ What's the overall financial condition of the company?
- ◆ How will shareholders react to repricing or similar actions?
- ◆ What's the philosophy of the management or board members?
- ◆ Are we willing to incur a significant charge to earnings?
- ◆ Should vesting schedules be adjusted and shorter option terms be put in place?
- ◆ Would restructuring the entire compensation package be appropriate?

Answers to these and other pertinent questions will help a company analyze its own situation and decide the best course of action.

GUIDEPOSTS FOR STRATEGIC PLANNING

Table 1 is a decision-making matrix designed to assist executives and financial managers in understanding the range of strategies available and selecting the most appropriate path for their organization. The alternatives are listed in order from the least aggressive to the most aggressive action.

COMMUNICATE

Whatever approach is used, leadership should take the opportunity to clearly communicate with employees about the issue. Avoidance will only exacerbate the problem and may generate further discontent. Messages may include:

- ◆ Clear assessment of the situation by the management team.
- ◆ Education on where options come from—that they represent a direct transfer of wealth from sharehold-

ers—and that there is a limit to how much can be transferred.

- ◆ Discussion of complexities and limitations in simply giving everyone more options.
- ◆ Explanation of potential reasons for the stock being underwater.
- ◆ Discussion on how the company is addressing the issue.
- ◆ Call to action for building positive momentum and spurring growth.
- ◆ Comparison of underwater levels to industry peers.
- ◆ Communicate the company's long-term prospects and viability.

It's also important to communicate the value of the options granted in terms beyond today's numbers. To build real ownership and accountability, successful companies find a way to convey some of the more intangible values such as the mission, vision, career growth opportunities, and leadership of the organization.

The market may be as unpredictable as the weather, but it pays to plan ahead. Whether tomorrow brings financial turbulence or tranquility, management should approach the combined issues of equitable compensation and underwater stock options from a variety of angles, addressing both short-term and long-term implications. And at the other end of the bargaining table, optionees should realize that stock option grants—unlike salary and cash bonus plans—are designed as longer-term rewards and are likely to regain value with the passage of time.

Underwater stock options and other prevailing market concerns may be spurring companies to rethink compensation packages to better meet their own corporate objectives, as well as those of employees and shareholders. And though the red-hot stock option craze has cooled significantly, the practice of granting options as part of a well-rounded compensation package will continue for the foreseeable future. Yet factors such as the size, importance, vesting schedule, and recipient level will likely shift—at least until the market becomes bullish again. ■

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