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Opinion: How Boards Can Address Underwater Stock Options

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The U.S. is currently grappling with the worst systemic underwater option situation since the early 2000s, when the dot-com bubble burst. Faced with widespread employee morale and retention challenges, a number of companies executed underwater option exchange programs to address the problem. But this is not 2001. Companies are still struggling with underwater options, except this time the business, shareholder and regulatory environment is radically different.

Stock option repricing often elicits a negative reaction due to past abuses, including aggressive programs meant to benefit only the employee, to the detriment of shareholders. The **New York Stock Exchange** and **Nasdaq** exchanges implemented shareholder approval requirements in 2003 following these aggressive actions by some organizations. Previously, boards enjoyed the ability to reprice options unilaterally unless the underlying equity plan expressly prohibited this action. But today a company’s plan must expressly permit repricings in order for a company to unilaterally reprice stock options without expressed shareholder approval.

These changes have fostered the evolution of a more balanced approach by which a company offers an exchange of underwater options for fewer new at-the-money options or restricted stock. This exchange approach strikes a balance between shareholder and employee interests.

While these more balanced exchange programs have been well received by shareholders and employees alike, they may not be the right solution for every company. There are a few criteria that should generally be satisfied before a board explores offering an exchange:

Business Case

A company's rationale for why the exchange is necessary to its business is one of these most important criteria for offering an exchange. Investors recognize that it's important for companies to put themselves in a strong position coming out of a recession, and retaining their top talent is an integral part of that strategy.

Company Performance Outlook

Boards also need to examine the likelihood that the stock price could rebound in the next 12 to 24 months based on specific business circumstances since these programs can often take a significant amount of time to design and roll out.

Percent of Overhang Underwater

In order to be a good candidate for an underwater exchange, there should be a significant percentage of outstanding options ("overhang") underwater. If only a few outstanding awards are underwater, there should be sufficient remaining incentive from the in-the-money awards to negate the need for an exchange. A reasonable rule of thumb is to explore an exchange if at least half of the outstanding options are underwater.

Level and Period of "Underwater-ness"

A company is not a good candidate if most of its options are within striking distance (i.e., less than 30%) of where the current stock price is trading or if the options are only recently underwater (i.e., past 12 months).

Level of Institutional Ownership and Impact of Corporate Governance Oversight Groups

Unlike when exchanges were offered a few years ago, shareholder considerations have taken on a much greater focus this time around. Corporate governance watchdogs such as **RiskMetrics Group** have had a significant impact on the design of exchange programs. Companies with a high level of institutional ownership will likely need to comply with these "shareholder-friendly" requirements.

Potential Value Created as a Multiple of Cost

Before launching into an underwater exchange, a company should evaluate the potential value created for eligible employees versus the cost of conducting the program.

Nearly every company using options will see them fall underwater at some point in time — but not every company is a good candidate for conducting an underwater exchange. Assessing whether such a program is right for you takes considerable due diligence. But as we have seen over the past year, there's a clear path to designing a balanced exchange that will be approved by shareholders and will be well received by employees.

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