SIMPSON
THACHER

CLIENT
MEMORANDUM

Navigating the Swift Currents of "Underwater" Stock Options

March 30, 2009

OVERVIEW

In an environment of plummeting stock prices, many public and private companies are now grappling with the fact that many, if not all, of their outstanding stock options are "underwater" (i.e., the per share exercise price of the stock option exceeds the per share value of the underlying equity). In many cases, these options are deeply underwater in light of the severe deterioration in the overall market, with little expectation of recovering their value in the foreseeable future. Equilar indicated the magnitude of this problem when it reported that, in the fourth quarter of 2008, 99% of Fortune 500 CEOs held at least some underwater options and that the weighted average exercise price for outstanding options was below the companies' respective stock prices at 72% of Fortune 500 companies.

As companies search for ways to address this issue, many companies reviewing their persistently and deeply out-of-the-money stock options are considering *repricing options* (i.e., lowering exercise prices to reflect the company's current share price without reducing the number of shares subject to the options) or conducting an *option exchange*. An option exchange offers employees the ability to exchange out-of-the-money options for at-the-money options covering fewer shares, but with roughly equivalent aggregate fair value. The exchange ratio typically is based on Black-Scholes values rather than intrinsic, or current market price, valuations. The option exchange is, in effect, another form of repricing, but results in less dilution to shareholders and, consequently, less upside for employees who accept the exchange by reducing the number of outstanding equity awards. Repricings and option exchanges have been popular this year. The New York Times recently reported, based on information from Equilar, that at least 48 companies (mostly technology companies) have proposed or completed a repricing or exchange this year, compared to 51 in all of last year. To date, however, only a small percentage of these companies are in the Fortune 500. Nonetheless, the number may well increase if the precipitous decline in stock prices since last September persists.

Although repricing or exchanging underwater stock options can be a powerful incentive tool for compensation committees to reinvigorate their employees, companies

Celebrating
125
YEARS
1884-2009

considering such a program should understand the obstacles, along with the benefits, to implementing such a program. This memorandum is intended to provide a brief overview of these benefits and obstacles, as well as noting potential alternatives to consider before approving a program.

BENEFITS OF OPTION REPRICING/EXCHANGE

The benefits of option repricings or exchanges include:

- Curing workplace morale issues by replacing effectively "worthless" options with options at current market prices (repricing) or a smaller number of equity-based incentives with approximately equivalent aggregate fair value (exchanges), in each case, having immediate upside potential
- Potentially replenishing the stock award plan pool by reducing the number of outstanding shares subject to outstanding awards (in the case of an exchange)
- Reducing potential future shareholder dilution from exercised options, with little or no accounting impact (if done using a "value neutral" exchange)
- Creating new compensation opportunities without any meaningful cash-flow cost to the company
- Obtaining a new retention device, to the extent the receipt of modified options is conditioned on employees' acceptance of new vesting periods
- Maintaining an equity incentive compensation structure familiar to employees

The foregoing is not an exhaustive list of the benefits of an option repricing or exchange, but highlights why there is such strong appeal for using such a program.

OBSTACLES TO OPTION REPRICING/EXCHANGE

Despite the benefits of option repricings or exchange programs, there are a number of obstacles which can impede effective implementation:

- Unless a stock option plan expressly permits option repricing or exchange (which is the case with a number of companies that have recently instituted such programs), NYSE and NASDAQ rules prohibit their implementation without prior shareholder approval. Obtaining shareholder approval often would require delaying a program for several months (i.e., this may mean waiting until the annual meeting to avoid the costs of a special meeting).
- The influential proxy-advisory firm, RiskMetrics Group, makes recommendations on option repricings and exchanges on a case-by-case basis, but generally instructs its subscribers to vote against any option repricing or exchange program submitted for a shareholder vote if the program would:
    - o include stock options with exercise pricesbelow the issuer's 52-week high stock price;[1]
    - o include options granted in the prior one year; or
    - o permit participation by executive officers or directors in the repricing or exchange.[2]
- If an equity incentive plan already permits an option repricing or exchange, RiskMetrics generally instructs its subscribers to vote against or withhold their vote for compensation committee members if the committee approves a repricing or exchange without a separate shareholder vote. In short, listed companies cannot avoid RiskMetrics' scrutiny – even through proper planning and prior share- holder approval of the plan – without

---

[1] In the absence of a dramatic stock market recovery, many companies' 52-week highs may continue to decline as we approach September/ October of the year.

[2] Notwithstanding RiskMetrics' voting policies, many repricings and exchanges have included senior management, although this has not typically been the case where programs have been submitted for shareholder approval.

another shareholder vote on the planned repricing or exchange.

- The process of obtaining shareholder approval requires a proxy statement (with a potential SEC review), while the process of offering employees an option exchange requires a tender offer (also with a potential SEC review).[3]
- Accounting rules under FAS 123R require an employer to expense the incremental additional value of the modified options, resulting in additional accounting charges for repricings and most exchange programs unless they are done as fair value exchanges.
- If the company's stock value continues to drop after an option repricing or exchange is completed, the company may need to consider another option repricing or exchange, or other incentive alternatives, in another six to twelve months to cure the problem. A second exchange may only exacerbate potential shareholder opposition.

These obstacles are often sufficient to cause senior executives and compensation committees to decide against the adoption of an option repricing or exchange program. Nonetheless, an increasing number of issuers have elected to proceed following the RiskMetrics guidelines[4] or, notwithstanding potential objections from RiskMetrics, have proceeded with a program that did not satisfy all of the RiskMetrics guidelines, but which fit the needs of the issuer.[5] Moreover, a number of companies have adopted programs without seeking shareholder approval. According to a RiskMetrics report on the technology, media and telecommunications sector, 19 companies (45% of firms studied) implemented option repricing or exchange programs in 2008 without shareholder approval.

INCENTIVE COMPENSATION ALTERNATIVES

Compensation committees and senior executives may have two different issues to evaluate as they consider the problems that result from significantly underwater options: (1) exploring alternatives to simply implementing an option repricing or a traditional option-for-option exchange program to replace existing underwater options; and (2) creating new ways of compensating their key employees in an environment of declining share prices.

Although option-for-option exchanges are the most popular, other approaches include the following:

- *Replacing Underwater Options with Restricted Shares or Restricted Stock Units (RSUs).* Unlike options, restricted shares and RSUs continue to have value when stock prices drop after the grant date. As a result, companies can avoid the "underwater option" trap by only using restricted shares or RSUs for future grants and also by offering to exchange underwater options for a fewer number of restricted shares or RSUs with

---

[3] While this memorandum focuses on public companies, many private companies are facing the same underwater option issues resulting from significant write-downs in equity values. Stock exchange rules and shareholder "perception" issues obviously will not be relevant for private companies, but private employers may nonetheless be required to comply with tender offer rules and will certainly want to evaluate other compensation, accounting and tax issues.

[4] Additional factors that RiskMetrics considers in evaluating repricings or exchanges include:

- Historic trading patterns – the stock price should not be so volatile that the options are likely to be back "in-the-money" over the near term.
- Rationale for the program – was the stock price decline beyond management's control?
- Is the exchange "value neutral"?
- Are surrendered options added back to the plan reserve?
- Option vesting – does the new option vest immediately or is there a black-out period?
- Term of the option – the term should remain the same as that of the replaced option.

[5] Examples include Google (which conducted a one-for-one exchange (i.e., a repricing) and allowed executive officers to participate), MGM Mirage (which allowed executive officers to participate), VMware (which conducted a one-for-one exchange) and R.H. Donnelley (which allowed executive officers to participate). Google did not seek shareholder approval, as its equity incentive plan permitted repricings. MGM, VMware and Donnelley obtained approval (although MGM is a controlled company).

comparable value. This will not only reduce the potential for shareholder dilution (and reduce the employees' equity leverage), but also give employees a sense that they continue to have something of value in a declining market. Restricted shares (which become taxable when vested) and RSUs (which become taxable when delivered or paid upon a fixed date) do not feature the tax timing flexibility of options (which generally are not taxable until an employee exercises the option (i.e., on any date the employee selects, subject to general securities/corporate law limitations)). The loss of flexibility in timing may, however, be acceptable in light of the greater downside protection that the full value shares provide over options.

- *Cashing Out Underwater Options.* A cash tender offer for underwater options typically would not require shareholder approval under exchange rules. Cashing out options addresses dilution issues and provides some current compensation to employees, but paying cash for underwater options presents its own set of issues, including:
  - cash payments may not be feasible for companies with liquidity issues,
  - employees would no longer be aligned with shareholders with respect to stock price movements,
  - cash payments lack a retention benefit unless the payment is conditioned on additional service or performance measures,
  - RiskMetrics generally still recommends no/withhold votes for compensation committee members if a committee approves a program without subjecting it to a shareholder vote,
  - the process for calculating the cash "value" for underwater options may be more closely scrutinized by shareholders than equity-for-equity programs, and
  - cash payments would be taxable upon receipt in contrast to the timing flexibility of options.

In addition to potential modifications to the typical form of an option repricing or exchange program, changes to a company's historical approach to incentive compensation may prove useful in the current market environment. Alternative incentive compensation awards can take a number of forms such as the following:

- *Grant Long-Term Cash Awards based on Operating Performance Measures.* Many employees may find cash-settled awards more rewarding than stock-based awards in this environment. Tying payouts and amounts to performance measures other than a company's stock price or earnings per share may help divert employee attention from stock prices (which, particularly in this market, may be significantly out of management's control). Cash-based awards could replace stock awards in part or in full. The disadvantage, of course, is that the employee's compensation is less directly aligned with the interests of shareholders.
- *Grant Full Value Performance Share Awards.* In lieu of granting additional stock options, companies could grant restricted shares or RSUs that vest in full shares subject to performance measures other than a company's stock price or earnings per share. This would have the benefit of mitigating any incentive to drive a company's stock price on a short-term basis above the option exercise price because the awards would have value from the first day of grant. Performance shares also typically would be granted in smaller numbers than option grants (resulting in less dilution) and would not result in terminated employees who are no longer contributing to the company's value creation

harvesting future value of stock options with long post-termination exercise periods. Many companies have changed the proportion of options and full-share awards to more heavily favor full shares.

As all of the foregoing indicates, option repricing and exchange programs, while offering significant benefits, should not be entered into without a full consideration of all the alternatives. Because this memorandum is simply an overview and every case is fact-specific, we recommend a more detailed analysis, with advice from legal counsel, accountants, compensation consultants and proxy solicitors, be completed before implementing such a program.

If you have any questions about the matters discussed in this memorandum, please contact your Simpson Thacher relationship partner or any of the following partners in the Executive Compensation and Employee Benefits department:

Alvin H. Brown
(212) 455-3033
abrown@stblaw.com

Tristan Brown
(650) 233-5140
tbrown@stblaw.com

Gregory T. Grogan
(212) 455-2477
ggrogan@stblaw.com

Brian D. Robbins
(212) 455-3090
brobbins@stblaw.com

Andrea K. Wahlquist
(212) 455-2622
awahlquist@stblaw.com

This memorandum was not intended or written to be used, and cannot be used, for the purpose of avoiding tax-related penalties under federal, state, or local tax law.

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
650-251-5000

Washington, D.C.
601 Pennsylvania Avenue, N.W.
North Building
Washington, D.C. 20004
202-220-7700

EUROPE

London
Citypoint
One Ropemaker Street
London EC2Y 9HU England
+44-20-7275-6500

ASIA

Beijing
3119 China World Tower One
1 Jianguomenwai Avenue
Beijing 100004, China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037, Japan
+81-3-5562-6200