Front of the News

Gilding Employees’ Stock Options

Despite regulatory pressure and wrath from shareholders, companies are still repricing option grants to retain employees.

By Robin Couch Cardillo

The earnings pain is worth the employee retention gain. That’s the apparent belief of companies that are lowering the exercise price of employee stock options in the face of shareholder wrath and bottom-line earnings hits.

The consequences of repricing employee options—which is meant to put the juice back into options grants that have fallen out-of-the-money because of a depressed share price—have become more dire. As of this month, the costs of newly repriced options are being reported in quarterly earnings statements as compensation expense, in accordance with a recent pronouncement from the Financial Accounting Standards Board (FASB).

Moreover, FASB expects companies to account for all repricings that occurred after December 15, 1998. (For more on the FASB edicts, see the box on page 8.)

“The FASB pretty much put the nail in the [repricing] coffin,” says David F. Hawkins, a consultant at Merrill Lynch who believes that options repricing is a valuable tool for retaining key employees. Hawkins, who also teaches business administration at the Harvard Business School, adds that the new guidance is forceful, notwithstanding its restatement of a well-known view. “It’s really just an interpretation of an old standard, but I think it says the FASB is pleased with the position it has taken,” he says. FASB issued its “guidance” at the end of March, he adds, admitting that it gave companies “fair warning.”
Full Speed Ahead
Several companies have recently initiated buyback plans with full awareness of the consequences. Barnesandnoble.com reported a non-cash charge of $175,000 for the first quarter of 2000 to reflect its launch in late March of a repricing program for nearly 5 million outstanding options. The repricing slashed the exercise price of about one-third of non-executive employees’ outstanding stock options to $8 from $16.

“It does make for some difficulties with shareholders,” CFO Marie Toulantis told a reporter at the time. The repricing, however, has worked for the dot.com’s employees. The company’s shares were trading near their 52-week low of about $8.46 a share in mid-June. Toulantis and other barnesandnoble.com officials would not comment for this story.

In May, CDNow, a struggling online retailer, said that it had repriced options during the first quarter for employees (including some senior officers, but not the company’s founders, and some board members). The options were repriced on March 20 at an exercise price of $5.625, the underlying shares’ closing price on that day. The shares, which had traded higher than $23 after CDNow’s IPO last year, stood at $3.78 at the end of March, and had rebounded to $4.25 in mid-June. As a result, the options remain worthless to employees and the repricing has not shown up in earnings reports.

A Conciliatory Approach
Iomega Corp., the once high-flying manufacturer of computer zip drives, repriced stock options for some of its key engineers and technical employees on April 24. But, deeply aware of the controversies over repricing, and mindful of its own past skirmishes with shareholders over a plummeting stock price, the Roy, Utah-based company kept a careful eye on its non-employee shareholders in developing the plan.

It began with the intention to mollify them about potential dilution from the outstanding options. The plan included a tiered approach, so that employees had to turn in from 1.5 to 2.5 of their old options for one of the new ones, according to the number they had been granted.

Then, after consulting with staff members at FASB, Iomega went even further. It sought formal approval for the plan from its shareholders. About 90% of them voted in favor, well above the 51% required by Iomega’s governance rules.

“Of course, there still was some negativity on [Internet] chat boards, and we received a few nasty letters from shareholders,” confides Tracy Welch, treasurer of the $1.5 billion company. But he says that the backlash was minimal. (Welch also said that Iomega executives had initially held extensive discussions with the FASB’s staff and believed they had found a loophole in the exposure draft regarding reporting requirements. “But the FASB shut it down,” he mournfully adds.)

The repricing program is open to selected employees (“key engineers
and technical people we are afraid to lose,” Welch says) on options that had exercise prices above $3.59 on the day of the April announcement. Iomega shares were trading on the New York Stock Exchange at about $3.69 in mid-June. Welch said that more than 80% of eligible employees were expected to take advantage of the repricing plan.

Pre-Approved Plans
Matt Ward, a principal of WestWard Pay Strategies in San Francisco heartily approves of Iomega’s unusually solicitous approach to shareholders. However, he would go even further. Since taking notice of a spate of repricings in 1997 the consultant says he has been advising his clients to ask their “more savvy shareholders” to pre-approve a general repricing plan. This allows companies to launch emergency repricing programs when quick action is needed— such as when employees start defecting because of worthless option grants. Ward suggests that the general plans companies submit to shareholders for pre-approval should include several trigger points before repricing occurs, such as a drop of at least 50% in share value that lasts, in the case of high-tech companies, for six to 12 weeks.

Shareholder Reaction
Unlike Iomega, some companies that have repriced, or are contemplating doing so, do not want to comment publicly so as not to draw shareholder or regulatory attention.

“Repricings just don’t smell good to shareholders,” says Deborah Lifshey, an associate in the New York City law firm of Fried, Frank who has advised companies on repricing plans. “They put out of whack the whole idea of lining up shareholders’ and management’s interests.”

However, some corporate executives say they have a potent response to complaining shareholders. “I tell them they aren’t going to do too well if the best people leave,” Grant Saviers, the former chief executive of Adaptec, told “USA Today” last year after the systems interface technology company repriced options last year. Merrill’s Hawkins says that repricing still works as a retention and recruiting strategy because it demonstrates that management understands employees’ problems. He also believes that companies that have repriced once become believers, and are likely to return to the strategy again.

The new sensitivity to shareholders may well reflect a growing number of threatened and actual lawsuits from disgruntled shareholders who believe that repricing schemes are discriminatory.

But shareholders won’t get much support from a research study by a long-time advocate of their rights.

Graef Crystal, the venerable critic of inflated executive compensation,
analyzed the stock performance of companies that repriced employee stock options in 1997. He found that shareholder returns on investment were higher throughout the 12 months following the repricings. Crystal’s research throws a wrench into shareholders’ claims that stock option repricing rewards underperformance, and benefits only a few, observers say. Indeed, many say that repricing programs are not losing steam. According to the National Center for Employee Ownership, 36% of public companies with broad-based stock option plans lowered option exercise prices between 1994 and 1997. Further, the group believes the trend is continuing. “Basically, the marketplace is saying, ‘Hey, you can get away with this,’” says Corey Rosen, executive director of the Oakland, Calif.-based NCEO. Reaction to repricings have not been sufficiently punitive, even with knowledge of FASB’s renewed attention, he explained.
The NCEO is conducting a new survey asking public U.S. companies whether they have repriced options in the first six months of 2000, and if they expect to do so again. Results won’t be tallied until the end of this summer. Rosen, whose group advocates employee share ownership, says there are alternatives to repricings that can build employee morale without infuriating shareholders. He suggests that companies step up employee incentives—such as additional vacation, improved benefits and more cash. Rosen also believes that many technology companies continue to be profligate with options-based signing bonuses. His recommendation: Phase in vesting periods for grants over longer periods of time than currently. Companies also should have a strong internal communications program that conveys to employees the message that owning part of the company is a long-term proposition. “Patience is very important for companies and employees to learn,” Rosen stresses. “But in the end, the most crucial lesson for everybody is that options shouldn’t be the primary reason you go to work. Ownership is a nice reward, but job satisfaction is most important.”

The Big Question
After all the headache of putting through a repricing, is it helping companies to meet their number-one goal of retaining key employees? The answer is a collective “hmmmmmm.” There are no hard data to cite, and anecdotal evidence proves little. Iomega’s Welch, for example, is not so sure that remodeling old options grants is the best way to go these days. “I don’t know if we’d do it again,” he says. “There probably are other ways we could accomplish the same objective, like just issuing additional options. There are some pretty large negatives with repricing, like the uncertainties we create on the income statement.”
He also pointed to the increased pressure that an option repricing puts on his company’s accounting, IT and treasury departments. Iomega had to write its own complex computer program to track all the individual option scenarios, including varying vesting schedules, he says. Hawkins, for his part, says he has plenty of anecdotal evidence to show that repricing is the way to go. “My daughter-in-law just left one firm whose stock tanked to another one with better stock options,” he says. “My sons work for companies with stock-option compensation, too. These young professionals just expect options as part of their compensation package. And they expect them to pay off.”

The NCEO’s Rosen, however, says employees of companies that are big grantors of options have generally proved themselves to be loyal. “I’m getting lots of calls from reporters asking about the repricing issue,” he says. “I haven’t had a single call from an employee. Nobody has called to say, ‘My options are underwater. What do I do?’ And why not? Because people are more sophisticated than the press gives them credit for. They’re not day traders.”

**The FASB Directive**

The Financial Accounting Standards Board’s interpretation of companies’ reporting responsibilities for repricing options was issued at the end of March. It came in the form of a guidance (interpretation No. 44) to clarify APB Opinion 25, which discusses accounting for any stock issued to employees.

FASB effectively said that the repricing of employee options make the grants a variable, rather than a fixed, expense. As a result they are considered a compensation expense that must be disclosed in every quarter in which they are granted.

The interpretation became effective on July 1.

It applies to new options awards and to modifications of options previously granted (including those transferred during business combinations). FASB said that all repricings that occurred after December 15, 1998, should be subject to variable accounting methods as of July 1.

A FASB official explained that the 1998 date does not mean that companies must retroactively apply the interpretation and possibly restate earnings. It does mean that the interpretation going forward applies to all options grants made as of Dec 15, 1998.

**High-Tech Repricers**

The following companies are among a growing number in the high-tech sector that have repriced employee stock options in the past few years, or that have such programs in place.

Actel
Adaptec
Compensation consultant Matt Ward suggests that companies considering repricing plans ask themselves the following questions:

- How far underwater are our options currently?
- Are we losing employees below the top executive level to competitors because of out-of-the-money options?
- What is the “right” price for the stock currently?
- Was the original grant made at the “wrong” price, and is the current price now the right price?
- Does the current stock price reflect overall market conditions, poor company financial performance or both?
- Are the conditions that seem to be affecting the stock price permanent or temporary?
- How are shareholders likely to react to a repricing?
- Have we repriced before? How recently? Did we exclude top executives?
- Is a repricing fair to employees who recently exercised options at depressed prices just before they went fully underwater?

Source: WestWard Pay Strategies