

# Torys on Corporate and Capital Markets

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## Dealing with Underwater Options: Sinking or Swimming in the Credit Crunch

By [Christina Medland](#)

Many companies have stock options that are underwater (the exercise price is higher than the current share price). Substantially underwater options are generally a poor incentive because they have no value unless the share price increases dramatically. Having a large “overhang” of underwater options uses up the shares reserved under the option plan, so new options cannot be granted; this prevents a company from implementing new option-based compensation.

There are four approaches to dealing with underwater options.

1. Ride it out
2. Cancel options
3. Reprice options
4. Reprice and compress options

### 1. Ride It Out

If options are not significantly underwater, maintaining existing options and providing some other performance incentives (such as a cash performance bonus) can be a workable solution, particularly if the share price is showing signs of recovery.

### 2. Cancel Options

A company may cancel underwater options so that it has room under the option plan to make new option grants with a fair market value exercise price. However, if replacement options are granted within three months of the cancellation, TSX will treat the cancellation as a repricing requiring shareholder approval. Further, most options require the consent of the optionholder to cancel even underwater options.

### 3. Reprice Options

A repricing is a reduction in the exercise price. For tax reasons and to comply with TSX rules, the new exercise price cannot be less than the price of a share on the repricing date. Repricings were very common a few years ago, when the tech bubble burst.

Now, most shareholder activists have indicated that they oppose a repricing of options. In particular, in Canada, the public materials from the following organizations state that they will vote against option repricings: Ontario Teachers' Pension Plan, Ontario Municipal Employees Retirement System (OMERS), CPP Investment Board, Canadian

To discuss these issues, please contact the author.

For media calls, please contact [Stuart Wood](#), Chief Marketing Officer, 416.865.8205.

To contact us, please email [info@torys.com](mailto:info@torys.com).

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Coalition for Good Governance, Public Sector Pension and Investment Board, British Columbia Investment Management Corporation and Ethical Funds.

The general rationale that these groups give for opposing option repricing is that the purpose of an option grant is to create alignment of interest between shareholders and management, and a repricing destroys that alignment by giving management a “fresh start” that shareholders cannot get.

Google repriced its options earlier this year under a rare U.S.-governed option plan that did not require shareholder consent to the repricing. Google’s shareholders had no say in the repricing, which made Google take a US\$460 million compensation charge.

#### 4. Reprice and Compress Options

Repricing and compressing options involves an exchange of a number of underwater options for fewer options with an exercise price equal to the current share price.

To give a very simple example, assume the current fair market value of a share is \$1. Employee A has 10 options with an exercise price of \$2 and with a Black-Scholes value of 50¢ per option, and Employee B has 10 options with an exercise price of \$5 and a Black-Scholes value of 10¢ per option. Employee A's options would be exchanged for \$5 of options with a \$1 exercise price (based on of a Black-Scholes valuation), and Employee B's options would be exchanged for \$1 of options with a \$1 exercise price (based on a Black-Scholes valuation).

Repricing and compressing has the following advantages:

- It gives key employees options with an exercise price equal to the current share price, which is a more effective incentive than options that are substantially underwater.
- It reduces the number of outstanding options and the level of potential shareholder dilution.
- The reduction is effected on a basis that is proportionate to the value of the option and the amount by which each option is underwater. This is fair among optionholders. A simple repricing gives a greater benefit the more underwater the options.

For companies that are not in a position to make cash awards (either cash bonuses or phantom equity awards) because of cash flow issues, repricing and compressing may be better than increasing the number of shares available under the option plan or amending the option plan to allow the grant of whole share compensation (i.e., restricted stock and restricted share units).

Provided that no “in-the-money value” is created on the repricing, and the exercise price of new options is not less than the current value of a share at the date of the repricing, an option repricing and compression can usually be effected without Canadian tax consequences.

RiskMetrics in Canada has indicated that it will generally vote against repricing, but will make exceptions if repricing is part of a broader plan amendment that substantially improves the plan and provided that the following conditions are met: (i) a value-for-value exchange is proposed; (ii) the top five most highly compensated executives are excluded; and (iii) the options that are cancelled on the repricing are not available for re-issuance under the plan.

In the United States, the reaction of shareholders is less categorical and more dependent on the particular circumstances. There, RiskMetrics makes case-by-case decisions that depend on

- the historic trading patterns of the stock – the stock price should not be likely to be back in-the-money in the near term;
- the rationale for exchange, particularly that the reasons for the reduction in share price were beyond management's control;
- whether the exchange is a value-for-value exchange;
- whether surrendered stock options are added back to the plan reserve;
- whether the new options have a blackout period and do not vest immediately;
- whether the term of the replacement option has the same term as the old (replaced) option;
- whether the exercise price is set at market price or a premium to market price; and
- whether executive officers and directors are excluded from the exchange.

Earlier this year, approximately 71% of Fortune 500 companies had options that were, on average, underwater. Over 100 U.S. companies have repriced options in the last one and a half years. As companies struggle to motivate management, we expect to see more repricings, despite shareholder opposition. **1**