

# EQUITY COMPENSATION STRATEGIES IN A BEAR MARKET

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# Welcome!



- › In order to minimize background noise, all calls have been muted upon entry
- › We will un-mute the lines for the Q&A session after the presentation
- › At the end of the session, you will be provided with a link to a survey
- › After completing the survey, you will have the opportunity to download today's presentation

# Today's presenter...



**Peter Suzman**  
Managing Partner  
FAS123 Solutions, LLC

- › Over fifteen years of hands-on experience in the compensation and benefits industry
- › Has extensively published, spoken and consulted on legal, accounting, tax and benefits aspects of plan design, option valuation and FAS 123R, including multiple presentations at the NASPP annual conferences and the SEC Institute
- › Has an undergraduate degree in Computer Science and graduated from Harvard Law School with honors
- › Practiced corporate law in Boston before founding the industry's first full service stock administration outsourcing firm which was subsequently acquired by Citigroup

# Today's presenter...



**Daniel Abrams**

Partner, Managing Director  
FAS123 Solutions, LLC

- › As FAS123 Solutions principal and director, services over 200 public company clients from fortune 50 to microcap
- › Frequent speaker at industry conferences
- › Has published or been quoted on valuation and risk management topics in the Financial Times, CFO magazine, Bloomberg, Corporate Finance Week, Risk Magazine, Compliance Week and others
- › Wrote the AFP Guide to Valuing Stock Options for the Association for Finance Professionals
- › Formerly senior economist at NERA within Marsh & McLennan
- › Trained in mathematics, computer science and economics in the doctoral programs of Cornell University and Yale University

# Today's presenter...



**Rajeev Kumar, CFA**  
Senior Managing Director of  
Research  
Georgeson

- › Joined Georgeson in January 2008
- › Served as Director of US Research at RiskMetrics Group, formerly ISS, consulting with Fortune 500, investment advisory and start-up companies on corporate governance matters
- › Supervised the annual issuance of more than 8,000 proxy advisory recommendations for US companies
- › Held positions in the areas of corporate governance, M&A, corporate development and strategic business planning and analysis
- › Is a Chartered Financial Analyst (CFA)
- › Has earned an M.B.A in finance from Tulane University and a B.S. in mechanical engineering from university in India.

# Today's presenter...



**Arthur H. Kohn**

Partner, New York Office  
Cleary Gottlieb Steen  
& Hamilton LLP

- › Practice focuses on compensation and benefit matters
- › Distinguished by *Chambers USA America's Leading Lawyers for Business* as one of the leading lawyers in the area of employee benefits and executive compensation and is recommended by *PLC Which Lawyer? Yearbook*
- › Joined the firm in 1986; became a partner in 1995
- › Received a J.D. degree and an undergraduate degree from Columbia University in 1986
- › Member of the Bar in New York

# Today's presenter...



**Kathleen M. Emberger**  
Counsel, New York Office  
Cleary Gottlieb Steen &  
Hamilton LLP

- › Practice focuses on executive compensation and benefits matters
- › Joined the firm in 1998; became counsel in 2007
- › Received a J.D. degree, *cum laude*, and an LL.M. in International and Comparative Law from Duke University School of Law in 1998 and an undergraduate degree, *magna cum laude*, from the University of Pennsylvania in 1995
- › Member of the Bar in New York
- › Fluent in French

# Equity Compensation Strategies in a Bear Market

## Option Repricing, Exchanges and Alternatives

- › Option Repricing:
  - › Strike price of existing option gets reduced
  - › Number of options stays same or gets reduced
- › Option Exchange:
  - › Existing outstanding option gets exchanged for another instrument – typically cash, capped option or restricted stock
- › Alternative Awards

# Option Repricings and Exchanges

Analysis from Multiple Perspectives of:

- › Employee retention and compensation policies
- › Accounting and valuation
- › Shareholder and investor relations
- › Legal

# Employee retention and compensation policies

## > **Problems:**

- > In the context of a substantial market-wide decline in stock prices, existing awards have become substantially less valuable
- > Empirical studies have shown that employees value underwater options at even less than their current reduced objective fair value
- > Severely underwater options will likely remain outstanding for many years until either the employee terminates or the contract term is reached. This creates overhang and ties-up the share-plan pool

## > **Goals:**

- > Re-incentivize employees – prevent “repricing by employee mobility”
- > Get old underwater options off the books

# Accounting Background and History of Repricings

## There have been three relevant accounting regimes:

- › APB 25 – prior to 1999
  - › Options freely repriced on a one-for-one basis
- › APB 25 + FIN 44 (effective in 1999)
  - › Response to Enron and accounting scandals
  - › Repricing produced variable accounting
  - › Only way to avoid variable accounting was “six-months-and-a-day” repricing
- › FAS 123R (2005)
  - › Repricing or exchange treated as a modification
  - › Freely allows repricing and exchanges – obstacles to repricing now lie in legal, plan restrictions and shareholder approval areas

# Modifications under FAS 123R

- › Repricings and exchanges of vested options and the vast majority of unvested options will be treated as a “probable-to-probable” modifications:
  - › Value existing options at date of modification (“mark-to-market”)
  - › Value new instrument at date of modification
  - › Any incremental value of new instrument over mark-to-market value of old instrument reflects additional economic value transfer by company to employee and adds to expense that must be recognized
  - › Amortize any new incremental value plus remaining unamortized compensation expense for old option over vesting period of new instrument
  - › Treatment for existing options that were not expected to vest because of a forfeiture rate is potentially different (improbable-to-improbable or improbable-to-probable)

# Value-for-Value Exchanges and Repricings

- › Value-for-value exchange or repricing is where there is no additional incremental expense
  - › Accounting cost to company stays the same
  - › Perceived value to employee often increases
  - › Generally favorably received by shareholders and proxy advisory services
  - › Only a partial solution - likely will need additional grants to re-incentivize employees

# Option Expected Term as Function of Moneyness and Remaining Term Under Specific Volatility and Risk Premium Assumptions

## Expected Term: Option Moneyness Sensitivity for a Specific Company

		Remaining Contract Term (Years)						
		1	2	3	4	5	6	7
Moneyness (Stock-to-Strike Ratio)	50%	0.9	1.8	2.6	3.2	3.7	4.2	4.7
	75%	0.9	1.7	2.4	2.9	3.5	3.8	4
	100%	0.8	1.4	1.8	2.2	2.4	2.6	2.8
	150%	0.7	1.2	1.4	1.6	1.8	1.9	2
	200%	0.7	1.1	1.3	1.4	1.6	1.6	1.7

# Option Exchange Ratios as a Function of Moneyness and Remaining Term Under Specific Volatility and Risk Premium Assumptions

Held Options Exchangeable For One ATM Option or One Restricted Share

Options Needed to Exchange for One at-the-Money Option

		Remaining Contract Term (Years)							
		10	9	8	7	6	5	4	3
Current Moneyness Factor (S/K)	25%	6.06	6.71	7.53	8.84	10.78	13.57	18.50	29.55
	50%	2.82	2.95	3.12	3.32	3.56	3.88	4.20	5.08
	75%	1.70	1.74	1.78	1.79	1.90	1.96	1.98	2.05
	90%	1.42	1.43	1.45	1.49	1.55	1.59	1.60	1.62

Options Needed to Exchange for One Restricted Share

		Remaining Contract Term (Years)							
		10	9	8	7	6	5	4	3
Current Moneyness Factor (S/K)	25%	12.82	14.49	16.67	20.00	25.00	33.33	50.00	90.91
	50%	5.95	6.37	6.90	7.52	8.26	9.52	11.36	15.63
	75%	3.60	3.75	3.94	4.05	4.41	4.81	5.35	6.31
	90%	3.01	3.08	3.21	3.37	3.60	3.91	4.32	4.94

# Option Mark-to-Market by Optionee

Optionee	Analysis Date	Options Granted	Options Outstanding	Options Exercised	Gains From Exercise	Value of Outstanding Options	
						Scenario 1	Scenario 2
00001943	4/1/2004	135,133	135,133	-	-	\$1,504,917.88	\$1,627,512.36
	4/2/2005	148,798	136,746	12,052	\$233,447.91	\$1,737,489.19	\$1,953,462.94
	4/1/2006	159,046	86,261	72,786	\$1,711,853.38	\$1,509,212.75	\$1,694,729.08
	6/15/2007	159,046	86,261	72,786	\$1,711,853.38	\$671,192.17	\$796,135.29
00001955	4/1/2004	198,144	198,144	-	-	\$2,396,409.73	\$2,701,800.09
	4/2/2005	243,694	243,694	-	-	\$3,296,979.88	\$3,987,508.44
	4/1/2006	271,024	240,562	30,462	\$865,935.10	\$3,927,841.97	\$4,618,470.75
	6/15/2007	271,024	236,580	34,444	\$911,087.61	\$1,689,099.24	\$2,136,784.31
00007864	4/1/2004	110,080	110,080	-	-	\$1,347,936.53	\$1,560,901.48
	4/2/2005	116,153	116,153	-	-	\$1,635,018.37	\$2,000,494.11
	4/1/2006	116,153	29,998	86,155	\$1,453,883.69	\$662,858.07	\$711,974.55
	6/15/2007	116,153	17,234	98,919	\$1,623,029.26	\$164,878.80	\$198,080.61
00007881	4/1/2004	-	-	-	-	-	-
	4/2/2005	89,582	89,582	-	-	\$1,257,093.78	\$1,496,017.52
	4/1/2006	99,831	99,831	-	-	\$1,614,648.50	\$1,950,256.93
	6/15/2007	99,831	99,831	-	-	\$687,510.22	\$941,839.00
00009623	4/1/2004	151,075	151,075	-	-	\$1,792,494.56	\$2,094,000.22
	4/2/2005	164,740	144,492	20,249	\$314,063.62	\$1,897,366.71	\$2,392,750.97
	4/1/2006	174,989	92,919	82,070	\$1,383,609.99	\$1,653,390.58	\$1,893,440.67
	6/15/2007	174,989	78,343	96,646	\$1,591,902.37	\$640,635.19	\$790,785.36

# Concerns Relating to Equity Compensation Related Proposals

- › Is it the right time to seek shareholder approval given stock price deterioration and scrutiny of compensation practices?
  - › Average opposition to stock incentive plan proposals has ranged from 16% to 26%\*
  - › Potential dilution is a significant factor for shareholders
  - › Only a handful of equity plan proposals fail in any given year
- › How to get support of proxy advisers like RiskMetrics?
- › How fits in with shareholder proposals on executive compensation?

*\*Source: RiskMetrics Background Report – 2007*

# RiskMetrics Policy on Option Exchange Proposals

- › Case-by-Case evaluation giving consideration to the following factors:
- › Participation – exclusion of directors and top five officers
- › Value-for-value exchange – replacement awards should be of an equal or lesser value
- › Terms of the surrendered options
  - › Exercise price – above the 52-week high for the stock price
  - › Grant date – at least two year ago
- › Terms of the replacement awards
  - › Vesting – restart the vesting or provide for a blackout period
  - › Term – in case of options, should not exceed original term
- › Rationale and timing – decline in share price beyond management's control; decline should not have happened within the past year.

# RiskMetrics Policy – Other Considerations

- › Surrendered options recycled for future issuance – proposal is subject to additional total cost (shareholder value transfer) and burn rate analysis
- › Common reasons for AGAINST vote recommendation on proposals YTD
  - › Exercise price of eligible options was less than 52-week high stock price
  - › Inclusion of top five executive officers
  - › Exchange was not value-for-value
- › 2009 policy updates – recent market deterioration not an acceptable reason
- › Types of replacement awards in proposals YTD – options preferred 3.5:1 over RS/RSUs
- › Repricing without shareholder approval – possibility of WITHHOLD recommendation from the compensation committee members

# Introduction – Alternative Approaches

- › Repricing
  - › Exchanging out-of-the-money stock options for stock options with lower exercise prices
- › Replacement
  - › Exchanging out-of-the-money stock options for other cash or equity-based incentive awards
- › Buybacks
  - › Exchanging out-of-the-money stock options for immediate or deferred cash payments

# Introduction – Legal and Tax Issues

- › Shareholder approval
- › Tender offer rules
- › Section 409A of the Internal Revenue Code
- › Plan provisions
- › Proxy disclosure
- › Fiduciary standards
- › Compensation policies
- › Other issues

# Shareholder Approval

- › NYSE listed company rules – material revision
- › NYSE listed company rules - authorized shares

# Tender Offer Rules

- › Definition of tender offer
- › Rules 13e-4 and 14e-1 under the Securities Exchange Act of 1934
  - › Best price rule
  - › All holders rule
  - › 20-day rule
  - › Schedule TO
  - › Prompt payment
- › SEC Exemptive Order
- › Material non-public information
- › Termination of tender offer

# Section 409A of the Internal Revenue Code

- › Option modification
- › Deferral of option income recognition
- › Cashout for fair value

# Plan Provisions

- › No repricing provision
- › Authorized shares
- › Transferability of awards
- › Minimum vesting standards

# Proxy Disclosure

- › Compensation Discussion & Analysis
- › Tabular and narrative disclosure

# Fiduciary Standards

- › Business judgment rule
  - › Duty of loyalty
  - › Duty of due care
  - › Duty of good faith
- › Risk assessment

# Compensation Policies

- › Equity grant policies
  - › Timing
- › Share retention guidelines

# Other Issues

- › Form S-8 registration
- › Broker-dealer issues in buybacks
  - › Know your client requirements
  - › Customer accounts
  - › Confirmations and statements
- › Section 162(m)
- › Incentive stock options
- › Non-US legal and tax considerations

# Post – FAS 123R, IFRS 2, and Section 3870 Landscape

- › Level playing field – all types of awards are now on comparable accounting footing
- › Renewed focus on pay-for-performance
- › Companies looking for an objective way to compare different types of awards
- › Proxy disclosures raise profile

# Criteria for Analyzing an Award

- › Expense (accounting cost) to Company
- › Perceived Value to Employee(s) in a diversity of macro (market and economic) conditions
- › Value to Company in a diversity of macro conditions
- › Communication of the mechanics and efficacy of the award to the employee and to shareholders

# Common Types of Performance Plans with *Market and non-Market Conditions*

- › Non-market Performance Conditions
  - › Typically based on internal metrics such as EBITDA, EPS, revenue, or meeting some goal such as building a plant or getting a product to market.
  - › Need to expense the actual number of awards that vest and reconcile, which can create volatile accounting estimates
- › Absolute Market Conditions
  - › Vesting contingent on reaching certain stock hurdles
  - › Generally seen for top couple of executives
  - › Influenced by general market movements
  - › Creates a discount comparatively against FAS 123(R) charge of normal full value share absent the vesting hurdle
- › Relative Market Conditions
  - › Depending on percentile rank after performance period, a percentage of awards will vest
  - › More broad based in distribution
  - › Normalized against general market movements; so more directly rewards idiosyncratic performance of the company
  - › Will not necessarily create a discount from original FAS 123(R) fair value if upside opportunities exist
  - › Challenge of picking reliable peers

# Relative Market Conditions - Provisions

- › Depending on percentile rank after performance period, a percentage of awards will vest
- › Can provide upside opportunities (generally up to 200%) if it outperforms comparator companies
- › Most common performance period is three years
- › Recommend at least around a dozen comparators
  - What to do if somebody drops out (i.e. business combinations, changes in the Index, etc.)
- › Generally see 20-day or greater averaging period
- › Mitigates “rising tide lifts all boats” effect

# Relative Market Conditions – FAS123(R) Valuation

- › Requires Monte Carlo simulation
- › Generally done in a “risk-neutral” framework
- › Projects stock prices for company and each relative peer company, including the underlying correlation of stock prices in the projection
- › Projected stock prices are used for determination of expected awards to vest as well as the discounting of future cash flows

# Advantages of Relative Market-Based Instruments

- › Reward grantee if stock performs better than peers, even if overall stock market or sector declines
- › Simple to administer – valued at the grant date once and for all with no true-up other than forfeiture
- › Valuation correctly done is objective and easy to audit

# Some of the Companies using Relative Market-Based Awards

**Time Warner**  
**Royal Bank of Canada**  
**Viacom**  
**Honeywell**  
**CBS**  
**American Express**  
**Home Depot**  
**Chevron**  
**Bearing Point**  
**Duke Energy**  
**Nordstroms**  
**Chubb**

**Hershey Foods**  
**International Paper**  
**Lexington Realty Trust**  
**MDU Resources**  
**Metlife**  
**Occidental Petroleum**  
**Pacific Gas & Electric**  
**Verizon**  
**Northwest Natural Gas**  
**ITT**  
**Goodrich**  
**Best Buy**

# Thank You

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