Frederic W. Cook & Co., Inc.

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A RESPONSE TO THOSE WHO WOULD ADVOCATE OPTION REPRICING

The sharp market drop of August and September brought forth numerous articles in the business press about stock option repricings. The tone of these articles was that option repricings, while lamentable and upsetting to investors, were likely to increase as companies sought to restore the incentive and retention value of employee stock options which had suddenly become "worthless." Various compensation consultants were quoted as predicting a wave of repricings, perhaps seeking to create a climate of safety in numbers.

Fortunately, the rebound in the stock market has diminished current interest in repricings. But many companies' options remain underwater, and who can say that another sharp drop in market prices might not occur that would renew interest in repricings.

We, like most compensation professionals, do not like option repricings. As advocates of pay for performance, we never recommend them. But suggestions for repricings are likely to arise any time a company experiences a period of underwater stock options. How should the compensation professional respond to a proposal that the company reprice its underwater options? Here is what we would say.

1. Stock Option Repricings are a Marginal Activity by Distressed Companies

Numerous news articles have reported that a flurry of stock option repricings have already occurred or are expected to occur if stock prices stay down. What is the evidence? The Wall Street Journal reported on October 30 that, "More than a dozen companies across a range of industries . . . quietly have repriced their employees' options in the last six weeks." And The New York Times reported on November 1 that, "In October alone, more than 100 companies revealed option repricings, either in announcements or in filings with the Securities and Exchange Commission. . ." Since there are about 10,000 publicly traded companies in the U.S., a few hundred repricings is hardly a trend or prevailing practice. At the other extreme, however, Business Week reported in its November 9 issue that, "In the past five years, 30% of all companies that have granted options have repriced them." This statement seems grossly over exaggerated.

The articles on repricings often name companies that have repriced their options. For the most part, the companies that have repriced their options this year are not well-known or highly regarded. This suggests that option repricings are a marginal activity undertaken by companies that have fallen into considerable distress. They are not an example of best practices to be followed by others.

2. Option Repricings Reward Employees for Poor Performance

We are in the middle of an earnings-driven stock market. Companies that have grown their earnings smartly have rewarded their shareholders with rising stock prices. Stock options have been wonderful incentives during this market, rewarding management in direct proportion to the value they help create for shareholders. Companies that have found themselves with seriously underwater stock options have generally not been able to claim external forces as causing their distress. Rather it is because of poor earnings performance for which management must bear primary responsibility. So, if executives have benefited from stock price increases in a rising stock market, why should they be insulated from the effects of falling stock prices when the reason for the decline is poor earnings performance?

If a company's stock price falls, and it cancels higher-priced options and replaces them with lower-priced options for the same number of shares, employees are not just protected from falling prices; they are rewarded for them. The reason is that, if the stock price just comes back to where it was when the cancelled option was granted, the gain on the repriced option will equal the exact amount the stock fell before the option was repriced. For example, assume an option is granted at $30 a share, the market value at grant. But then the stock price falls to $20 at which time the option at $30 is cancelled and replaced with a new one at $20. Investors have lost $10 a share. If the market price comes back up to $30, executives have gained $10, the exact amount that shareholders lost before the repricing. Option repricings do not protect management from falling stock prices, they reward them for poor performance.

3. Repricings Violate the Underlying Concept of Stock Options

The concept of a stock option is ingeniously simple. It says to the employee, come and work with us and we will give you a right (but not an obligation) to buy our stock at today's price. If we are successful together and our stock price appreciates, you may exercise your right to buy the stock and share in the appreciation you have helped create. If we are not successful, you do not have to buy the stock. This is the simple essence of a stock option – a right to share in appreciation after it has been achieved. Stockholders generally support stock options because they know employees only benefit if shareholders benefit. The interests of shareholders and employees are directly linked.

Stock option cancellations and repricings turn this logic on its head. The interests of employees are placed ahead of the interests of shareholders. No one would ever consider canceling and reissuing stock options when the price has risen. They only occur when the price has fallen. Does anyone offer the investor who happened to buy stock at the same time the option was granted the opportunity to rescind the purchase if the price falls and buy back in at a lower price? Of course not, so why should employees be offered this opportunity? A stock option is a contract between shareholders and employees that lets employees share in future increases in company value. An option repricing is a unilateral change in the terms of that contract that benefits employees at the expense of shareholders.

In fact, an option that has been repriced is even less performance-based than a gift of "free" stock (i.e., restricted shares), which at least fluctuates in value directly with shareholder investment values.

Legal or not, option pricings are morally questionable. They break the implicit contract between shareholders and employees to share proportionately in the gains employees help create. They put the interests of employees ahead of shareholders by destroying the symmetry of sharing.

4. <u>The Retention Rationale is Fallacious</u>

Companies that reprice their options often cite as their rationale the need to restore the incentive and retention power of their stock options, which had become "worthless" because the market value dropped below the option price. Our answer to this is that option repricings are the wrong way to achieve this objective. First, just because an option is underwater does not mean an option is worthless. The Black-Scholes option pricing model has taught us that underwater options, just like premium-priced options, have considerable value depending on the remaining length of the option term.

Second, a company can reestablish retention and incentive by continuing its practice of normal annual grants, leaving underwater options in place. It can even accelerate next year's grant and give higher-than-normal grants to those key employees whose retention is critical. The new grants will be at the lower price and should be highly motivational if the company has solved its problems and the stock price recovers. If it does not, then repricing the options would not have helped anyway.

5. <u>Option Repricings are Expensive and Destructive to Shareholder Value</u>

Some argue option repricings have no cost to shareholders; hence, they benefit employees without harming shareholders. But option repricings hurt shareholder value in three ways:

(1) <u>They increase EPS dilution</u> -- If stock prices recover, the lower option price results in the company being able to buy back fewer shares with option proceeds, increasing shares outstanding for EPS purposes. Diluted EPS will be lower than if the repricings had not occurred. Since diluted EPS drives stock price, an option repricing reduces the portion of future increases in stock price that goes to shareholders and transfers this value to employees.

(2) <u>They decrease cash flow</u> -- When lower-priced options are exercised, less cash comes into the company and more cash must be diverted from other uses if the company desires to repurchase option shares on the market.

(3) <u>They may preclude pooling treatment in acquisitions</u> -- A disproportion change in the equity position of one shareholder group (optionees) vs. other shareholders may preclude pooling treatment for two years after the option repricing. If so,

then the company may find itself less able to grow by acquisition or find its value to possible acquirers impaired.

6. Value -for-Value Repricings Show Lack of Confidence in Future Stock Price Growth

Some companies that have repriced their options have attempted to ameliorate shareholder anger by structuring the repriced options so that they are less valuable to employees. Instead of a one-for-one share repricing, which is always beneficial to employees, the cancelled options are replaced with ones for fewer shares. The number of repriced shares is set so that the present value of the new, at-the-money option is the same as the present value of the replaced, underwater option using the Black-Scholes option-pricing model or, preferably, a stock-growth model. Other actions sometimes taken by such companies are to exclude top executives from the repricing altogether and to tack on additional vesting requirements to the repriced options.

Certainly, for those companies that feel compelled to reprice their options, this is a far fairer and more justifiable way to proceed than a straight share-for-share repricing. Value-for-value repricings are not an outright giveaway to employees. In exchange for the repricing, the company (and its shareholders) benefit from having fewer options outstanding to dilute future earnings and more shares available in the option pool.

So what is wrong with value-for-value repricings? First and foremost, all of the objections discussed previously remain valid, only less so. Second, they force employees to make a bet based on their view of the company's future. Canceling an underwater option contract in exchange for a new one requires employee consent. Accepting a share-for-share repricing is easy; the employee is always better off under any future stock growth scenario. A value-for-value repricing is different. The employee with the lower-priced but fewer-shares option will always be better off at stock price growth up through the old option price to some higher price. But thereafter, if the stock price grows enough beyond the original option price that the fewer shares represented by the repriced option produce less total option profit, the employees would have been better off if the option had never been repriced. This happened with value-for-value repricings at several high-profile companies that repriced in years past. Companies that offer and employees who accept value-for-value repricings are expressing limited faith in the ability of the stock price to recover much beyond the original option price.

Making adjustments to the terms of repriced options to make them more palatable to shareholders and less valuable to employees is a compromise between the ignoble act of a full repricing and the positive act of leaving the underwater option alone. A stock option is a contract between shareholders and employees whereby employees win only when shareholders win. A repricing changes that contract in a way that favors employees at the expense of shareholders. Value-for-value repricings do not address the fact that any repricing violates the concept of stock options.

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Those of us who strongly advocate stock options as an ideal way of aligning the interests of managers and employees with shareholders do so in the belief that it is morally right for shareholders to share a portion of increases in shareholder value with the people who help create that value. Those who support repricings, or acquiesce in their use, contribute to a public perception that executive compensation is a rigged game, which erodes shareholder support for stock options. An option repricing is a selfish act that benefits a few at the expense of many. Repricings violate the underlying concepts on which stock options are based and compromise the alignment of interests between employees and shareholders.

Frederic W. Cook

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