



## SECTION REVIEW

### **Stock options: What should a company do when the market falls?**

*By Stanley B. Kay*

Although dormant for the past three years, the renewed rise of the stock market has encouraged some companies to renew their use of stock options as an incentive tool. When the company's stock is climbing (and seemingly nowhere to go but up), stock options represent a low-risk, no-cash way to attract and retain talented employees at all levels of the organization, particularly in a tight-labor market. Also, by giving employees an ownership stake, companies create a tangible incentive to keep the staff focused on growing the value of the company.

Unfortunately, the volatility of the stock market in recent years has jolted many companies back to reality, with a timely reminder that stocks that are not going up are not much of a retention incentive. So-called "small cap" companies, with a relatively modest market capitalization, can be particularly hard hit, as institutional investors shift their capital to "safer," more established "large cap" companies. In a short period of time, a small cap company can see a sizable chunk of its paper value vanish - and watch in frustration as once-valuable stock options sink underwater.

In such circumstances, senior management may feel pressure to "reprice" options downward to reflect the lower stock value, in order to keep key employees on board - a step most institutional investors vehemently oppose. As a result, companies face a delicate balancing act.

By doing nothing - and forcing employee shareholders to assume the same downward risk as ordinary shareholders - companies risk losing top performers. The incentive to stay and "grow the company," after all, is significantly reduced when employees realize that their stock options - often given as an alternative to higher cash compensation - may be worthless for several years.

The tempting alternative for many companies is to reprice their stock options. But companies contemplating that alternative face complicated and risky legal and business issues. In a true bear market - as opposed to a temporary correction - shareholders may be quick to seek legal remedies for any business decision that looks like corporate waste.

Board members who granted and repriced stock options autonomously in the past, with little outside dissent, now face a vocal and sometimes hostile constituency. Institutional investors, representing a growing percentage of outstanding shares, have begun to wield their clout by challenging company leadership and taking a strong stand against special deals for insiders. Dissatisfied shareholders have shown an increasing willingness to sue for breach of fiduciary duty, prompting board members and their advisors to tread carefully on repricing for fear they will



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end up in court. In addition, companies that reprice options must comply with recent strict changes to the proxy rules, requiring additional public disclosures. Many institutional investors now also hold any new options plan hostage unless the company includes an affirmative prohibition against repricing.

The opposition of major shareholders to repricing isn't hard to understand, since they have no comparable cushion against the eroding value of their investments. However, most shareholders also aren't anxious to watch the company's leading executives walk out the door, depressing the company's performance further. On the other hand, companies that automatically reprice options risk removing much of the incentive for employees to avoid a decline in the company's stock price in the first place.

In the midst of these mixed signals, what's a growing company to do?

Unfortunately, there aren't any hard-and-fast rules. But any company considering repricing as a response to a market slide should follow several guidelines:

- Repricing should only be considered in the event of a sustained, significant decline in a company's stock price. It's not a solution for a temporary drop - even a large one - but only when the stock value seems unlikely to recover in the near future.
- A company that reprices options should only do so if it requires compensating benefits from the employees in return, such as an extended vesting schedule or tighter restrictions on exercise.
- Repricing should be optional, giving individual employees the choice to retain their vested options at the original price.
- Options should only be repriced if they are significantly underwater - and if options represent a substantial portion of top employees' compensation. If a company can afford to increase cash compensation, doing so may be a better alternative to repricing.
- If the board chooses to reprice, it should document the process thoroughly, including a record of the facts and figures backing up the decision. Proper documentation is essential for the board's defense in the all-too-likely event of securities litigation.

Above all, companies contemplating repricing should map out a comprehensive strategy before acting. Consider the example of a company, seeking to retain its top executives, quickly reprices all options to a new, lower market price, without changing vesting requirements or putting a moratorium on exercising options after the new valuation. A month later, the stock abruptly rebounds to its old trading range. Suddenly, the repricing plan - intended to create incentives for key employees to stay - instead gives them powerful reverse incentives to exercise their options by leaving the company. Adding insult to injury, the board may also face a lawsuit from its shareholders.

There is no easy answer to the repricing issue - and significant risks regardless of the path a company chooses. Instead of succumbing to the capricious charms of the stock market, senior management may be better served by using a variety of methods for retaining talented employees, not the least of which is affording them the opportunity for job satisfaction through a company that is growing and profitable.

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