For some companies, stock options have been the primary equity compensation vehicle in long-term incentive plans.

The financial downturn and subsequent economic recession of 2008 have pummeled stock prices, and as a result, stock options have gone significantly underwater, wiping away much of their value.

This drop in equity compensation value reduces future expectations and causes major retention and motivation dilemmas for executives and senior management. Most companies grant equity compensation either on a value basis, determined through a binomial; the Black-Scholes option valuation model; or on market value. The lower the stock price, the more shares it takes to reward individuals at levels similar to previous years, thus increasing dilution levels.

As a result, shareholders are pressuring management to rein in dilution in order to maximize their returns. Further, companies may also be caught off guard with a shortage of shares available for grant in their long-term incentive plans and must ask their shareholders to approve amendments to increase the number of shares available for grant.

As the economy begins to recover from the recession, a long-term equity compensation strategy is critical in attracting and retaining talented leaders. Companies must now cope with the challenge of how to recruit and retain key talent, and be in a position to drive innovation and maintain a competitive edge, while rewarding employees for success in a more predictable form of income, all while maximizing shareholder returns.

The challenge is even greater, given the devaluation of stock options and high levels of dilution. Companies are now re-examining their long-term equity compensation strategies, taking into account their specific needs and characteristics and what approach will best serve the company, its shareholders, its executives and senior management. Specifically:

For the company. How to achieve business and human capital objectives, while minimizing the economic costs and accounting impact?

For the shareholders. How to create the right alignment of their interests and executive interests, while minimizing dilution and increasing the net return to shareholders?

For the executives and senior management. How to provide perceived value that is...
CONSIDERING THE (STOCK) OPTIONS

Commensurate with the level of contribution and effort delivered?

As a result, the structures of long-term incentive plans are undergoing a transformation. Specifically, some companies have deemphasized the use of stock options and begun introducing other time- and performance-based equity vehicles that promote a long-term share ownership perspective for executives and senior management. This strategy closely aligns executives and senior management interests with achievement of longer-term financial objectives that enhance shareholder value, while at the same time limiting the dilutive effects of previous stock option grants.

RSUs Versus SARs

The most prevalent shift is the increasing use of Restricted Stock Units (RSUs), which are considered full-value awards, and Stock Appreciation Rights (SARs), which are considered appreciation value awards. These equity vehicles help lower shareholder dilution because a company can issue fewer shares to provide the same prior year value as compared to stock options. Some companies have replaced stock options entirely with either RSUs or SARs or a combination of both, while other companies are complementing stock options with RSUs, SARs, or a combination of both.

In determining whether an RSU or SAR is the right choice, companies should ensure their compensation strategies meet their business strategy, market characteristics, and talent needs. Just as a company’s business strategy is unique and crafted to create an advantage over its competitors, compensation strategy should also fit the distinct business. Business and talent needs should also help in the decision about which vehicles are right for the company and business strategy.

When considering an RSU or SAR, a company should look at the following elements:

Business needs and market characteristics.

Consider business stages and growth potential. For example, a mature company with limited growth potential may favor RSUs. These are also appropriate for a company focused on total return to shareholders, dividends and cash flows, or for one experiencing high stock volatility. In contrast, a company in a high-growth phase or with high stock appreciation or low stock volatility might consider SARs.

Talent needs and characteristics.

If employees are more comfortable with vehicles that offer a lower risk and, in exchange, a lower reward, RSUs may be appropriate. A company with a high risk of turnover should also consider RSUs. The opposite situation of high risk and reward or low turnover favors SARs.

Performance/rewards philosophy.

Use RSUs to insulate employees from downside risk in a falling market or provide moderate wealth-accumulation opportunities. SARs provide greater upside potential and risk along with significant wealth-accumulation opportunities.

What is an RSU?

An RSU is an arrangement whereby no grant of shares is made, rather the individual is granted units, with each unit equal in value to a share of stock on the grant date. On satisfaction of a vesting requirement, the individual is entitled to shares equal to the current value of the units.

Compared to a stock option, an RSU results in fewer shares being issued, since it provides the individual with less downside risk. Typically, most companies grant an RSU award equal to 30 to 50 percent of a stock option award. The reason is that an RSU will always be worth something, as the individual will always receive the same number of shares of common stock upon vesting. Additionally, the shares will have value to them, regardless of whether the stock price declines after the grant date. Thus RSUs will almost always provide compensation to an individual in a down market, since they are almost always in the money, compared to a stock option, which could be underwater. For this reason, an RSU would be more favorable to a stock option for the individual.

From the perspective of investors and shareholders, when an RSU vests, the employee is in the same shoes as a shareholder, since they then have voting and dividend rights, which encourage a sense of ownership and identification with the company. As a result, closely aligning employees’ interests with achievement of longer-term financial objectives of the company enhances shareholder value.

For example, if a company grants 10,000 stock options having an exercise price or “strike” price (the stock price on the date of grant) of $5, and subsequently it falls to $3, the stock option is underwater and worthless. On the other hand, if 4,000 RSUs are granted and on the vesting date the stock price is $3, the individual would receive 4,000 shares of common stock valued at $12,000, which is taxed as ordinary income.

It is important to note that the individual does not receive any cash on the vesting date. He or she is responsible for taxes on the vesting date. The way the taxes are paid is determined by the company either by net share settlement (selling enough shares of the company’s common stock to cover the taxes) or the individual paying cash. The individual may elect to sell the shares on the vesting date or might consider holding onto them, believing that the stock price will increase.

In the case of a net share settlement, the individual will never be in a cash-loss position, because shares were sold on the vesting date to cover the taxes. Subsequently, if shares are sold, the individual has capital gains or losses based on the holding period, which begins at the time of vesting. The tax basis is the amount included as ordinary income. In the case of paying cash for taxes, the individual could potentially be in a cash-loss position if the stock price significantly decreases and is unable to sell for a period of time due to restrictions placed by the company. Most companies carry restrictions prohibiting the sale of shares over a period of time based on (1) black out periods for earnings releases, and (2) liquidity events such as capital raises and merger-and-acquisition transactions that limit the amount of shares entering the market.
What is a SAR?
SARs work much like stock options. A company grants an award, which provides an individual with the ability to profit from the gain made in the value of a set number of shares over and above the price set in the award. However, the holder of a SAR receives no benefit unless the underlying stock value appreciates. So the value of a SAR is a function of corporate performance, giving the holder an incentive to improve financial performance with the expectation of a higher stock price, which leads to creation of shareholder value.

As a result, investors and shareholders begin to focus on the “value transfer” (the amount of company market value granted to individuals) rather than on the number or dollar value of stock options granted. Unlike stock options, SARs offer a solution to individuals where no cash is needed to acquire shares under the award at exercise date, thus making them more attractive than stock options. Depending on the plan’s design, the gain is paid in stock or cash or a combination of both. However, the company does not generate any cash flow from the exercise of a SAR compared to a stock option. For employees, the tax consequences of SARs and non-qualified stock options are the same.

Upon exercise, stock-settled SARs require the use of fewer shares while delivering the same economic value to individuals as stock options. For example, a company will issue only enough shares to cover the appreciation of the stock price. Because options require payment of an exercise price, a company must issue more shares to deliver the same net value.

Consider two companies, A and B, each with a stock price of $10. Say the companies grant options at $10 and stock price appreciates to $20. To receive $20 in net value, an employee of Company A must exercise two stock options having an aggregate exercise price of $20, for which he will receive two shares, having an aggregate value of $40, in return. To receive the same $20 in net value, the employee of Company B exercises two SARs and receives one share of stock. If the SAR is settled in cash, no shares are issued.

When negotiating loan agreements that give consideration to future financial results, such as loan covenants, it is important to specify the basis of accounting that will be employed by using a “frozen GAAP” clause, wherein the accounting principles employed at the relationship’s start are consistent throughout the term of the agreement.

Typically, companies with significant amounts of stock-based compensation use EBITDA, adjusted for stock-based compensation expense (Adjusted EBITDA) to evaluate the effectiveness of operational strategies and evaluate its capacity to service debt. Further, Adjusted EBITDA should be used to calculate various interest or debt-service coverage ratios.

Companies should review their long-term incentive plan’s design, taking into account their specific business needs and characteristics by identifying what’s right for the company, what’s right for the plan participants, and what’s right for the shareholders.

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