

A Director's Guide to **EXECUTIVE COMPENSATION**

THOMSON
★
CARSWELL

Volume 3, No. 4

November 2008

**LEXP
EVENTS**

Underwater Stock Options and Variable Pay Gone

Now What?

Underwater stock options and non-existent variable pay – yet another fall-out from current the economic crisis. What seems to have started as a sub-prime mortgage meltdown in the U.S. is having extensive rippling effects around the world, far beyond its roots. These effects include: significant losses of shareholder wealth; mass layoffs; long-standing businesses like Lehman Brothers vanishing; whole countries like Iceland and Pakistan approaching bankruptcy and seeking billions of dollars of relief from the International Monetary Fund and others; along with swift changes in consumer attitudes from frivolousness to frugality, carefree spending to careful spending and living large on debt to living or striving to live debt free; and, the list goes on.

So where does all of this leave executive compensation, a substantial portion of which typically consists of equity-based compensation and variable incentive pay based on financial metrics. Well, most of it has been wiped-out or drastically reduced, for the time being.

The issue now is: what should your organization do about it?

What your organization should do about it depends on many factors. This newsletter sets out the various factors to be considered in deciding whether to provide redress for underwater stock options and the types of redress available. The focus is on stock options because they continue to be a significant element in executive compensation and have received significant publicity as their ability to continue acting as a performance incentive may have been hardest hit by the economic crisis, as revealed in the Canadian and U.S. statistics set out below.

Stock Option Basics

A stock option is a right to acquire a common share of a company at a specified price, called the exercise price. The exercise price of a stock option must be at least equal to the fair market value of share at the time of the grant to comply with the requirements of the

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

Nadine Côté provides compensation consulting services as the National Lead, Compensation Advisory Services at Ernst & Young LLP. She is also an employment lawyer and the author of *Executive Compensation: A Director's Guide*, the first comprehensive book in Canada on executive compensation.



General Editor & Author
nadine.cote@ca.ey.com
ncote@bell.blackberry.net

From the Editor

I am pleased to be the new General Editor of these newsletters and welcome you to our improved format. In our new format, I will continue to provide practical advice and legal commentaries on executive compensation. As a new feature, from time to time, comments, opinions and interviews with other executive compensation specialists will be included. Hopefully, you will find the new format interesting and your comments and ideas for topics are welcomed at nadine.cote@ca.ey.com or ncote@bell.blackberry.net.

— Nadine Côté LL.B.

CONTENTS

Stock option basics	1
Compensation governance.....	2
Alternatives to underwater options	4
Approvals and disclosure	4
Taxation and accounting.....	4
New disclosure rules introduced	4

Toronto Stock Exchange ("TSX") and to qualify for preferential income tax treatment by the employee.¹

Stock options are typically subject to vesting provisions that must be satisfied before the employee can pay the exercise price to acquire the share. Vesting provisions can be time-based or based on achieving certain performance measures. Stock options usually have expiry dates, typically ranging from 7 to 10 years from the date of the grant, after which the stock option cannot be exercised. Expiry terms are common practice, though no longer required.

Stock options are "in-the-money" when the fair market value of the common share underlying the option is greater than its exercise price. Conversely, stock options are "underwater" when the fair market value of the common share underlying the stock option is less than its exercise price. There is no benefit to exercising an underwater stock option because the option holder

would be paying more to acquire a company's share than the share is worth. However, this does not mean that holding an underwater option is of no benefit. There may still be a benefit to holding an underwater stock option depending on the likelihood of a company's share price increasing above the option's exercise price during the term of the option, thereby enabling the option holder to realize a gain on exercising the option.

Compensation Governance

From a compensation governance perspective, the starting point in determining if your organization should provide redress for underwater stock options involves assessing if the purposes for which the grants were made are still being met. The purposes for establishing a stock option plan are often set out in the introductory language of the plan.

The following sets out the purposes

most commonly cited for granting stock options and how the ability to fulfil these purposes may be affected by an economic crisis with tumbling financial markets. If the purposes for awarding the stock options are no longer being met, your organization may be well positioned to: justify re-pricing outstanding underwater stock options from a compensation governance perspective; obtain any necessary board or shareholder approvals; and, avoid criticism from shareholders and institutional investors.

Aligning the Interests of Shareholders and Option holders

One of the purposes commonly cited for awarding stock options is to align the interests of option holders with the interests of shareholders. Their interests may be readily aligned when a company's share price is increasing. Both parties can benefit equally from gains above the fair market value of the shares from the date of the grant of the stock option to the date it is exercised, assuming a fixed exercise price. However, there is no limit on the amount of gain that may be realized on exercising stock options and the gain may be attributable to economic prosperity and rising financial markets, rather than the performance of the executives or the company.

During periods of declining share values when stock options are underwater, the interests of shareholders and option holders are someone aligned because executives have lost the benefit of their stock options and shareholders have suffered a loss in the value of their shareholdings. However, stock options have been criticized in this respect because shareholders experience the full loss of the decline in value; whereas, option holders are buffered from losses in share value below the exercise price of the option because there is no requirement to exercise an underwater option. Reducing the exercise price of a stock option or providing another form of redress or preferential treatment could further exacerbate this dichotomy.

Attracting, Motivating and Retaining Top Talent

Another purpose commonly cited for granting stock options is attracting, moti-

Canadian executives holding the most unexercised stock options, vested and unvested

\$436.7 million held by William Doyle, Potash Corp. of Saskatchewan
\$141.4 million held by Gerald Schwartz, Onex Corp.
\$139.2 million held by Robert Gratton, Power Financial Corp.
\$115.3 million held by Michael Lazaridis, Research In Motion Ltd.
\$115.3 million held by James Basillie, Research In Motion Ltd.

Other statistics for the CEOs of Canada's 100 largest companies
\$26.7 billion, total value of equity-based holdings of all these CEOs
\$2 million, median cash compensation of a top 100 CEO
\$5.9 million, median total compensation of a top 100 CEO*

**Janet McFarland, "Options drive rise in CEO pay"
The Globe and Mail, (6 October 2008) B1, B7.*

U.S. Statistics on Fortune 500 Companies as of October 17, 2008*

- Approximately 90% of CEOs held underwater stock options versus 61% at the end of fiscal year 2007
- Median percentage of options held by CEOs that were underwater was approximately 83% versus 18% at the end of fiscal year 2007
- Median value of in-the-money options held by CEOs dropped 63% from \$13.5 million at the end of fiscal 2007 to \$5 million, yet a significant portion were exercisable

**Equilar, Inc., an executive compensation research firm:
"Executive Compensation Trends" November 2008*

vating and retaining top talent. Granting new options with exercise prices based on the current deflated share prices may well be effective in attracting new talent. The financial market meltdown has not only affected highly leveraged, underperforming companies, but the share prices of financially healthy, well established and well performing companies have also decreased. Awarding stock options at times when a company's share price is undervalued as a result of the economic crisis may result in providing an executive a windfall when the company's share price rises solely because the financial market and general economy stabilize, rather than being attributable to the performance of the executive or the company.

Whether holding an underwater stock option will act as incentive to motivate an executive to perform depends on several factors, including: the extent to which the option is underwater; the risk of the organization becoming insolvent; the executive's opinion on whether the option will become "in-the-money" before its expiry; and, the executive's ability to influence the share value.

Whether holding an underwater stock option provides incentive to an executive to remain employed with a company also depends on several factors. For example, consideration needs to be given to the competitiveness of the job market. Generally, organizations are interested in retaining their trained

executives and want to avoid losing this talent to a competitor or alternate employer. This risk may be magnified if an executive's compensation package is no longer competitive because he or she is unable to realize any gain by exercising in-the-money stock options as the options are underwater. This assumes that the executive can earn more compensation elsewhere and that his or her stock options are underwater for reasons unique to the organization. However, the current decline in share prices is occurring on a global level and executives at competitors or other organizations may be similarly situated in terms of holding underwater stock options. Furthermore, an organization may be leery of granting options with exercise prices reflecting all time lows in its share price, due to the unintended windfall that may occur if share prices rise due to economic and market stability, rather than the performance of the company or the executive.

Moreover, the lack of global financial stability is leading to cost containment, cost cutting and downsizing, thereby creating job insecurity at all levels. This may further alleviate the risk that an executive will resign and walk away from any potential severance payment, for work elsewhere that may not provide any greater compensation or job security.

Unless other organizations implement measures to compensate executives for underwater options, there may not be a

need to redress underwater options to remain competitive and retain the executive. Given the economic and financial pressures on organizations during these volatile periods, it remains to be seen to what degree organizations will implement alternate incentives and the amount of any alternate incentives. Early evidence indicates organizations are, in fact, considering alternate incentives to address underwater stock options; however, the amount or value of the incentives is unknown.

Long-term Incentive for Participation in Long-term Growth

A further purpose commonly cited for granting stock options is to provide a long-term incentive for executives to participate in the long-term growth of an organization. Whether this purpose continues to be fulfilled when executives are holding underwater options depends on several factors, including the status of a particular grant. Stock options are typically provided as long-term incentives, that is, incentives with a term in excess of three years. If an executive's stock options have not yet vested and will only vest over the next few years, it may be premature to provide redress for underwater stock options at this time. When the stock options eventually do vest and are exercisable by the executive, market conditions may be different. At that time, the stock options may be in-

For Compensation, Benefits and Pension Professionals!

Canadian Compensation & Benefits Reporter helps organizations and HR professionals better manage compensation, benefits and pensions. It's an insightful, how-to publication for HR departments looking to provide training and current information to their compensation, benefits and pension specialists, as well as for smaller employers without dedicated HR specialists.

Subscribe to **Canadian Compensation & Benefits Reporter** now and save \$65! You'll receive 12 issues of this invaluable resource for only \$195, a significant savings from the regular price of \$260. (Offer available to new subscribers only.)

- News on the latest developments and trends in the sector and how they may affect your business;
- Recent studies and surveys;
- Checklists for procedures, from basic to more complex processes;
- Key legislative updates;
- Case studies illustrating successes and challenges;
- Articles on career development and certification;
- Ask an Expert: An expert panel of advisors responds to questions posed by readers;
- Court rulings that could impact your approach and techniques;
- Resources such as books, notable new publications and conferences; and
- Profiles of compensation, benefits and pensions professionals.

Order Online at: www.hrreporter.com/ccbr



Taking Canadian pensions to a new level-affordability

BY MELISSA WARELIN
 New plan combines risk-sharing and flexibility
 A pension plan without the employer risk of a defined benefit (DB) plan, but with all the accounting rewards of a defined contribution (DC), is the framework for the affordable defined benefit plan (ADB). This is a concept Anu's new whitepaper, Restoring Retirement Security, explores as a new Canadian pension plan possibility. This alternative is in line with changes wanted by plan sponsors. Approximately 65 per cent of survey respondents indicated they are interested in adopting alternative pension plan structures to the existing DB and DC-type plans. These plan sponsors reported a desire to achieve a risk-sharing intermediate between the current DB and DC structures, according to a 2007 survey of 81 nation-wide pension plan sponsors conducted by Anu Consulting. In Canada there is an environment where you have DB in one extreme of the risk-sharing spectrum and DC at the other end, said Barry Cox, the president of Anu Consulting. "With the tremendously high downturn in the economic conditions and financial markets, we can't predict the future, so having the ability to make some alterations to your program part way through, which is what the ADB does allow you to do, introduces a greater level of fairness to all parties," he said. The paper was released last month in Vancouver. The ADB plan is based on a model put in place by the University of British Columbia in 1972. The plan combines the best features of both a DB and DC plan in a neutral

In This Issue

Summits	2
National caregiver plan wanted, Retirement advice	2
In Depth	4
New government clarification around health care plans	4
LEGISLATURE	6
Sponsors want consistent retirement legislation	6
ASK AN EXPERT	7
Keeping staff motivated without large pay increases	7

Pensions gone to the dogs in India

Secure retirement for pups
 As an esteemed member of the Tamil Nadu police dog squad Oscar spent his career sniffing out bombs, investigating crime scenes and providing security to VIPs. After 10 years of faithful service, this hard-working canine got to a pension, reported the India Times. When Oscar was slowed down by age, it was only natural that sub-inspector N Kothakkam, who has been with the dog squad for the past 30 years, recommended that he finally retire. Retired dogs live in a separate kennel and receive a set amount of money per year to take care of food, vaccinations and grooming. The pension and retirement rule was introduced in India in 2005 to give the pups the assurance of a comfortable retirement. Prior to the rule, the dogs were auctioned off to

the-money or the form of redress then needed may be different that what is currently appropriate. If the executive has stock options that recently vested and are underwater, yet several years remain until their expiry, it may also be premature to provide redress. If the executive's options vested when they were in-the-money but the executive chose not to exercise the options, consideration should be given as to whether the organization should provide redress for an executive who suffered a loss due to his or her personal investment decision in failing to exercise the stock options when they were in-the-money.

Alternatives for Underwater Options

There are various alternative types of redress that may be provided for underwater stock options, including:

- Re-pricing stock options – if anticipate the outstanding underwater options will not rise and become in-the-money during their term
- Providing whole share awards – if needed to re-align the interests of employee shareholders with other

shareholders

- Buying back underwater options – that is, providing a one-time cash incentive and cancelling outstanding options. This would provide an immediate incentive if the executive performed well despite a company's decline in share value attributable to market conditions; and, it avoids double recovery by the executive should the options become in-the-money during their term
- Enhancing severance or change of control payments – if the organization wants to retain an executive and alleviate concerns over job security in the event there is a risk of downsizing or being the target of an acquisition

Approvals and Disclosure

Providing redress for underwater stock options may require the approval of various interested stakeholders. For example, reducing the exercise price of stock options or cancelling outstanding options and re-granting options within three months of the related cancellation likely requires the approval of the majority of the directors

and shareholders, and may even require excluding the vote of those who will benefit from the change. In order to obtain the necessary approvals, it will be important to be able to justify the need for providing redress, as set out above.

Providing redress for underwater stock options may also be required to be disclosed, as part of a reporting issuer's continuous disclosure obligations. The disclosure required will include describing the type and amount of redress provided and the basis for providing the redress.

Taxation and Accounting Implications

Providing redress for underwater stock options will have various tax consequences to executives and accounting implications for employers. The tax and accounting implications of the various forms of redress will need to be considered in assessing which form of redress is most appropriate for your organization and its executives.

Summary

In sum, the decision to provide redress for underwater stock options should not be taken lightly. A full analysis will be required to determine:

- If the purposes for which the grant of stock options were made continue to be met
- The approvals and disclosure that will be required in making any change
- The tax implications for executives and the accounting implications for employers of making any changes

New Disclosure Rules Introduced

On September 18, 2008, the Canadian Securities Administrators (CSA) adopted new executive compensation disclosure rules. Reporting issuers with fiscal year ends on or after December 31, 2008 are required to comply with the new rules. The new rules require much more detailed disclosure of executive compensation. Reporting issuers should allow themselves more time to prepare for the new form of executive compensation disclosure.

¹ If the company is a Canadian Controlled Private Company, as defined in the *Income Tax Act* (Canada), preferential tax treatment may be available even if the exercise price of the stock option is less than the fair market value of the underlying share at the time of the grant, provided the share acquired on exercise of the option is held for at least two years.

A comprehensive review of compensation disclosure and insider reporting obligations and the consequences of non-compliance with those obligations is available in the regularly updated loose-leaf book published by Thomson Reuters Canada Ltd., titled "*Executive Compensation: A Director's Guide*" by Nadine Côté.