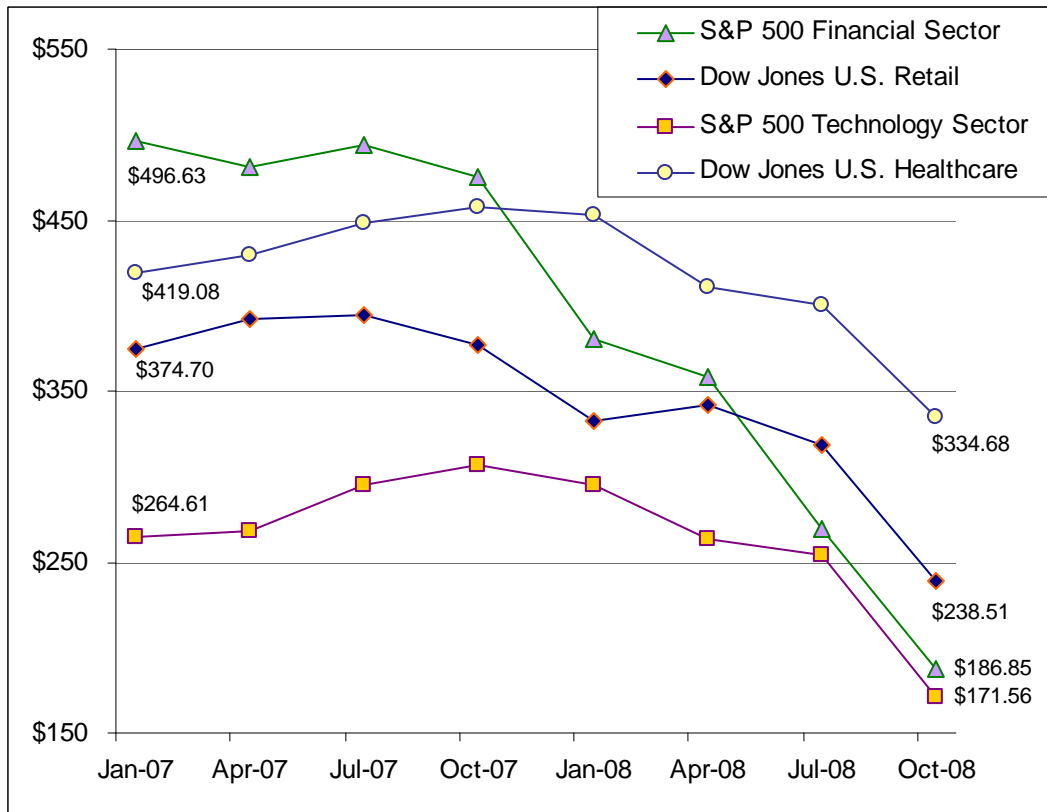


## Swimming Through Underwater Stock Options: Strategies for Navigating Financial, Retention, and Motivation Obstacles

**Amalfi Consulting, LLC.**

It is not news that many organizations in a variety of industries such as the financial services, home building, automotive, and retail industries are experiencing a market downturn and an associated drop in stock price. As a result, many stock option grants are significantly underwater and not expected to rebound to their original strike price over the next few years.



This leaves many companies asking “how can we stop the bleeding?” referring to the expense they continue to record for stock option grants that are underwater. The short answer to this question is that under the accounting rules of FASB Statement 123(R) (FAS 123(R)) the bleeding cannot be stopped. Companies also struggle with the retention of key employees when one of their primary retention vehicles, stock options, are now considered worthless.

A company has several alternatives, but must take into consideration a variety of factors that could impact their course of action. There may be specific equity plan limitations, applicable SEC tender offer rules, stock exchange listing requirements, shareholder approval concerns, and accounting issues. This paper attempts to identify the most common solutions as well as advantages and disadvantages of each alternative in the context of the above factors. Once a company performs its due diligence it will be in a better position to determine the right course of action that will ideally benefit the company, employee, and shareholder.

### **When in Doubt, Do Nothing**

The simplest strategy is to leave the underwater options, maintaining the ultimate alignment between the employees and the shareholders who also suffer from the decline in share price. From an accounting perspective, there is no additional expense for those options already vested. For options that are still vesting, the organization will be required to continue recording any unamortized expense. Although it may seem counter-intuitive, even underwater options have some value under the valuation methodologies of FAS 123(R).

There are downsides to not taking any action on deeply<sup>1</sup> underwater stock options that should be considered. The communication of the value of stock options to non-executive employees can be difficult; having options go underwater compounds this issue. Employee retention and motivation may suffer due to the lack of any intrinsic value to the options. Should the options go deeply underwater, their effectiveness as a retention tool is severely impaired. If employees do not believe the stock price will recover enough to bring their options in-the-money, there is likely to be little concern over the loss of options upon voluntary termination. From a motivational standpoint, employees may perceive there is little chance their efforts will result in the necessary positive impact on the stock price, thus they may be less likely to perform.

Finally, employees do not exercise vested underwater options, leaving such options in a suspended state. Vested and unexercised underwater options reduce share availability for future grants from the equity plan pool and may inhibit the organization's ability to secure additional shares for future equity compensation programs.

Leaving underwater options alone may also be an appropriate choice for organizations that perceive the drop in stock price to be temporary or insignificant. Organizations placing a priority on shareholder perceptions and accounting expense may determine leaving underwater options alone is the best course of action. This choice does not alleviate issues regarding employee retention, dilution levels, or equity plan share availability,

### **Cancel Underwater Options without a Replacement or Exchange**

Under this approach the organization cancels the underwater options, normally requiring grantee approval, without offering any recompense to the employee. Under accounting rules, this is considered to be a repurchase of the outstanding options for zero consideration. If an organization selects this course of action, they should be aware that this does not remove the expense associated with the option grant as all remaining unamortized expense would need to be recognized immediately. Simply leaving the underwater options alone may be a more effective approach from an accounting perspective. Options forfeited pursuant to original terms of the grant, over the life of the grant, could possibly provide some expense savings.

Plans typically do not allow for unilateral cancellation of options grants; i.e., employees must agree to the cancellation. In addition, there is no benefit to the organization in terms of employee retention or motivation since employees are not offered anything in exchange for the cancelled options.

If the cancelled options are permitted to return to the equity plan pool, the organization will benefit through an extension of the life of the option plan and an increase in share availability for future grants. If the cancelled options are not returned to the equity plan pool, the

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<sup>1</sup> The assessment of the severity of the depth of the underwater option will be unique to each organization. Industry type, age of the organization, historical volatility and other factors will all play a role in making such a determination.

organization would see a reduction in overhang levels and potential shareholder dilution. Unless there is a strong concern regarding share availability, there is little reason for an organization to select this course of action. Organizations should also be aware that if they include named executive officers in this action, the rationale for doing so must be discussed in the CD&A. Tender offer rules may also apply in this situation, which would require the organization to go through a tender offer filing with the Securities and Exchange Commission (SEC).

### **Extend the Option Expiration Date**

An extension of the option expiration date allows the option grant more time for the stock price to increase in value. An extension of the expiration date is considered a modification of the original grant. Under FAS 123(R), modifications of options grants require the organization to determine if the value immediately after the modification exceeds the fair value of the underwater options. In the case of an extension of the expiration date with no other offsetting change, there will always be an incremental value which must be expensed.

In addition, many option plans contain a provision limiting the term of options to 10 (or sometimes fewer) years. Any extension beyond such a plan-imposed limit would be a material modification of the plan requiring shareholder approval under both NASDAQ and NYSE rules. Most shareholder advisory firms consider extending option expiration dates beyond 10 years to be a poor practice and may likely recommend a vote against such a proposal.

If the stock price continues to drop, the extension of the expiration date may not produce the desired results, and the options would continue to lack retention and motivational value. Even if the stock price does not drop further, extending the expiration date may not be sufficient to overcome employee retention and motivational issue; e.g., if employees are not willing to wait for the option price to increase, or if employees do not think the price will rebound during the extended period.

Finally, there are tax effects to extending the term of an option. First, if the option grant is an incentive stock option (ISO) grant, the limitations on ISO's prohibit the extension of the option expiration date beyond 10 years from the date of grant. Under Internal Revenue Code Section 409A, extending the term of an option beyond its original term would be deemed to be a new grant. This is not a problem for an underwater option, but if the option were in-the-money at the time of the extension, the option would lose its exemption from 409A, subjecting the holder to a number of potential negative tax consequences.

### **Accelerate the Vesting and the Expensing of the Underwater Options**

Under this course of action the organization shortens the vesting schedule applied to the option grant, typically allowing the vesting and expensing to be completed within the current fiscal year. As a result, the organization takes a hit on earnings during a more narrowly defined time frame, since the vested options would be expensed immediately<sup>2</sup>. Accelerating the vesting schedule of the original grant would be considered a modification of the original terms of the grant. On the accounting front there should not be an incremental expense; options that are underwater when they are accelerated shorten the vesting schedule which reduces the expected

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<sup>2</sup> Note that if the options are considerably underwater, then expensing may not in fact be immediate, but rather over a derived service period that would be calculated. The reason for this is that the grantee could not exercise the option immediately even though it is fully vested because it is underwater – thus the acceleration is in fact non-substantive. (See footnote 69 to FAS 123R)

term and hence reduces fair value. However, acceleration of vesting could actually cost the organization more than leaving the options alone, as the company is likely to lose expense savings from potential award forfeitures.

This approach does not alleviate employee motivation and retention concerns. No options return to the option plan pool, so there is no benefit in terms of share availability or overhang. Shareholders may raise concerns regarding both of these issues as well as the potential increase in expense (due to forfeiture issue noted above). The acceleration of expense recognition would also increase compensation levels reported in the summary compensation table of the company's proxy filing for the name executive officers for the year in which the acceleration occurs.

Finally, if the underwater options are incentive stock options (ISO's), accelerating the vesting could disqualify the ISO status to the extent the acceleration results in an employee having stock options valued at more than \$100,000 exercisable in a single year. The acceleration of the vesting and expensing of underwater options is an approach that may be appropriate for a limited group of organizations that seek to remove the accounting expense from future years. However, the downsides of this approach may outweigh this accounting benefit.

### **Accelerate the Timing of New Equity Grants**

An organization may decide to leave the existing underwater options alone and instead accelerate the granting schedule for new options, or make additional grants of other forms of equity such as full-value shares. This course of action addresses employee motivation and retention concerns by providing new equity grants.

Although the new equity awards would presumably enhance employee motivation and retention efforts for the organization, the underwater options remain outstanding contributing to the depletion of the option plan pool. To get back to the "regular" granting cycle, it may be necessary to leave a long gap before normal grants are made in the following years. Under FAS 123(R) these additional grants would be expensed in the same fashion as a normally scheduled equity award. If the organization is simply accelerating the timing of new equity awards, there may be a lower than expected expense if the new awards are granted when the stock price is low.

There is a flip-side to this accounting benefit in that more options may be granted because the stock price is low, thereby increasing dilution levels. To address this concern, some organizations may elect to grant fewer options than historical grant levels. Others may choose to use a different form of equity for the new grants such as restricted stock, restricted stock units, or performance shares (collectively "full-value awards") provided the equity plan allows for these types of awards. These full-value awards typically require fewer shares than option grants to deliver the same grant date value, preserving shares for future awards. In addition, restricted stock provides value to the employee even if the stock price continues to decline. This is a good alternative if employees' past experiences with stock option grants have been poor. Note that the timing of the taxable event is less flexible with restricted stock because it is taxed as it vests under U.S. tax law unless an 83b election is made by the recipient.

When issuing equity awards outside of a normal schedule, organizations should be aware that concerns may be raised regarding "spring-loading" or "bullet-dodging" depending upon the timing of the new grant. Spring-loading involves timing an option grant to precede good news to optimize the potential value appreciation of the grant. Bullet-dodging is the delay of an award until just after bad news regarding the company is reported so that the award may be made after a drop in stock price. Grants made outside of the company's normal granting cycle have been

identified by the Public Company Accounting Oversight Board (PCAOB) as an area of risk that auditors should examine. If named executive officers receive acceleration on the timing of option awards or additional option awards, the rationale for this action must be discussed in the Compensation Discussion and Analysis (CD&A) of the company's proxy filing.

### **Option Exchange Programs**

The following programs are the most commonly implemented approaches to handling deeply underwater stock options. Under an exchange program the company would make a determination of the value of the underwater option and use this value as a basis for the determination of the exchange level for cash, new options or full-value shares. While many companies begin the process with a value-for-value exchange as the ideal goal, most have underwater options at many different strike prices<sup>3</sup>. In such a situation a true value-neutral exchange would be an administratively burdensome task and employee communication would be very difficult.

It should be noted that these "exchange" alternatives are usually restricted to non-executive employees. Most shareholder groups believe that executive and board members should be held responsible for the drop in stock price and should not benefit from the exchange programs described below. If executives are included, it is not uncommon to give them lower exchange rates, higher strike prices, and/or longer vesting periods to further incent them to increase the stock price. Another consideration to keep in mind is that both the NYSE and NASDAQ deem such exchange programs to be a form of "option repricing" and have rules requiring shareholder approval for the implementation of underwater option exchange programs unless the applicable plan explicitly permits such exchanges or repricings without shareholder approval. Some equity plans explicitly forbid such exchanges or repricings.

Finally, in most cases, the terms of the plan would require employee acceptance of any of these exchange offers, which would constitute an "issuer tender offer" under federal securities laws because the participant must make an investment decision with respect to the offer. Issuer tender offers must be filed with the SEC and comply with strict requirements set out in the Securities Exchange Act.

#### ***Exchange for New Options***

In this form of an underwater option exchange program, the grantee is provided a tender offer of new stock options in exchange for cancelling the underwater stock options. This is treated as a modification of the original option award under FAS 123(R) and the company will be required to continue to record the entire expense associated with the initial grant of the cancelled underwater options. If the new option grant is equal or less in value to the underwater options, the company will not incur incremental accounting charges. If the new award is higher in value, then the company will need to expense the incremental value, adding the expense to the amount already being recorded for the original grant.

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<sup>3</sup> In this situation, most organizations resort to dividing the underwater options into groups based on strike price and then assigning specific exchange ratios to each price grouping. For example, all options above \$50 might be exchanged at a 5:1 ratio, those from \$40 to \$49 at a 4:1 ratio, and those from \$30 to \$39 at a 3:1 ratio.

Most companies aim for “value-neutral” grants<sup>4</sup> in which the fair value of the new option grant is identical (or slightly less if rounding is desired) to the fair value of the underwater options at the time of the exchange. The number of replacement options is typically less than the number of underwater options which will increase the equity pool or reduce overhang depending upon how the surplus of cancelled options is treated under the terms of the applicable equity plan. The company has some flexibility with the vesting schedule of the new grant and can follow the original vesting schedule or put a new schedule in place to further the organization’s retention goals. One major benefit of this approach is that a value-neutral exchange will avoid additional expense. In addition, it can restore motivational and retention objectives and be more acceptable to shareholders, as nearly all exchange programs require shareholder approval.

#### *Repricing Options*

Sometimes an option repricing is as simple as amending an option to decrease the exercise price leaving the original options outstanding. In some cases, an option exchange or replacement program is deemed to be an option repricing. Equity compensation accounting rules treat both cases as a modification of the original option award resulting in an additional expense equal to the excess of the fair value of the “new” option over the fair value of the “old” option. Any unamortized expense associated with the initial option grant will continue to be recorded.

A simple repricing may not involve a tender offer if the terms of the equity plan allow the company to unilaterally amend an option in a manner that is beneficial to the optionee, such as a mere reduction in the exercise price. Where the optionee is not required to make any investment decision, there is no tender offer. Whether or not a tender offer filing with the SEC is needed will require a fact-specific determination and legal counsel should be involved in this decision.

While this strategy is beneficial to the employee and may restore some motivational and retention aspects of the option grant, there are no additional benefits to the company or shareholders. Besides the additional accounting impact, shares are not restored to the equity pool. Most plans explicitly prohibit repricings without shareholder approval, and it is unlikely that shareholders will approve a 1-to-1 repricing, absent some other meaningful concessions, such as additional vesting requirements. This strategy may also increase the risk of a lawsuit or other form of shareholder activism.

#### *Exchange for Full-Value Shares*

In this form of underwater option exchange program, the optionee is offered a full-value award (e.g., restricted stock or restricted stock units) in exchange for cancelling the underwater stock options. This is treated as a modification of the original grant under FAS 123(R) and the company is required to continue to record the entire expense

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<sup>4</sup> Often a true value-neutral exchange is not possible, such as when the options are so deeply underwater that a value-neutral exchange would result in an offering of extremely small new grant amounts that will likely be rejected by employees. In such a case a company is likely to increase the exchange value through a cap on the exchange ratio (i.e., a maximum ratio of 5 underwater options to 1 current fair market value option) to ensure the offer is accepted by employees. The result is the company will end up with some incremental cost for the exchange, but the program will stand a better chance of success.

associated with the initial grant of the cancelled underwater options. Typically most replacement grants are “value-neutral” in which the new full-value award is equal or less in value to the underwater options. In this case the company will not incur incremental accounting charges. If the new award is higher in value, then the company will need to expense the incremental value<sup>5</sup>.

Benefits of exchanging underwater options with full-value awards are that they provide immediate value to the recipient and the vesting period maintains the retention aspect of the original stock option grant. The number of full-value shares provided in this type of exchange is typically less than the number of options originally issued, which potentially increases share availability and lowers dilution. A potential drawback to the employees is that they will be taxed when the full-value award<sup>6</sup> vests as opposed to having control over the taxable event (i.e., when they choose to exercise options). One other downside for the employees is that they will hold fewer shares from a full-value share exchange, so the upside potential when the stock price rebounds is lower. If the purpose of the original stock option grant was to encourage employee ownership, the level of ownership may also be reduced by a full-value share exchange. Once again shareholder approval of such an exchange will likely be required, and the tender offer rules of the SEC must be followed.

### ***Exchange for Cash***

Under a cash exchange program the organization offers a cash payment to the employee in exchange for cancelling the underwater stock options. The offer typically consists of cash equal to the current fair value of the underwater options. The cancellation associated with the tender offer requires a cash outlay, and the company will immediately record any unamortized expense associated with the option grant. The company does not record an additional expense for a cash payment (provided that the cash exchange value is equal to or less than the fair value of the underwater options, i.e., a “value-neutral” exchange). If the company chooses to provide a higher cash value, the company will incur an expense equal to the incremental cash payment.

From the employee’s perspective the benefit of a cash exchange is that they are provided some value for their underwater options. However, the employee is taxed at the time of the cash payment, which may result in a final cash payout that may not be perceived as meaningful. Providing some level of value to employees for underwater options may alleviate some of the organization’s concerns regarding employee morale; however, if there is no vesting period applied to the cash payment, the retention aspects of the original option award is lost. A cash payment also lacks the appreciation potential of a stock option award or a restricted stock award and does not provide employee stock ownership.

If the equity plan allows for cancelled options to be returned to the equity plan pool, a cash exchange will extend the life of the equity plan. If the equity plan does not allow the cancelled options to be returned to the equity plan pool, the organization would

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<sup>5</sup> Amortization depends on the vesting schedule of the new award. The incremental expense plus the remaining unamortized expense is amortized over the remaining vesting of the new awards.

<sup>6</sup> If the award is restricted stock, the recipient can make an 83(b) election to pay tax at time of issue instead of when the restricted stock vests.

receive a benefit in the form of reduced overhang. This strategy may be deemed a “repricing” under NYSE or NASDAQ rules, in which case shareholder approval is required. Finally, if this practice is perceived to set a precedent of paying cash for stock option grants, then the company may be at risk of having to use liability accounting for future equity awards.

## **Conclusion**

As demonstrated in this article, there are many approaches a company can take in addressing underwater stock options starting with the simplest, leaving the underwater options alone. This continues to give the optionee the same risk and opportunity as the shareholders, which is one of the primary intentions behind an equity program. Recent accounting rules now require a company to record any unamortized expense for underwater options, while potentially not realizing any return on their investment (such as motivating and retaining key employees). Since the company must expense underwater stock options, it makes sense to consider a strategy that helps recapture some of the motivational and retentive aspects of the equity awards. Depending upon the course of action chosen, it may also be possible to restore some shares to the equity plan pool and extend the life of the plan. Each organization will need to assess the best strategy for them in the context of their current market situation, employee retention and motivation goals, equity plan limitations, shareholder concerns, and exchange listing requirements.

The company should also consider how long and how deep an option is underwater to spur any type of action. Shareholders may perceive any action as a “bailout” for poor performance and a break in the link between performance and pay. Care should be taken in determining the employees eligible for these programs; it may be appropriate to adopt one approach for non-executive employees and another approach or a modified approach for executives (such as different exchange rates or equity vehicles). The best strategy should restore some of the motivational and retentive aspects of equity grants while minimizing new incremental expenses. As a result, shareholders should benefit by having a strategy that helps the company retain their best employees and motivates them to drive the company to new performance levels. In addition, depending on the approach taken, the shareholders may experience reduced dilution and longer equity plan life.

Many of the strategies we present are considered tender offers and thus involve a complicated filing process with the SEC, a potentially expensive process to undergo. Keep in mind that the employees must decide whether to accept the tender offer, so an offer that appears to be a poor deal to the employee may not be accepted. We advise bringing all parties to the table when discussing these strategies, including human resources, stock plan administrators, SEC and legal counsel, and accounting partners. Once a strategy is selected, education and communication around such offers is critical to the success of the program.

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## EXAMPLES OF RECENT UNDERWATER OPTION EXCHANGE PROGRAMS

In the following section, we provide brief summaries of recently implemented underwater option exchange programs. The examples were drawn from the organizations in the table below and data was gathered from tender offer filings (form SC TO-I) filed with the SEC:

Organization	Industry	Date of Tender Offer	Type of Exchange Program Implemented
Rockville Financial, Inc.	National Commercial Bank	9/26/2007	Cash Tender for Underwater Options
Riverbed Technology	Computer Services	5/1/2008	New Options for Underwater Options
Toll Brothers	Construction Services/Home Building	6/16/2008	New Options for Underwater Options
Limelight Networks	Broadcasting & Network TV	5/15/2008	Restricted Stock for Underwater Options
Natural Health Trends Corp.	Retail (Drugs)	5/25/2007	Restricted Stock for Underwater Options

Our research of tender offers filed in the past 33 months (January 1, 2006 through September 8, 2008) unearthed only one commercial bank which had undergone such a process. The examples we summarize represent practices from a general sampling of publicly traded organizations including the commercial bank (Rockville Financial, Inc.).

### *Cash for Underwater Options*

Of the three types of exchange programs possible, this is the least commonly implemented. In a recent study done by Radford Surveys on 50 publicly traded companies, only 6% implemented a cash exchange program. Most cash exchange offers for stock options occurred within the context of a merger, not due to a concern regarding underwater options.

1. **Rockville Financial Inc. (RCKB):** Under this tender offer, RCKB offered to purchase the underwater options of their non-executive employees. The offer was to purchase all options with an exercise price of \$17.77 for \$2.61 in cash per option. On the date of the tender offer filing, the stock was trading at \$13.78.

Eligible Option Strike Price	Stock Price on Date of Offer Filing	Difference	Term of Offer	BOD/Proxy Execs Eligible?
\$17.77	\$13.78	-22.45%	\$2.61 in cash per option.	No

The determination of the amount to offer was made by a Board appointed Pricing Committee consisting of the Bank's President and CEO, Chief Operating Officer, and Chief Financial Officer. The amount was determined in consideration of the unamortized expense for the Company related to the underwater stock options. No additional details were provided as to how the final cash offer was calculated.

### *New Options for Underwater Options*

Of the three types of exchange programs possible, this is the second most commonly implemented program. In the aforementioned study done by Radford Surveys, 43% implemented an option-for-option exchange program. We summarize two examples of such exchanges below.

1. **Riverbed Technology, Inc. (RVBD):** On May 1, 2008, RVBD filed a tender offer with the SEC for an option-for-option exchange program. All employees within the U.S. were eligible with the exception of the Board of Directors and top executive management. A threshold exercise price was used to determine options eligible for the exchange (only options priced at \$16.404 or greater were eligible). At the time of the anticipated exchange date (May 30, 2008) the stock was trading at \$17.95 per share. On May 1, 2008, the day the offer was filed, the price was \$14.38 per share.

Eligible Option Strike Price	Stock Price on Date of Offer Filing	Difference	Term of Offer	BOD/Proxy Execs Eligible?
\$16.404 or greater	\$14.38	-12.31%	Option replacement at 0.85 new options for each underwater option	No

Options that would expire prior to the exchange date were excluded. Options subject to a domestic relations order were also exempt from the program. Each option was exchanged at a 1 to 0.85 ratio, and each replacement option had a 5-year expiration term. The vesting schedule on the original underwater options was applied to the newly issue options. The exercise price applied to the options was the closing price on the day of the exchange.

2. **Toll Brothers, Inc. (TOL):** On June 16, 2008, TOL filed a tender offer with the SEC for an option-for-option exchange program. All employees within the U.S. were eligible with the exception of the Board of Directors and top executive management. A threshold exercise price was used to determine options eligible for the exchange (only options priced at \$27.24 or greater on June 5, 2008 were eligible). At the time of the anticipated exchange date (July 18, 2008) the stock was trading at \$18.92 per share. On June 16, 2008, the day the offer was filed, the price was \$20.41 per share.

Eligible Option Strike Price	Stock Price on Date of Offer Filing	Difference	Term of Offer	BOD/Proxy Execs Eligible?
\$27.24 or greater	\$20.41	-25.07%	Exchange ratio varied based on each award. Value-neutral exchange rate was used.	No

The exchange ratio was determined through the use of a lattice option valuation model (Black-Scholes is a form of lattice option valuation modeling and is the likely model used here). Each exchange ratio was determined by dividing the estimated fair value of the applicable Replacement Option by the estimated fair value of the corresponding Eligible Option that was tendered for exchange. As a result of this methodology, the exchange was a value-neutral exchange.

### ***Restricted Stock for Underwater Options***

Of the three types of exchange programs possible, this is the most commonly implemented program. Restricted stock exchanges provide employees with value even if the stock price continues to fluctuate. This provides employee retention benefits to the organization and may also benefit shareholders in terms of reduced dilution. We summarize two examples of restricted stock for underwater option exchanges below.

1. **Limelight Networks, Inc. (LLNW):** LLNW filed a tender offer with the SEC on May 15, 2008. This offer provided employees with the opportunity to exchange eligible options for restricted stock units (RSU's). All employees within the U.S., Japan and the United Kingdom were eligible with the exception of the Board of Directors and top executive management. Rather than using a threshold exercise price to determine options eligible for the exchange, LLNW made all options awarded after April 1, 2008 eligible for the exchange; (according to proxy filings the option exercise price on April 2, 2008 was \$12.00 per share). At the time of the anticipated exchange date (June 16, 2008) the stock was trading at \$3.50 per share. On May 15, 2008, the day the offer was filed, the price was \$2.96 per share. In the table below we provide estimates of what the exchange prices would be based on the dates of eligibility.

<b>Eligible Option Strike Price</b>	<b>Stock Price on Date of Offer Filing</b>	<b>Difference</b>	<b>Term of Offer</b>	<b>BOD/Proxy Execs Eligible?</b>
\$12.00	\$2.96	-75.33%	Exchange of one restricted stock unit for every two underwater options.	No

LLNW chose a single exchange ratio, despite the likelihood of multiple exercise prices on the underwater options. The ratio selected was one RSU for every two options. The vesting schedule on the original underwater options was not carried over to the RSU awards. Instead, a three-year prorated vesting schedule (an even portion every 6 months) was applied to the RSUs. The value of an RSU is equivalent to the price of a share of stock and will rise and fall with the value of a share of stock.

2. **Natural Health Trends Corp. (BHIP):** On May 25, 2007, BHIP filed a tender offer with the SEC for a restricted stock-for-option exchange program. All employees within the U.S. and most employees outside of the U.S. were eligible with the exception of the Board of Directors. Unlike most exchange programs, BHIP did allow top executive management to participate. BHIP also stated that they anticipated following the expiration of the offer to exchange, they would enter into an agreement with each director allowing them to make such an exchange.

BHIP applied a threshold price to determine the options eligible for the exchange. Under their program the option had to have an exercise price greater than \$9.00 per share or the closing sale price of the common stock reported on the Nasdaq Global Market on the date the offer expired. At the time of the anticipated closing of the offer (June 25, 2007) the stock was trading at \$3.40 per share. On May 25, 2007, the day the offer was filed, the price was \$3.48 per share.

**Natural Health Trends Corp. (BHIP): (continued)**

Eligible Option Strike Price	Stock Price on Date of Offer Filing	Difference	Term of Offer	BOD/Proxy Execs Eligible?
\$9.00	\$3.48	-61.33%	Exchange of restricted stock for underwater options with ratio determined based upon a value-neutral exchange rate.	Top Executives eligible. Directors not eligible.

The exact exchange ratio was applied on an award specific basis. The exchange rate was determined on a value-neutral exchange based on a Black-Scholes option pricing model with rounding to address fractional award levels. All restricted stock rights received in exchange for eligible options were subjected to a vesting schedule. The vesting was a three-year prorated vesting with portions of the awards vesting on a monthly basis.

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