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Public Thrift Compensation

The Need For Converted Thrifts To Take Action Before Stock Option Expensing Takes Effect

The new rules of the Financial Accounting Standards Board ("FASB") requiring the expensing of stock options and employee stock purchase plans take effect for most public companies in the third quarter of 2005, and for small business issuers and private companies, in 2006. These rules, contained in FAS 123R, raise a number of important disclosure issues that are still being grappled with by various companies as they prepare for this year's proxy season. We will address many of these issues in a forthcoming securities disclosure alert. This alert deals with issues that are peculiar to converted thrifts.

All thrifts that have converted to stock form and issued stock publicly through a mutual holding company reorganization or a full conversion in the last four years and have

- ♦ granted options that have not yet vested, or
- ♦ options that have not yet been granted

should be aware that there are strategies that may be available prior to the effective date of the new rules that could minimize the effect of the expense rules in the near term.

FAS 123R requires companies to estimate the "fair value" of all options. Companies must decide how to estimate the "fair value" of options using the Black-Scholes or other option pricing model such as a lattice or other binomial model. FAS 123R provides detailed requirements that the option pricing model must take into account and the various models have their strengths and weaknesses. While the binomial model may provide flexibility for the requisite assumptions that must be made, this model requires complex and

extensive data analysis and computations. The Black-Scholes model tends to be simpler but is not as flexible. Companies must be careful in determining the assumptions to place into whichever model is selected, since the assumptions can have a significant effect on the resulting values of options, and therefore on the size of the expense. FAS 123R also contains requirements for the financial statement disclosures relating to the expensing of options.

The expense rules apply to any options that vest or are granted after the effective date. For many institutions, the effect of this expense, depending on the number of options outstanding, may have a material adverse effect on earnings and key financial ratios. In addition, the necessity for option expensing will require companies that wish to break out cash earnings to comply with the SEC's new rules under Sarbanes-Oxley with respect to pro forma disclosures. Converted thrifts should begin developing strategies to plan for the effect of the new rules now while there is still some room for flexibility for unvested and ungranted options.

ACTIONS THAT CONVERTED THRIFTS SHOULD CONSIDER IMMEDIATELY

- ♦ Converted thrifts with ungranted options should consider granting options before the effective date of the rules.
- ♦ Converted thrifts with issued but unvested options should consider vesting them before the effective date of the rules.
- ♦ Converted thrifts with options where the vesting cannot be accelerated should consider strategies that effectively lift the restrictions.

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- ◆ Converted thrifts should consider ways to reduce the fair value of the options to decrease the effect on net income.
- ◆ Converted thrifts should be considering the most appropriate valuation models for options to be granted in the future and planning for the required financial statement disclosures.

Each of these situations raise various securities disclosure and banking regulatory issues that must be carefully considered in fashioning a particular strategy. Just as important, given the current sensitivities regarding the duty of directors to pursue a deliberate and informed process in fixing executive compensation, is the requisite degree of diligence that must be followed. With the pending deadlines, it is imperative that boards begin that process as soon as possible in order to avoid a record of hasty or ill-considered actions. Since the *Disney* decision regarding personal director liability, it is especially

important to allow sufficient time for outside counsel and advisors to develop their recommendations as to the proper strategies.

Employee Stock Purchase Plans (“ESPPs”) will also trigger expense recognition unless they meet certain requirements. If you have an ESPP, your plan should be reviewed to determine what changes, if any, are needed to avoid the expensing requirement.

ABOUT THE AUTHORS

Partners Douglas Faucette, Larry Hansen, Janet Love, Colleen Hennessy and Kerry Vyverberg, and Associate Tim Farber are experienced in representing publicly and privately held thrifts and other depository institutions. Please contact any of the authors if you are interested in exploring the possible alternatives in planning for the effectiveness of the new share-based payment expense rules.