Option Repricing and Exchanges

Stock options are a significant component of incentive compensation for many employees—both executives and rank-and-file. But following the recent significant declines in the stock markets, the options held by many public company employees are "underwater"—the exercise price is greater than the market price. Even many privately held-companies have seen the fair market value of their stock decline, causing their outstanding options to be underwater, as well. As a result, those now valueless options no longer serve their incentive purpose, and affected companies are looking for ways to restore those incentives to motivate and retain employees.

There are three principal approaches to try to restore those incentives:

- issue new options (or other incentive awards, such as restricted stock);
- reprice underwater options (that is, make the exercise price no less than the current fair market value); or
- offer cash, new options or other incentive awards in exchange for outstanding underwater options (or offer to materially amend terms of the underwater options other than the exercise price—a material amendment generally is treated the same as an exchange).

Each of these possible solutions raises securities law and stock exchange issues, accounting issues, tax issues and corporate governance issues (primarily affecting public companies) that need to be considered in deciding whether and how to restore those lost incentives.

Securities Law and Stock Exchange Issues

With respect to public companies, NASDAQ, the New York Stock Exchange (NYSE) and NYSE Amex all require repricings to be approved by shareholders unless the incentive plan under which the options were granted specifically permits repricings without shareholder approval. As a result, general authority to amend a plan without shareholder approval is not sufficient for exchange-listed companies. Privately-held and non-exchange-listed companies are not subject to the exchanges' requirements, so those companies may effect repricings without shareholder approval so long as the incentive plan reserves general authority to amend the plan and the option agreement.

An alternative to repricing is to issue new options (or other incentive awards, such as restricted stock) to affected employees, leaving the underwater options in place. This is often done by accelerating the granting of the current year's options (for example, granting options in May or June rather than December) to try to take advantage of the current lower market price for the underlying shares. However, there must be sufficient awards available for grant under an approved plan if a company wishes to issue new plan-based awards without shareholder approval. If a company wishes to issue new plan-based awards but does not have sufficient awards available for grant under an existing plan, the company will need to either amend an existing plan or adopt a new plan. Any such amendment or new plan would need to be approved by shareholders, and a public company generally should file a Form S-8 registration statement with the Securities and Exchange Commission (SEC) relating to the additional shares issuable under the amended or new plan.

Neither of the foregoing alternatives would require the approval of the option holders. However, as an alternative strategy, a company may wish to revise terms of the options other than the exercise price—such as resetting the vesting period—or pay cash or issue other incentive awards, such as restricted stock, in exchange for underwater options. In that event, the company generally would need consent of the option holder, and the transaction would be deemed a tender offer under the rules of the SEC. The tender offer rules require that the company (whether public or privately-held), among other things, keep the offer open for at least twenty days and other formal requirements. A public company must also file a Schedule TO with the SEC before the offer is commenced, and the SEC may provide comments that require modifications to the Schedule TO and the tender offer. Following a tender offer, the company also must file an amended Schedule TO with the SEC to report the results of the tender offer. Privately-held companies effecting a tender offer would need to comply with applicable state securities laws.

Accounting Issues

Since the advent of accounting standard FAS 123R, repricing of options no longer would have significant detrimental impact on a company's earnings. Rather, the repriced option is valued, and that new value is compared to the value of the option immediately prior to repricing. The increase in value of the repriced option is charged to earnings over the remaining vesting period (or immediately, if the option is fully vested).

If additional awards are granted without canceling outstanding options, then the fair value of the new awards (as opposed to the incremental value compared to the underwater options) is charged to earnings over the vesting period. The original fair value of the underwater options will continue to be expensed unless they were already fully expensed.

In an exchange offer situation, both the original fair value of the underwater options and the incremental value of the new awards are required to be expensed. However, companies that wish to avoid additional accounting charges may devise a value-for-value exchange, such that the value of the replacement awards will equal the value of the options surrendered. There are several factors that come into play in crafting a value-for-value exchange, including reducing the size of the award, extending the vesting period and reducing the life of the award. In addition, if a new award has a longer vesting period, the expense may be recognized over either the remaining vesting period of the original grant or the vesting period of the new award, at the company's option.

Tax Issues

There may be tax implications if the options being repriced are incentive stock options (ISOs). One of the requirements for an ISO is that no more than $100,000 in value of ISOs can first vest in any single year. If more vests, the option agreement can either provide for a deferral of vesting or the additional amount can be non-statutory options.

In a repricing or an ISO-for-ISO exchange, the ISO rules take the position that the vesting of both ISOs count towards the $100,000 annual limit. In other words, if, during the year of the repricing or exchange, the old options had already vested before the repricing or exchange, and the new options also vest in part in that same year, the aggregate value of the vested

ISOs cannot exceed $100,000. For example, if a participant had an option where a tranche with a value (determined at the time the option was granted) of $80,000 vested on February 3, then on May 9, the option was repriced and the participant vested in $30,000 worth of options in the same year, under the ISO rules, $110,000 worth of options would have vested and $10,000 could not be ISOs. This is basically a math problem that can usually be avoided with careful planning.

Corporate Governance Issues

Public companies need to keep in mind that even though outstanding underwater options are worthless to the option holders, any of the solutions discussed above could encounter shareholder resistance and rankle institutional investors, corporate governance watchdogs and proxy advisers. Shareholders receive no relief when share prices fall, so they may reject the idea of rescuing underwater option-holders. Similarly, institutional investors, corporate governance watchdogs and proxy advisers carefully scrutinize such proposals and generally only back them, if at all, when company executives are precluded from participating and where they believe that management is not responsible for the drop in share price.

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Now may be the time to take action if you want to address the lost incentive value of underwater stock options. For more information, please contact the Seyfarth attorney with whom you work, or any *Corporate and Finance Practice Group* attorney on our website.

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