

Morgan Lewis

Dealing With Underwater Options

Option Repricings, Option Exchanges, Option Buyouts



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THREE TECHNIQUES FOR DEALING WITH UNDERWATER OPTIONS

1. Option Repricing: The underwater option is cancelled and replaced with an at-the-money option
2. Option Exchange: The underwater option is exchanged for a restricted stock unit award
3. Option Buyout: The option is purchased by the issuer for cash

ISSUES FOR CONSIDERATION

- 1 Exchange Mechanism
- 2 Stockholder Approval Issues
 - NYSE/NASDAQ Requirements
 - Proxy Advisors
 - Proxy Statements
- 3 Structure
 - Exchange Ratio
 - Eligibility
 - Vesting
 - Treatment of Cancelled Options
- 4 Tender Offer Rules
- 5 SEC Disclosure/Reporting Requirements
- 6 Tax Implications
- 7 Accounting Implications

EXCHANGE MECHANISM

- One-for-one exchanges not likely (but see Google exchange offer)
 - Shareholder Approval
 - Additional Accounting Cost
 - Pressure on IRC Section 162(m) Limits
- Value-for-value exchange more likely
 - Underwater option revalued and exchanged for cash or securities of comparable value
 - Immediate reduction to option overhang
 - Potential net inflow to the plan reserve
- RSUs may be better replacement security
 - Protection against further stock price declines
 - Facilitates conversion to RSU program

STOCKHOLDER APPROVAL ISSUES

- NYSE/NASDAQ rules require stockholder approval of option repricing/exchange programs unless the plan permits option repricings:
 - Some interpretive flexibility exists under NASDAQ rules
 - Addition of an amendment to authorize option repricing is deemed a “material amendment” that requires stockholder approval
- For purposes of these rules, option repricing includes:
 - Lowering the exercise price of an outstanding option
 - Exchanging an underwater option for another option or other equity security such as restricted stock or restricted stock units
 - Any other action treated as a repricing for accounting purposes
- NYSE/NASDAQ rules do not require stockholder approval of cash buyouts of underwater options

PROXY ADVISOR CONSIDERATIONS

- Institutional Shareholder Services (“ISS”) will recommend a stockholder vote against an equity compensation plan that permits option repricing without a stockholder vote
- ISS will recommend a vote against (or withhold a vote for) members of the Compensation Committee if options are repriced without stockholder approval even if such repricing is allowed under the plan
- ISS will review option repricing proposals on a case-by-case basis, taking into account a number of factors, including:
 - Whether officers and directors can participate
 - Whether the cancelled options are added back to the plan reserve
 - Whether there is a value-for-value exchange
 - Whether the vesting period is reset

PROXY ADVISOR CONSIDERATIONS

- If cancelled options are to be added back to the plan reserve, ISS will not recommend stockholder approval if the issuer's burn rate for the three most recent years exceeds one standard deviation above the industry mean and is more than 2% of the outstanding shares of the issuer's common stock
- ISS also requires that the exercise price of the options to be cancelled be in excess of the 52-week high for the underlying stock
- ISS has indicated that the options to be cancelled should have been outstanding for a significant period (two or three years) to avoid any implication that the repricing is being done to take advantage of the short-term stock price decline

PROXY STATEMENT ISSUES

- Public companies seeking stockholder approval of option repricing programs must comply with the proxy solicitation requirements, including the disclosure requirements of Item 10 of Schedule 14A.

STRUCTURAL ISSUES FOR THE EXCHANGE – FORM OF EXCHANGE

- Repricing of Option

Advantages: Easier to explain to employees

No new administrative structure required

Disadvantages: Potential loss of IRC Section 422 incentive stock option status for repriced options

Complicates calculation of IRC Section 162(m) limitations

Repriced option may subsequently go underwater

STRUCTURAL ISSUES FOR THE EXCHANGE – FORM OF EXCHANGE

- Exchange of options for RSUs

Advantages:

Declines in stock price do not render RSUs worthless

Better correlation between value delivered to employee and financial statement cost to issuer

Disadvantages:

Employees have less control over taxable event

Tax withholding issues must be addressed

Service-vesting RSUs do not qualify as performance-based compensation for IRC Section 162(m) purposes

STRUCTURAL ISSUES FOR THE EXCHANGE – FORM OF EXCHANGE

- Buyout of options for cash

Advantages:

Simplicity

No stockholder approval requirement

Eliminates option overhang

Disadvantages:

Requires cash outlay by company

Need to issue replacement equity compensation

Plan interpretive issues as to status of repurchased options with respect to share reserve

STRUCTURAL ISSUES FOR THE EXCHANGE

- Exchange Ratio

- Underwater options are typically divided into separate groupings based on their respective exercise prices
- For each grouping a separate exchange ratio is established based on the highest-valued option in the grouping
- Ratio would be tied to a value-for-value exchange, with Black Scholes value of underwater option to be recalculated on the basis of current relation of exercise price to fair market value
- Additional financial statement cost (FAS 123(R) expense) to the extent value of replacement award exceeds value of underwater option at time of exchange

STRUCTURAL ISSUES FOR THE EXCHANGE – ELIGIBILITY

- Eligible Optionees
 - Participation of officers and directors may impact stockholder approval
 - Participation of employees in foreign jurisdictions adds administrative complexity
- Eligible Options
 - Should be limited to options significantly out of the money
 - Stock price volatility should be considered

STRUCTURAL ISSUES FOR THE EXCHANGE

- Vesting periods
 - Replacement security should not retain the vesting schedule of the replaced option. New vesting requirements should be imposed.
- Disposition of cancelled options
 - Stockholder approval may be more difficult to obtain if cancelled options are returned to the plan reserve (e.g., ISS burn-rate analysis)

TENDER OFFER IMPLICATIONS

- Unless the program is limited to a small number of executive officers or other similarly sophisticated optionees, the program must comply with the federal rules and regulations governing tender offers
- Companies with a class of securities registered under the Securities Exchange Act of 1934, as amended (“Exchange Act”), must comply with the tender offer requirements set forth in Rule 13e-4 under the Exchange Act
- SEC has provided limited relief from the “All Holders” and “Best Price” requirements of Rule 13e-4. Accordingly, not all optionees have to be included, and different amounts can be paid in the form of replacement securities to various categories of optionees (i.e., different exchange ratios)

TENDER OFFER IMPLICATIONS (cont'd)

- Companies subject to Rule 13e-4 must file a Schedule TO with the SEC at the commencement of the tender offer
- Participants must be provided with a formal offer document that provides required information regarding the terms of the offer, the replacement securities, the business and stock price performance of the company, the officers and directors of the company (including level of participation in the offer) and the procedures for tendering underwater options and withdrawing tendered options
- Letter of transmittal to be used to tender options and certain other ancillary documents must also be delivered to the option holders

TENDER OFFER IMPLICATIONS (cont'd)

- The offer must be kept open for at least 20 business days
- The offer is subject to SEC review, and amendments to the offer may be required
- Amendments to the offer initiated by the company will require the filing of an amendment to the Schedule TO
- Certain amendments may require the extension of the offer period

TENDER OFFER IMPLICATIONS (cont'd)

- Option repricing programs implemented by companies without a class of securities registered under the Exchange Act will be subject to Regulation 14E under such act
- Regulation 14E requires the offer to remain open for at least 20 business days and the consideration for the tendered securities to be paid promptly
- Regulation 14E also prohibits certain practices in connection with the offer

SEC DISCLOSURE/REPORTING REQUIREMENTS

- Summary Compensation Table
 - Incremental fair value of replacement award must be included to the extent amortized over the fiscal years covered by the table
- Grants of Plan-Based Awards Table
 - Replacement grant must be included in the table, and the incremental value of the replacement grant disclosed in the “Grant Date Fair Value” column
- Description of option repricing program must form part of the narrative discussion accompanying the tables

SEC DISCLOSURE/REPORTING REQUIREMENTS (cont'd)

- Compensation discussion and analysis must address the reasons for the option repricing program and its conformity to the company's stated compensation philosophy if the named executive officers participate
- Cancellation of the underwater option and receipt of any replacement securities must be reported by Section 16 insiders on a Form 4 report filed within two business days after the effective date of such cancellation (the date the company accepts the tendered options)
- The cancellation of the option and the receipt of the replacement security should qualify for one of the exemptions under SEC Rule 16(b)-3 so that there are no deemed purchases or sales of securities for Section 16(b) short-swing trading purposes

TAX ISSUES

- Issues applicable to IRC Section 422 Incentive Stock Options
 - Replacement ISO resets two-year holding period measured from grant date of replacement ISO
 - \$100K limit on initial exercisability of ISOs
 - Any shares for which the cancelled option would first become exercisable during the year of cancellation, whether before or after the date of actual cancellation, count against the \$100K limit
 - Any shares that become exercisable under the replacement ISO in the year of cancellation also count against the \$100K limit
 - Cash-out of underwater ISOs held by employees will trigger the withholding of applicable income and employment taxes

TAX ISSUES (cont'd)

- Section 409A Regulations do not preclude repricing of the underwater option provided the exercise price per share of replacement option is at or above the fair market per share on the new grant date
- Preamble to the Section 409A Regulations indicates that a series of repricings may signify the lack of a fixed exercise price and trigger a deferred compensation arrangement
- Potential Section 409A issue if underwater options are replaced with RSUs that vest in whole or in part after the expiration date of the maximum term of the replaced option

TAX ISSUES (cont'd)

- For IRC Section 162(m) purposes, both the cancelled option and the replacement option will count against the per-participant limit under the plan
 - May be more of a problem if the per-participant limit is an aggregate limit over the term of the plan rather than an annual limit
- If RSUs are the replacement security:
 - Service-vesting RSUs do not qualify as performance-based compensation for IRC Section 162(m) purposes
 - Applicable withholding taxes must be collected at the time of vesting (FICA) and at the time of issuance (Income)
 - Net share issuance may be most efficient method for collecting withholding taxes

FINANCIAL ACCOUNTING IMPLICATIONS

- Additional FAS 123(R) compensation cost arises only to the extent FAS 123(R) value of the replacement security (or cash buy-out price) exceeds the FAS 123(R) value of the underwater option as measured immediately prior to replacement
- Incremental cost is added to the original unamortized FAS 123(R) cost of the cancelled option and the aggregate cost is amortized over the applicable service period

Note: The full original FAS 123(R) cost of the cancelled option will still have to be recognized if the replacement security is not forfeited during the original vesting period of the cancelled option, but is forfeited prior to completion of the new vesting period

INTERNATIONAL CONSIDERATIONS

- Tax issues
 - Taxability of exchange
 - Previously taxed awards
 - Employer tax issues
 - Approved/qualified plans may not permit repricing
 - Structure of replacement awards
- Local compliance
 - Prospectus/registration
 - Exchange control
 - Labor law
 - Data privacy
 - Electronic signature

Questions?

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