Public Company Stock Option Repricings: A Primer

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Introduction

Stock options are often a significant, and critical, component of a public company's compensation and benefits programs as they align the interests of employees and stockholders—when the company's stock price increases, option holders and stockholders alike benefit. When a company's stock price falls below the exercise price of outstanding options (that is, when the options become "underwater"), the incentive value of the options is reduced and, if the stock price falls significantly and/ or experiences a sustained decline, the incentive value can be all but eliminated. When options have been underwater for a prolonged period of time, public companies invariably consider a variety of ways to restore that lost value, including by "repricing" the options.

The term "repricing" can be effected with several different types of structures, ranging from a straightforward reduction in the exercise price of an outstanding option to the exchange of the option for a different type of equity award and/or a cash payment. For a public company, whether to pursue a repricing and the structure of any repricing that is pursued will be informed by a number of compensation, governance, legal, accounting, tax and investor relations considerations. In this alert, we provide an in-depth discussion of the key considerations that are relevant to any option repricing program (the highlights of which are provided in the box below), a summary of common repricing structures (including advantages and disadvantages of those structures), and a discussion of the approval and implementation process for a repricing.

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Repricing Considerations in a Nutshell

Profile of Underwater Options – Companies must understand how many underwater options are outstanding (in absolute numbers and as a percentage of outstanding options), how deeply underwater those options are, what the remaining terms of the underwater options are, who holds the underwater options, whether key employees necessary to drive the business have other equity awards or compensatory arrangements that are sufficiently incentivizing and retentive, as well as the number of remaining shares available under the company's equity plan and the ability to successfully increase the shares available under the plan if needed. Scoping the compensation and business need for a repricing in this way provides the framework through which the considerations below can be analyzed more deliberately.

Stockholder Approval and Investor Relations – Companies traded on a stock exchange generally must obtain stockholder approval of an option repricing. This may be because the exchange's listing rules and the terms of the underlying equity plan require it or, even where they do not, because it may be prudent to seek such approval to avoid jeopardizing stockholder approval of subsequent equity compensation proposals (such as equity plan or say-on-pay proposals), to avoid receiving votes against members of the company's compensation committee and to mitigate the likelihood of stockholder litigation. As a result, companies must understand their stockholder base, which repricing structures are more likely to obtain a favorable proxy advisor recommendation, which structures are most likely to receive stockholder approval and whether such structures accomplish the company's intended compensation and business goals.

Equity Plan Terms – In addition to any terms relating to whether or not stockholder consent may be required, terms such as the number of shares that remain available for issuance under the company's equity plan, the plan's share recycling provisions, any per-participant limits (including limits on non-employee director compensation) and minimum vesting provisions may all inform the appropriate (and permissible) structure of a repricing.

Accounting and Tax Considerations – The structure of the option repricing will determine whether or not the repricing will generate incremental compensation expenses. And while option repricings can generally be undertaken without any significant adverse tax consequences, a repricing may result in a loss of "incentive stock option" status for the original underwater options.

Future Outlook – If the company's circumstances or market forces are such that the stock's trading price may (or is likely to) further decline after a repricing has been undertaken, the company may achieve the desired compensation and business goals only if underwater options are exchanged for a different type of equity award and/or cash rather than relying on a structure that simply reduces the exercise price of underwater options.

Eligible Participants – The tax, securities and other local law requirements applicable to non-U.S. employees must be analyzed on a jurisdiction-by-jurisdiction basis.

Time and Expense – If stockholder approval of an option repricing is required, significant internal resources will be needed (as well as external legal, accounting and compensation consultant costs incurred) as the company must solicit that approval by preparing, filing and disseminating a proxy statement, which may be included as part of the annual meeting proxy statement, but may be in connection with a special meeting of stockholders. In addition, to effect the repricing itself often requires a tender offer (effected by filing a Schedule TO with the Securities Exchange Commission (the "SEC")) which will also result in significant internal and external costs.

Repricing Considerations

Option repricing is a complex, time-consuming and costly undertaking that must be approached cautiously and deliberately, with significant input from the company's counsel, independent compensation consultant, accountants and other outside advisors. That time, cost and planning may be well worth it, though, if the company can successfully undertake a repricing that achieves its compensatory and business goals. In order to realize that result, the company will have to carefully consider the following:

1. Employee Incentives. Stock options are intended to align the interests of employees and stockholders—when the company's stock price increases, option holders and stockholders alike benefit. When a company's stock price falls below the exercise price of outstanding options, the incentive value of the options is reduced and, if the stock price falls significantly and/or experiences a sustained decline, the incentive and retentive value can be all but eliminated. Even in a poor economy, a company's executives and key employees often have other employment opportunities, and the lack of effective equity incentives may make the departure of those individuals—where the employees can receive new options with exercise prices reflecting the prevailing market conditions—more likely. As a result, a company may believe that option repricing is necessary to retain employees who are instrumental for the company's success.

2. Stockholder Approval and Investor Relations. The New York Stock Exchange (NYSE) and Nasdaq require listed companies to obtain stockholder approval of any repricing *unless* the underlying equity plan explicitly permits options to be repriced without stockholder approval. The exchanges take an expansive view of what qualifies as a repricing that is subject to stockholder approval, including the following actions: (1) reducing the exercise price of an option after it is granted, (2) canceling an option at a time when its exercise price exceeds the fair market value of the underlying stock in exchange for another option, restricted stock or other equity, except in connection with a merger, acquisition, spin-off or other similar corporate transaction, (3) any other action that is treated as a repricing under generally accepted accounting principles, or (4) any other action that has the same effect as any of the foregoing. While the stockholder approval requirement may be avoided if the company's equity plan permits repricings without stockholder approval, few plans include such explicit authority to reprice options without stockholder approval because the company's institutional investors often rely on the recommendations of proxy voting advisory services like Institutional Shareholder Services (ISS) and Glass Lewis, and those services strongly disfavor option repricings generally, and repricings that can be effected without stockholder consent in particular. ISS, for example, will recommend against stockholder approval of any equity plan that permits repricing without stockholder approval and will recommend against the members of the company's compensation committee if a company with such authority actually goes ahead and reprices options without stockholder approval. Similarly, Glass Lewis notes that an equity plan should not permit repricing of stock options and reviews any repricing history and any express or implied rights to reprice when assessing equity plan proposals. Glass Lewis will also generally

recommend against the members of a company's compensation committee if the company reprices options without stockholder approval. Thus, in most cases, a company that is listed on the NYSE or Nasdaq will need, or consider it prudent, to obtain stockholder approval before repricing outstanding options and, for many companies, obtaining a favorable recommendation from the proxy voting advisory services will be a critical factor in obtaining stockholder approval.

ISS Voting Guidelines

ISS 2023 voting guidelines state that it evaluates option repricing proposals on a case-by-case basis, giving consideration to the following factors:

- Historic trading patterns—the stock price should not be so volatile that the options are likely to be back "in the money" over the near term.
- Rationale for the repricing—was the stock price decline beyond management's control?
- Is this a value-for-value exchange?
- Are surrendered stock options added back to the plan reserve? If so, then also take into consideration the company's total cost of equity plans and its three-year average burn rate.
- Timing—repricing should occur at least one year out from any precipitous drop in company's stock price.
- Option vesting—does the new option vest immediately or is there a blackout period (i.e., limitation on exercisability)?
- Term of the option—the term should remain the same as that of the repriced option.
- Exercise price—should be set at fair market or premium to market.
- Participants—executive officers and directors must be excluded.

The ISS voting guidelines also note that ISS evaluates:

- The intent, rationale, and timing of any repricing proposal, including whether the repricing proposal clearly articulates why the board is choosing to conduct a repricing at this point in time. ISS notes that repricing underwater options after a recent precipitous drop in the company's stock price demonstrates poor timing and warrants additional scrutiny.
- The terms of the surrendered options, such as the grant date, exercise price and vesting schedule. Grant dates of surrendered options should be far enough back (two to three years) so as not to suggest that repricings are being done to take advantage of short-term downward price movements. Similarly, the exercise price of surrendered options should be above the 52-week high for the company's stock price.

Glass Lewis Voting Guidelines

Believing that employees should have downside risk in their equity-based compensation program (and that repricings eliminate that risk and potentially encourage unjustified risk-taking behavior

that may be detrimental stockholders), per its 2023 voting guidelines, Glass Lewis has announced that it is generally opposed to the repricing of employee and director options regardless of how it is accomplished. The only circumstance where Glass Lewis may consider a repricing to be acceptable is if macroeconomic or industry trends, rather than specific company issues, cause a stock's value to decline dramatically and the repricing is necessary to motivate and retain employees. Even then, the repricing will only be acceptable if (i) the impact to the company's stock price approximately reflects the market or industry price decline in terms of timing and magnitude and (ii) the following features are included in the repricing program:

- Officers and directors cannot participate in the program; and
- The exchange is value-neutral or value-creative to shareholders using very conservative assumptions.

In addition, in evaluating the appropriateness of the program design, Glass Lewis will also consider the inclusion of the following features:

- The vesting requirements on exchange or repricing options are extended beyond one year;
- Shares reserved for options that are reacquired in an option exchange will permanently retire (i.e., will not be available for future grants) so as to prevent additional shareholder dilution in the future; and
- Management and the board make a cogent case for needing to motivate and retain existing employees, such as being in a competitive employment market.

Investor Relations Generally

Whether or not stockholder approval of option repricing is required—and especially if stockholder approval is not required—the company should consider investor relations and any reputational consequences of a repricing. Some stockholders may recognize the importance of incentivizing and retaining key employees and fully support a repricing that achieves those goals. On the other hand, some investors may view an option repricing as unfair to stockholders who cannot "reprice" their investment. Repricings have also been criticized as removing the risk from what is supposed to be a risk/reward mechanism, and for severing the link between the interests of employees and stockholders.

Investor relations considerations are particularly important if the company anticipates seeking stockholder approval of other proposals that may be used by stockholders to signal disfavor with a board that approved a repricing without stockholder approval, such as a new equity plan or an increase in the shares available under an existing equity plan. In certain cases, stockholders may also vote "against" or "withhold" votes from directors—particularly members of the compensation committee.

Ultimately, a company must understand its stockholder base in order to successfully pursue an option repricing (with or without stockholder approval): Does the stockholder base strictly follow ISS and/or Glass Lewis recommendations? Is it made up of institutional investors that have their own voting guidelines? Is it comprised of several key, sympathetic investors (who are likely to approve) and retail investors (who may not vote at all)? With that knowledge and working with a proxy solicitor, the company may then determine whether the company can structure a repricing that will achieve its compensation and business goals or whether the composition of the company's stockholder base makes a successful repricing unlikely.

3. Proxy Statement and Other SEC Disclosures. If stockholder approval of an option repricing is sought, the company will need to comply with the SEC's rules relating to proxy solicitations and provide the following types of disclosures in its proxy statement:

- a description of the proposed repricing, including the option holders who are eligible to participate in the program, the options that are eligible to be repriced, the exchange ratio, and the terms of the replacement options or other equity awards or the cash to be received in exchange for the underwater options;
- a table, in a prescribed format, showing the benefits to be received by the company's executive officers and directors and by the employees in the aggregate;
- an explanation of the reasons for the repricing and alternatives considered; and
- the tax consequences and accounting treatment of the repricing.

Although SEC rules do not require the filing of a preliminary proxy statement for adoption or amendment of an equity plan (including an amendment to an equity plan to allow for a repricing without stockholder approval), inclusion of a proposal to approve an option repricing in a proxy statement generally will require the filing of a preliminary proxy statement. The preliminary proxy statement must be publicly filed with the SEC at least 10 calendar days before mailing the definitive proxy statement. The mailing may be further delayed if, during the initial 10-day period, the SEC staff notifies the company that it will be reviewing the preliminary proxy filing.

If the repricing proposal is successful and the company's "named executive officers" participate in the option repricing, a Form 8-K (under Item 5.02(e)) may be required to be filed with the SEC within four business days after the new grants in the repricing. In addition, the company's Section 16 filers must report both the cancellation of the underwater option and the grant of the new option or other equity award on a Form 4 within two business days after the new grants. The company's next annual meeting proxy statement must include the compensation cost and incremental fair value of the replacement options or other equity awards in the executive compensation tables and discuss the repricing program in the accompanying narrative disclosure. The repricing programs will also need to be addressed in the Compensation Discussion & Analysis (CD&A) section, by companies required to provide a CD&A.

4. Tender Offer Compliance. Nearly all option repricing programs by public companies must comply with the SEC's tender offer rules. The SEC takes the position that option repricings in which employees may elect to surrender underwater options for new securities containing different vesting or other terms or a reduced number of shares—which is generally the case with a value-for-value exchange designed to win stockholder approval—are exchange offers which must be conducted in compliance with the tender offer rules.

The relevant tender offer rules consist of:

- Rule 13e-4 under the Securities Exchange Act of 1934 (the "Exchange Act"), which regulates the company's communications in connection with the tender offer and requires, among other things, the filing with the SEC of a Schedule TO and other written offering material, and the dissemination to option holders of disclosure documents; and
- Regulation 14E, a set of rules prohibiting certain practices in connection with tender offers and requiring, among other things, that tender offers remain open for at least 20 business days.

Schedule TO is filed on EDGAR and requires payment of a filing fee. If stockholder approval of the repricing is required, the filing of the Schedule TO can be made after such approval is obtained, or the Schedule TO can be filed prior to the receipt of stockholder approval, but with the commencement of the exchange offer contingent on obtaining stockholder approval. The Schedule TO and other repricing documentation—typically including detailed employee communication materials—is extensive. The tender offer rules apply to essentially all communications in connection with an exchange offer and may, for example, require the company to file with the SEC a public announcement that it intends to reprice options.

The tender offer rules ordinarily require companies to treat all stockholders equally (the so-called "all holders" and "best price" provisions). In the context of an option repricing, however, the SEC permits companies to treat option holders differently in a manner consistent with the company's compensation policies and practices.

5. Risk of Litigation. The risk of litigation cannot be completely discounted if a repricing is implemented without stockholder approval. A board's decision to reprice underwater options for employees that is thoughtfully adopted after full review should be upheld by the courts as a proper exercise of the board's business judgment. However, a repricing that includes directors is likely to be subject to a higher level of review—the so called "entire fairness" standard.

In addition, care should be taken that the terms of the repricing do not result in the company exceeding any limits on awards contained in the equity plan, including any per-participant limit, any limit on the compensation that may be paid to non-employee directors in a year (when director options are being repriced) and any minimum vesting provisions. Inadvertently tripping such limits (because the repriced options are treated as new grants and will themselves be counted against or subject to such limits) is low-hanging fruit for plaintiffs' attorneys.

6. Accounting Treatment. ASC Topic 718 requires all companies to estimate the fair value of an employee stock option at the grant date, using the Black-Scholes or another valuation method, and to recognize that value as compensation expense over the option vesting period. When an option is repriced, ASC 718 requires the fair value of the new options (or other securities issued in exchange for underwater options) minus the current fair value of the surrendered options to be recorded as compensation expense over the remaining vesting period of the repriced options or other securities. In a value-for-value exchange program, the incremental fair value—and additional compensation charge—should approximate zero (as a practical matter, achieving an incremental value that is exactly zero is difficult because the exchange ratio is typically set before the tender process commences whereas the compensation charge is based on the actual value of the stock on the date the substitute award is granted.). If a more employee-friendly exchange ratio is used, however, there could be significant new compensation charges. In addition, the ongoing compensation charges associated with the canceled options are not eliminated, even if the compensation charges associated with the repriced options are lower than the original compensation charges. As such, working with the company's accountants to understand the accounting implications and financial reporting requirements of any proposed repricing is important.

7. U.S. Tax Consequences. Option repricing generally does not result in taxable income to option holders or a tax deduction to the company, but it does present several potential tax issues:

- *ISO Rules*:
  - *Options-for-Options Repricing:* A repricing structured as an options-for-options exchange is treated under the incentive stock option ("ISO") rules as a deemed new grant of the repriced options. As with the grant of any option, the new (repriced) options may qualify as ISOs if all Internal Revenue Code ("Code") requirements are satisfied on the effective date of grant, but only to the extent that the annual per person $100,000 limitation is not exceeded. However, in connection with a repricing the $100,000 limitation must be calculated taking into account (i) first, all vesting that has or could have occurred in the year of the repricing under all outstanding ISOs (including the underwater options being repriced) held by the option holder as of the date of the repricing and (ii) second, all vesting that applies to the repriced options held by the option holder in the year of the repricing. This nuance to the $100,000 limitation often results in options that originally qualified as ISOs becoming non-statutory stock options ("NSOs") as a result of the repricing. In addition, the deemed new grant of the repriced options restarts the holding period required to obtain the preferential tax treatment applicable to ISOs. Specifically, to obtain that preferential treatment, the ISO shares cannot be disposed of earlier than two years from the date of grant of the option (i.e., the date of the repricing) and one year from the date of exercise. The application of either (or both) of these two rules can mean that option holder consent is required for the repricing of ISOs, even where the repricing is structured as a one-for-one exchange with no change in vesting.

- *All Repricing Structures:* Offering a holder of an ISO the opportunity to participate in a repricing may constitute a "modification" of the outstanding ISO which causes the ISO to become an NSO, even if the employee ultimately declines the offer. The "modification" issue for ISOs can be avoided if the repricing offer is open for less than 30 calendar days. Because the tender offer rules require a repricing offer to remain open for at least 20 business days, coordination of these two time periods can become tricky, especially if there are intervening holidays. Under the tender offer rules, the day the offer is mailed or distributed is day 1 and the offer must remain open until midnight on day 20 (counting business days only). The ISO regulations do not have specific rules on how to count days.

– *Code Section 409A*: Code Section 409A imposes harsh tax consequences on the holders of options that have an exercise price below the fair market value of the underlying stock on the date of grant. As with ISOs, for Code Section 409A purposes, a repricing is considered a cancellation of the underwater option and the grant of a new option. As long as the exercise price of the new (repriced) option is set at or above the fair market value of the underlying stock on the date of grant, there should be no issue under Code Section 409A (although an issue could arise if there is a pattern of repeated repricings). For this purpose, the date of grant is when the actions necessary to complete the repricing, such as the option holder's acceptance followed by the expiration of the tender offer period, have been completed. The new exercise price must equal or exceed the fair market value of the underlying stock on that date.

– *Code Section 162(m)*: To the extent an underwater option qualifies as grandfathered performance-based compensation within the meaning of Code Section 162(m), the repricing of such an option will result in the loss of that grandfathered status. As a result, if the repriced award is held by a "covered employee", determined in accordance with Code Section 162(m), the compensation resulting from the exercise of that repriced option (or the vesting or settlement of another equity award, or cash) will be subject to the $1 million deduction limitation imposed by Code Section 162(m).

8. Treatment of Foreign Employees. An option repricing program made available to employees residing in foreign countries may be subject to securities, tax and other local law requirements that differ from those in the United States. Compliance with these requirements—and providing descriptions of the securities and tax consequences in all applicable jurisdictions—can become burdensome if the company has employees in many foreign countries. Unless the company is willing to incur the expense of complying with all local law requirements, foreign employees will need to be excluded from any repricing program, which may alienate a portion of the company's workforce.

9. Available Alternatives. While weighing all of the foregoing considerations, the company should also assess whether its goals could be achieved by a means other than by a repricing. For example, are there sufficient shares available under the equity plan to permit the company to leave the underwater options outstanding and address the retentive and incentive value of equity

holdings differently, such as by granting new awards, perhaps in the form of RSUs, to some or all employees? Are cash retention awards a viable alternative? The company should satisfy itself that its compensation and business goals in fact cannot be properly achieved without undertaking the repricing—and then be prepared to describe that analysis to stockholders.

Common Repricing Structures

"One-for-one" option exchanges—in which employees surrender underwater options in exchange for an equivalent number of new, at-the-market options with the same vesting schedule as the surrendered options—may be the most straightforward, but tend to be the least favored by stockholders. As described above, value-for-value exchanges are often necessary to win stockholder approval and, even if stockholder approval is not required or is readily attainable, to blunt investor criticism of, or reprisals relating to, the repricing.

Although the details of repricing structures can vary widely (and they can even be combined to create more complex programs), public company option repricings typically take one of the following three forms:

1. Options-for-Options. Employees are given the choice of keeping existing options or surrendering them for cancellation in exchange for the grant of new options with an exercise price equal to (or above) the current market price. The new options may cover a smaller number of shares than the surrendered options, and may be either ISOs (assuming they qualify for ISO treatment) or NSOs. The vesting schedule of the new options may match the vesting schedule of the surrendered options or, more typically, be reset in whole or in part.

2. Options-for-RSUs. Employees are given the choice of keeping existing options or surrendering them for cancellation in exchange for the grant of RSUs. RSUs represent the company's commitment to issue shares of stock in the future as the conditions to issuance are satisfied. The number of RSUs is often (but not always) smaller than the number of shares subject to the surrendered options. The vesting schedule of the RSUs may match the vesting schedule of the surrendered options or, more typically, be reset in whole or in part. There usually is no purchase price for the RSUs.

3. Options-for-Cash. Employees are given the choice of keeping existing options or surrendering them for cancellation in exchange for an immediate cash payment from the company. The cash payments are taxed upon receipt at ordinary income rates and are subject to withholding.

All three structures would require stockholder approval (unless a repricing without stockholder approval is explicitly permitted by the underlying equity plan) and consequently would require the company to comply with SEC proxy statement rules and usually with the SEC tender offer rules in effecting such a repricing program. The key advantages and disadvantages to each structure are summarized in the following table:

	Advantages	**Disadvantages**
Options-for-Options	• Easy to describe and understand • Employees control the timing of taxation as timing of exercise of the repriced option is in their control • Potential dilution is reduced (assuming exchange ratio is greater than one-to-one)	• Repriced options may become underwater over time, potentially defeating purpose of repricing • Number of repriced options may be limited by any per-participant or compensation limits set forth in the plan • Repriced ISOs may no longer qualify for ISO treatment and become NSOs
Options-for-RSUs	• RSUs always retain some value absent bankruptcy and cannot become underwater • Issuance of RSUs is not limited by ISO rules • Potential dilution is reduced (assuming exchange ratio will be greater than one-for-one (and if value-for-value, the exchange ratio will be even greater than an option-for-option structure))	• May be more difficult to describe and understand if RSUs are not otherwise part of the company's compensation program • Employees lose control over timing of taxation (RSUs result in taxable compensation income to the holder as and when the shares are vested) • Assuming a greater than one-for-one exchange ratio, fewer RSUs will be granted than the number of shares that were subject to the surrendered options, so there is typically less upside for holder • Number of RSUs may be limited by any per-participant or compensation limits set forth in the plan
Options-for-Cash	• Easy to describe and understand • Eliminates risk of new securities becoming worthless • Provides immediate value to employees • Maximum reduction in dilution	• Employees lose control over timing of taxation (cash is taxed upon receipt) • Employees lose equity upside • Consumes company's cash • Provides no retention value (unless cash payments are subject to vesting) • Amount of cash may be limited by any plan compensation limits

Approval and Implementation Process

1. Program Structure. Once the profiles of both the company's underwater options and its stockholder base have been identified, the starting point of the option repricing process is to design a program that will achieve the company's objectives, comply with applicable plan and legal requirements, and be likely to obtain stockholder approval, if required. This process usually starts with coordination among the company's compensation consultants and legal counsel, with input from the company's human resources, legal, tax, finance, accounting and investor relations teams. Four key parameters in designing a repricing program are:

– *Participant Eligibility*: Under ISS and Glass Lewis guidelines, the company's executive officers and directors must be excluded. If executive officers or directors are not excluded, some companies provide them with less favorable terms compared to the terms being offered to other employees. In addition, since the replacement award (whether an option or RSU) is treated as a new equity grant, former employees, directors and consultants generally may not be included in the repricing.

– *Exchange Terms*: The exchange terms include the type of options or other securities that will be issued in exchange for underwater options and the ratio for such exchange (i.e., one-for-one or a greater ratio). A program with a value for value exchange ratio is more likely to win a favorable recommendation from proxy advisory services and stockholder approval.

– *Option Eligibility*: The options that are eligible to be repriced under the program must be determined. Under ISS guidelines, options that have an exercise price that is lower than the 52 week high for the stock price may not be included. Many programs also exclude options granted within the prior year by analogy to the ISS guidelines that state that the price decline should not have happened within the past year.

– *Vesting*: Although existing vesting schedules can be carried over to the repriced options (or other securities) granted in exchange for underwater options, more typically vesting schedules are reset in whole or in part in order to create new retention incentives and/ or to adjust the value of the new grant (and certainly to the extent the replacement award is RSUs, some vesting would be needed to avoid the RSUs being taxable at grant). Further, minimum vesting provisions of equity plans must be considered.

The board of directors will also need to determine whether surrendered options are returned to the plan or retired. Although many plans permit canceled options to replenish the plan, companies sometimes agree not to do so in order to increase the dilution savings from the repricing program and help convince stockholders to support it. In addition, the extent to which options replenish the plan is a factor analyzed by ISS and Glass Lewis in determining whether to recommend for or against approval of a repricing proposal.

In practice, there are trade-offs among these parameters, and many option repricing programs that did not meet all of these guidelines have been approved by stockholders.

2. Board Approval. The company's board must approve an option repricing program. Prudent board practices should be followed, including the establishment of a persuasive record showing careful consideration of relevant factors and the receipt of input from the company's compensation consultant and outside counsel, as well as internally from HR, legal, tax, finance and accounting. The board should clearly articulate a legitimate business rationale for the repricing, and should be advised of the program's accounting consequences and financial reporting, stockholder approval and public disclosure requirements. The record should also reflect which alternatives to a repricing were considered and why such alternatives were not pursued/did not achieve the company's compensation and business goals. Relevant information for board consideration would generally include:

- The terms of the existing options, including the exercise price, the holders of the options and the retentive value of the existing options;
- the magnitude and timing of additional compensation charges to the company's P&L;
- the basis for the proposed exchange ratio;
- the estimated amounts by which the option pool will be replenished and stockholder dilution reduced;
- the anticipated cash cost to the company (if cash payments will be made as part of the program); and
- the overall expense and timing of the program.

If the company's Section 16 officers or directors are to be included in the program, the board should adopt appropriate resolutions to exempt the repricing exchange from the short-swing liability provisions of Section 16(b) of the Exchange Act.

3. Compensation Committee Involvement. The company's compensation committee should participate in the development and approval of the repricing program to the extent required by the plan terms, the compensation committee's charter and applicable stock exchange rules. Many boards delegate authority for equity plan administration to the compensation committee. NYSE rules require a listed company to have a compensation committee that determines and approves (either as a committee or together with the other independent directors) the CEO's compensation and makes recommendations to the board with respect to non-CEO compensation, compensation plans and equity-based plans. Nasdaq requires that executive officer compensation of a listed company be determined, or recommended to the board for determination, by either a compensation committee composed solely of independent directors or a majority of the independent members of the board.

4. Stockholder Approval. If stockholder approval of the repricing program is required or deemed desirable, approval may be sought at a company's regular annual meeting or a special

meeting of stockholders. Stockholder approval can be structured as approval of the repricing program itself or as an amendment to the equity plan to permit the repricing. Inclusion of an option repricing proposal in the company's proxy statement for a regular annual meeting presents obvious efficiencies, and is generally preferred in order to avoid the additional effort and expense required for a special meeting and the heightened prominence that would accompany it. As noted above, a preliminary proxy statement generally will be required if the stockholder approval of a repricing program is sought, and thus additional time must be built into the stockholder approval timeline (though a preliminary proxy statement is not required to amend an equity plan to permit repricings without stockholder approval).

5. SEC Compliance. As discussed above, the tender offer rules will generally apply to any option repricing program including an exchange offer, the proxy rules will apply if stockholder approval is sought, and various other SEC disclosures will be required in connection with the repricing.

6. Exchange Offer Documents. If the tender offer rules apply, detailed information about the terms and mechanics of the option repricing program will need to be set forth in an "offer to exchange" that is delivered to employees and filed with the SEC. These materials are usually complex and require significant time to prepare.

Conclusion

Determining whether a repricing is the appropriate and best means to accomplish the company's compensation and business goals is thus a substantial undertaking, requiring a thoughtful balancing of the company's need to incent and retain its key talent against the provisions of the company's equity plan, the SEC rules, investor considerations and reactions. Given the complexity of the issues, and the need in most cases to structure a repricing program that can win stockholder approval, companies considering a repricing should begin— – together with their outside counsel and compensation consultants— – the analysis of the foregoing factors well in advance of the meeting of stockholders at which any repricing-related approval will be sought.

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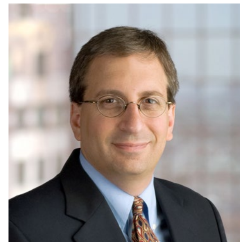

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