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Stock Option Planning For Mergers and Acquisitions

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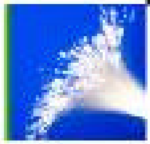
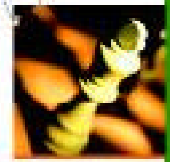
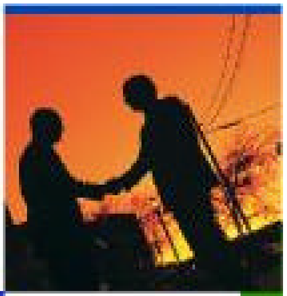
Today's Topics

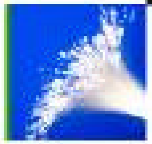


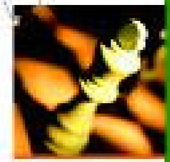


- Consideration of plan provisions
- Assumption vs. substitution of options
- Shareholder approval issues
- ISO issues
- NSO issues
- Cashing out options
- Golden parachute rules
- Accounting considerations and planning opportunities
- Securities law considerations

Common Plan Provisions Governing M&A Transactions





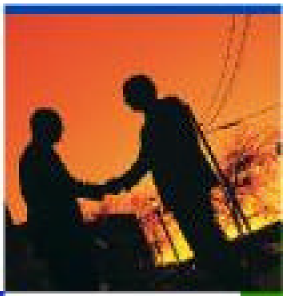


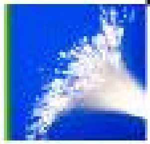
> Provisions for changes in capital structure

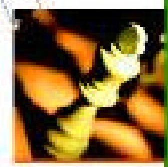
- What if stock subject to options is converted to stock of another corporation, cash, or other deal consideration?
- What if Buyer wants options terminated?

> Provisions for changes in vesting

Provisions for Changes in Capital Structure

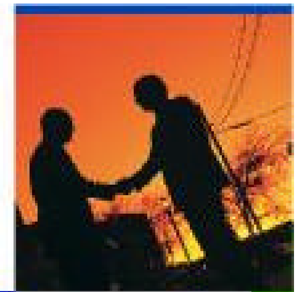


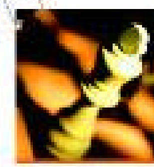




- Most plans require assumption of options, unless Buyer refuses, in which case options are accelerated and terminated.
- This approach generally was used to avoid accounting issues.
- Is this still the best approach?
  - Could provide unintended benefit from acceleration
  - No more pooling
- Should plans be changed?
  - Give board choice of alternatives?
    - Provide for assumption
    - Allow acceleration and termination—do you give unintended benefit or do you provide for restricted stock?
    - Cash-out of options

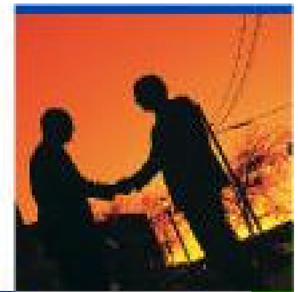
Provisions for Changes in Vesting

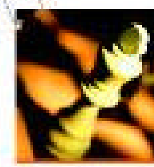




- If plans give a benefit, they generally provide for automatic acceleration.
  - This approach allowed acceleration without pooling issues.
  - No more pooling accounting
- Should plans be changed?
  - Give board choice?
  - Continue automatic acceleration for employee protection?
- Change in control definitions
  - Acquisition of greater than 50%
  - Change in board (proxy contest)
- Amount of vesting
- Are provisions located in plan or option agreement?

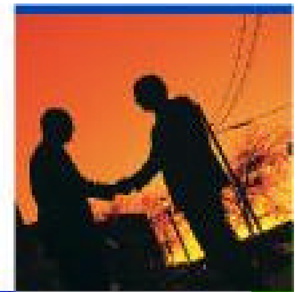
Assumption vs. Substitution of Options

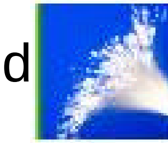


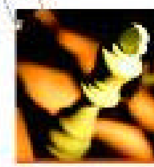


- Assumption
  - When is it used?
  - Why is it used?
- Substitution
  - When is it used?
  - Why is it used?

Shareholder Approval Issues

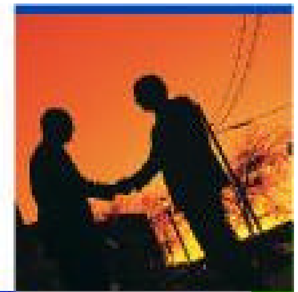


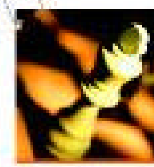




- For ISO purposes, Buyer's shareholders are not required to approve assumption/substitution of existing options.
- For ISO purposes, Buyer's shareholders are required to approve plan if future ISO grants will occur under the plan.
- Code Section 162(m) may also require shareholder approval if future grants will occur under the plan.
- Exchange rules may also require shareholder approval if future grants will occur under the plan.

ISO Issues





- Identify ISOs and NSOs
- Consider the $100,000 rule in the context of accelerations
- General requirements of Code Section 424
  - Section 424(a): “corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation . . .”
  - Treas. Reg. Sec. 1.425-1(a): “. . . If such action . . . results in a significant number of employees being transferred to a new employer or discharged, or in the creation or severance of a parent-subsidiary relationship”
  - Section 424(a): No increase in spread/ratio and no additional benefits

ISO Issues

> Fair market value

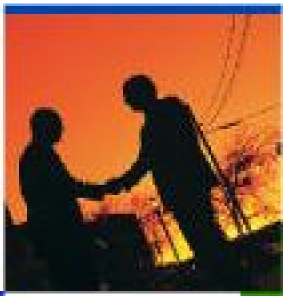
> Part-cash / part-stock transactions

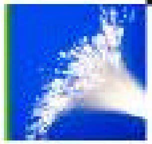
> Fractional shares

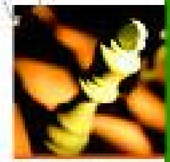
- Rounding
- Cash in lieu of fractional shares at time of exercise
- Canceling fractional share piece and adjusting exercise price

> Contingent shares

- Use a formula
- Optionholders should be on parity with shareholders
- Alternatively, value contingent shares



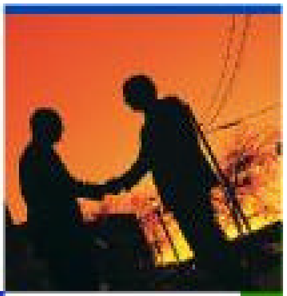


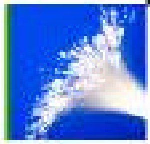


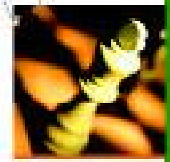
NSO Issues

> Generally should not be a taxable event

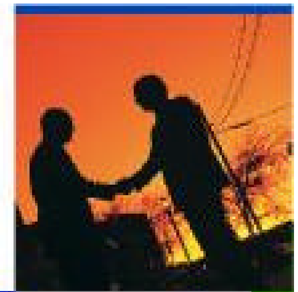
> May be issues for significantly in-the-money options

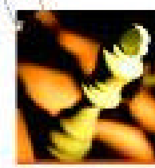






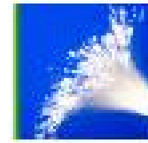
Cash Payments in Cancellation of Options

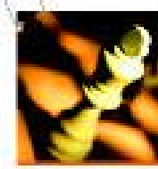




- Are the payments deductible?
- Which company gets the deduction?
- Which company has the withholding obligation?
- Which company has the information reporting obligation?
- Certain timing issues relating to ISOs

Golden Parachute Rules





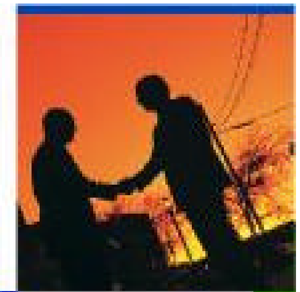
> Overview

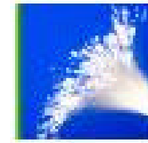
- Imposes excise tax on and disallows corporate deduction for payments to “disqualified individuals” contingent upon change of control
- Newly proposed regulations provide guidance in applying these rules.

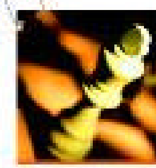
> What to do?

- Public seller
- Private seller

Accounting Considerations

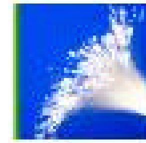




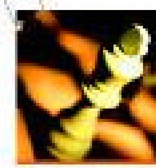


- Purchase price increased by fair value of replacement options, whether vested or unvested
  - Fair value generally Black-Scholes calculation
  - Purchase price adjustment for unvested options
    - Purchase price reduced by spread on assumed unvested options
    - Charge equal to spread amortized over the remaining vesting period of the options
- No additional charges as a result of modifications of options since treated as grant of new options
- Seller’s variable accounting typically ceases upon acquisition.

Accounting-Related Planning Opportunities

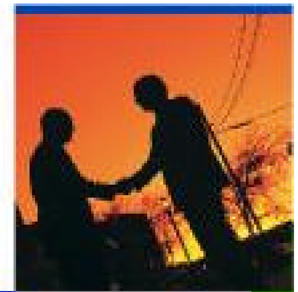


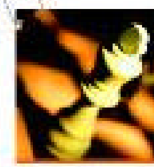
- Strategic pre-acquisition acceleration



- Pre-acquisition modifications
- Repricings

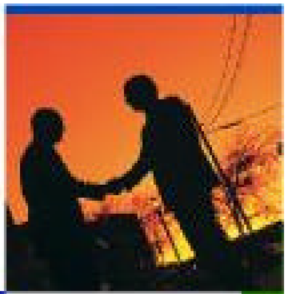
Securities Law Considerations

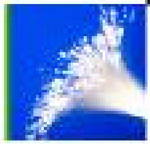


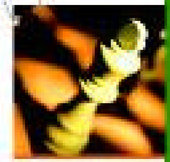


- Merger may cause Section 16(b) liability
- An SEC No-Action Letter provides that liability may be avoided if appropriate approvals are obtained.
- Seller's board must approve disposition of Seller stock by Section 16 officers and directors of Seller.
- Buyer's board must approve acquisition of Buyer stock by Seller employees who will be (or might be) Section 16 officers or directors of Buyer.
- Approval must occur on or after date of merger agreement and before merger is consummated.
- Certain specificity requirements apply.

Summary of Issues







- Review plans in light of changes in accounting rules.
- It is generally better to assume (rather than substitute for) options in transactions.
- Early detection of golden parachute issues may allow for mitigation of adverse consequences.
- Advance planning for option cashouts is essential.
- Consider accounting-related opportunities in planning for transactions.

Questions and Answers

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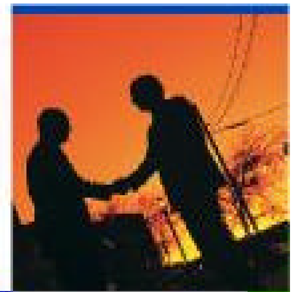

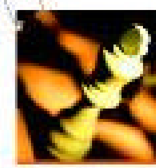

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