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Option Repricing, Version 2009

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Option repricing has received renewed attention in the wake of the broad market declines that began in 2008 and have continued into 2009. Unlike the market contraction of 2000-2002 that disproportionately affected technology companies, the market collapse of the past year has spared few sectors or issuers, prompting companies across industries to reexamine their equity incentive programs and consider various techniques to restore the intended benefits of those programs, including repricing “underwater” options (that is, options with exercise prices in excess of the current fair market value of the underlying stock). At the same time, changes in stock exchange and SEC rules have made it significantly more difficult—although not impossible—for a public company to implement an option repricing, although the terms of any repricing are likely to be more stockholder-friendly than in the past.

“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 cancelled options—are now almost unheard of at public companies. So-called “value-for-value” exchanges are usually necessary to win stockholder approval and, even if stockholder approval is not required or is readily attainable, to blunt investor criticism of the repricing.

There are three general approaches to option repricing:

- *Options-for-options*, in which underwater options are cancelled in exchange for new options (typically covering a smaller number of shares) with a lower exercise price (equal to or sometimes higher than the fair market of the underlying stock);

- *Options-for-stock*, in which underwater options are cancelled in exchange for shares of restricted stock or restricted stock units (typically covering an even smaller number of shares since no, or a nominal, purchase price is paid for the restricted shares, enabling the recipient to benefit from the full value of the shares rather than just the value in excess of the option exercise price); and

- *Options-for-cash*, in which underwater options are cancelled in exchange for a cash payment.

Approximately 50 US public companies repriced options in 2008, representing a three fold increase from 2007. A majority of the companies that repriced options in 2008 did not obtain stockholder approval, generally because they had plans that permitted repricing without stockholder approval—in many cases, these were older plans that had been previously approved by stockholders in an environment with less intense scrutiny of executive compensation practices. The balance of the companies that repriced options in 2008 without stockholder approval were not required to obtain stockholder approval because they were not listed on Nasdaq or NYSE, or because they paid cash for underwater options.

A wide variety of employment, governance, legal, accounting and tax considerations are relevant to any option repricing program. Each company must assess these factors in light of its own circumstances. *The following summary of the principal considerations that generally are relevant when considering option repricing is extracted from a more detailed memorandum on the topic that we have prepared to assist clients who are considering option repricing.*

Employee Incentives

Stock options are intended to provide incentives to motivate and retain the employees who are expected to contribute to the success of the company. Unlike some forms of compensation, stock options align the interests of employees and stockholders—when the company's stock price increases, optionholders and stockholders alike benefit. When a company's stock price falls well below the exercise price of outstanding options, the incentive value of the options is substantially reduced or eliminated. Even in a poor economy, a company's most important employees often have other employment opportunities, and the lack of effective equity incentives may make the departure of key employees to competitors—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 officers and employees who are instrumental for the company's future success. This rationale alone, however, will likely be insufficient to obtain stockholder approval unless the repricing is structured in a manner that meets the guidelines of the major proxy advisory services, as discussed further below.

Stockholder Approval

As a result of changes in Nasdaq and NYSE listing standards in 2003, listed companies must obtain stockholder approval of option repricings unless the underlying plan specifically permits options to be repriced (there is no similar requirement for companies traded in the over-the-counter market). Although Nasdaq and NYSE rules permit a stock plan to explicitly authorize repricing without stockholder approval, listed companies have a strong incentive not to include such provisions in their plans—the leading proxy voting advisory service, RiskMetrics Group, which now operates the former ISS proxy advisory service (RMG), will recommend against stockholder approval of any stock plan that permits repricing without stockholder approval. Moreover, even if repricing authority is contained in its stock plan, a company may be leery of exercising that authority because

RMG will recommend against the members of the company's compensation committee if that company repriced options without stockholder approval, even if the repricing was permitted under the terms of the stock plan. Thus, in most cases, a company that is listed on Nasdaq or NYSE will need, or consider it prudent, to obtain stockholder approval before repricing outstanding options.

For most companies, a critical factor in obtaining stockholder approval is a favorable recommendation from RMG and any other proxy advisory services that the company's institutional stockholders follow. RMG voting guidelines state that it evaluates option repricing proposals on a case by case basis, giving consideration to a number of factors, the three most critical of which are:

– *"Value-for-Value" Exchange*: The RMG voting guidelines state that the value of the surrendered (underwater) options should equal the value of the new (repriced) options or other securities received in exchange for the underwater options, measured by RMG's binomial valuation model. As a result, in a value for value exchange, a repriced option must cover a smaller number of shares than the surrendered option for which it is exchanged—the exchange ratio will depend on the historic volatility of the company's stock price and other factors used by the valuation model.

– *Exclusion of Directors and Officers*: The RMG voting guidelines state that the company's directors and top five officers should be excluded from the repricing.

– *Timing of Repricing*: The RMG voting guidelines state that repricing after a recent precipitous drop in the company's stock price is "poor timing" and will be scrutinized. RMG guidelines specifically state that the price decline "should not have happened within the past year" and that the exercise price of surrendered options should be higher than the 52 week high for the stock price.

Proxy Statement and Other SEC Disclosures

If stockholder approval of an option repricing program is sought, the company will need to comply with the SEC's rules relating to proxy solicitations.

If the company's "named executive officers" participate in the option repricing program, a Form 8 K under Item 5.02(e) must 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 on a Form 4 within two business days after the new grants.

Following an option repricing, the company's next annual meeting proxy statement must include the compensation cost and incremental fair value of the repriced options in the executive compensation tables and discuss the repricing program in the accompanying narrative disclosure as well as in the Compensation Discussion & Analysis (CD&A) section.

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 exercise 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, 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 repricing communications, 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.

  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.

Investor Relations

Whether or not stockholder approval of option repricing is required—and especially if stockholder approval is *not* required—the company should consider the investor relations consequences. Option repricing is intensely disliked by many institutional stockholders, who view the practice as fundamentally unfair to public stockholders who cannot turn in their shares for lower priced shares when market prices drop. Similarly, option repricing is often criticized as removing the risk from what is supposed to be a risk/reward mechanism, and for severing the link between the interests of executives and stockholders. With the recent and unprecedented focus on executive compensation, investor criticism of option repricing is likely to increase.

Accounting Treatment

Not all has worsened in the option repricing climate since the last surge in repricings in 2001-2002. Changes in the required accounting treatment of stock options have reduced the potential accounting barriers to repricing, although it remains imperative that the company discuss the accounting implications and financial reporting requirements of any proposed repricing program with its accountants.

Prior accounting rules (APB 25 and FIN 44) often required a company that repriced options to treat them as “variable” for accounting purposes during the remaining life of the repriced options. With variable accounting treatment, the company was required to take a charge against earnings at the end of each fiscal quarter, measured by reference to the difference between the exercise price of the repriced options and the then current fair market value of the underlying stock. The effect on earnings could be unpredictable and substantial. As a result, many companies structured option repricing programs in a manner intended to avoid variable accounting treatment. The most popular technique to avoid variable accounting was to cancel underwater options in return for the company’s promise to grant new options (with an exercise price equal to the then fair market value) six months and one day later. This so-called “6 + 1” technique is no longer necessary.

FAS 123R, implemented in late 2005, now 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, FAS 123R 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.[1] In a value for value exchange program, the incremental fair value—and additional compensation charge—should approximate zero. 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 cancelled options are not eliminated, even if the compensation charges associated with the repriced options are lower than the original compensation charges.

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*: Offering a holder of an outstanding incentive stock option (ISO) the opportunity to participate in a repricing program may constitute a “modification” of the outstanding ISO, even if the employee declines the offer. A modification may cause an ISO to become a non-statutory stock option (NSO) or may cause other negative tax consequences. 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.

- *Section 409A*: Section 409A of the Internal Revenue Code, which applies to all stock options granted or vesting on or after January 1, 2005, 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. For purposes of Section 409A, 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 Section 409A (although an issue could arise if there is a pattern of repeated repricings).

- *Section 162(m)*: Repriced options will be treated as new grants for purposes of Section 162(m) of the Internal Revenue Code. Section 162(m)—applicable to public companies only—generally disallows a tax deduction for compensation in excess of $1,000,000 paid in any year by a public company to its CEO or three other highest paid officers (other than the CFO), and for this purpose “compensation” includes compensation income attributable to stock options. In addition, in order to qualify for certain exceptions from Section 162(m), a company’s option plan must limit the number of shares that can be granted to any one person during a specified period of time. A repricing is treated as a new grant, so both the original grant and the new grant must be considered when measuring compliance with the plan’s per-participant limit. As a result, the per-participant limit could prevent the repricing of some or all options.[2]

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.

[1] If the surrendered option was accounted for under APB 25 and FIN 44, the calculation may be different.

[2] This discussion does not address the consequences of Section 162(m)(5) on corporations that are participating in the Treasury Department’s Troubled Asset Relief Program.

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