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Legal Matters

A Look at the Impact of Major Rules and Court Decisions

By Maryann A. Waryjas and Mark Wood

Treading Water

A year-plus of lower stock prices has put the options of many corporate managers and employees "under water." With current price below the exercise price, companies feel the need to reprice these options to retain the incentive they promise. But institutions don't like repricing; after all, their share values are lower, too. Maryann Waryjas and Mark Wood provide a primer for companies on how to reprice options to minimize accounting complications and deal with SEC rules involving tender offers.

Institutional investors are **strongly opposed** to repricings, and companies are concerned about the corporate governance issues surrounding them.

With stock prices plummeting during the last year, many of the stock options issued by companies to incentivize and compensate employees are now "under water" or worth less than their exercise prices. Recognizing that underwater options neither properly compensate employees nor create an incentive to stay, some companies have implemented option repricings in efforts to keep employees from jumping ship and to reward them for their perseverance and loyalty.

Option repricings take many forms, from simply reducing exercise prices of outstanding options to offering employees the opportunity to exchange current options for new ones with lower exercise prices. The structure of a company's option repricing is likely to be driven by a number of factors, including stockholder concerns, accounting considerations, and securities laws issues.

Simple option repricings are no longer common. Institutional investors are strongly opposed to repricings, leaving companies concerned about governance issues. Stockholders, with no relief from falling prices, have shown concern over the dilutive effects of repricings. And, importantly, neither stockholders nor boards of directors want to bestow an undeserved benefit on executive officers — likely to be the people responsible for the stock's falling price.

Three Choices

Sensitive to these concerns, companies determined to reprice options have three choices: Reduce the total number of shares for which repriced options are exercisable, lengthen the vesting schedule of repriced options, or change the tax status of repriced options (i.e., from incentive stock options to a nonqualified stock options). Companies also may choose to incentivize and compensate their rank-and-file employees by repricing their options, but not executive officers and directors, seen as more accountable for the company's performance.

Because accounting treatment can be significantly adverse, repricings often are designed to minimize or avoid certain types of accounting treatment. Ordinarily, an option granted with a fair market value exercise price results in no compensation expense for the company. However, repriced options can be costly under Financial Accounting Standards Board Interpretation No. 44, namely "Accounting for Certain Transactions Involving Stock Compensation: An Interpretation of APB Opinion No. 25," which applies to all options repriced since December 15, 1998.

According to the rule, an option that is repriced followed by the stock price rising above the exercise price is subject to variable accounting. The company incurs a compen-

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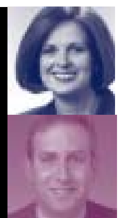

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sation expense based on the difference between the stock price and the exercise price, as measured in each accounting period, until the option is exercised or canceled or expires.

Further, under FASB 44, new options at a lower exercise price that replace canceled options are viewed as a repricing, leaving the new options subject to variable accounting. However, to be considered a repricing, the new options must be granted within six months before or after the cancellation.

Companies have several alternatives for structuring repricings to minimize or avoid variable accounting:

- Companies canceling old options and issuing new ones with lower exercise prices can minimize the adverse accounting treatment by shortening the vesting schedule and/or the life of new options. For example, Amazon.com, Inc., issued new options that begin vesting in six months and expire in approximately 30 months.

- Companies may issue new options without canceling old ones. The new options should not be subject to variable accounting, but the company will have twice as many options outstanding, resulting in much greater potential dilution.

- Companies may issue new options that expire six months and one day after a stock price target is achieved, without canceling old options, to fill the gap between the exercise price of the old ones and the current stock price. As long as the new options do not expire until at least six months and one day after the stock price target is achieved. the new options should not be subject to variable accounting, and the company will have twice as many options outstanding only until the new options expire.

- Companies may issue restricted stock to replace canceled options. Restricted stock is not subject to variable accounting, but

More Repricing This Year

Investors, especially institutions, are inclined to react negatively to company initiatives to reprice or exchange underwater executive and employee stock options. Their reasoning is understandable: Our shares are worth less than they were before – why should the company bail out its employees?

Companies argue that options are a critical incentive to attract and keep top managers, software development wizards, scientists, and other key employees. The issue appears to be especially intense in technology businesses.

Shareholder activists have viewed the issue variously in recent years. A couple of years ago, the State of Wisconsin Investment Board (SWIB) mounted a strong campaign to deter certain companies from reissuing options, submitting proposals and holding meetings with executives. SWIB is still against repricing, but works and holding meetings with executives. SWIB is still against repricing, but works more closely with companies now to negotiate satisfactory settlements.

In fact, only one proposal was filed this year, asking Sprint to get shareholder approval of any repricing plan. Most popular actions by companies involve restricted stock awards, option exchange programs, and canceling underwater options to later issue new ones.

Indeed, the pickup in repricing activity in 2001 is substantial, according to The Investor Responsibility Research Center. IRRC scrutinizes 10-Q reports, proxy statements, and 10-year option repricing tables to discover the companies taking actions. In 2000, some 31 companies did some form of repricing, says Drew Hambly, senior research analyst at IRRC. In contract, the number has nearly doubled to 59 companies so far this year, he reports.

Of these, 20 were out-and-out repricing of underwater options, while 39 involved restricted stock or cancellation followed six months and a day later by the issuing of new options as a way to circumvent the new Financial Accounting Standards Board (FASB) rule involving variable accounting.

What Some Companies Did

At least a half-dozen companies asked their shareholders this year to approve restricted stock grants, including Coca-Cola. Restricted stock doesn't have a stated/or minimal exercise price, which essentially enables the owner to be compensated even when the price doesn't rise. Holders also have voting rights and receive dividends. IRRC expects restricted stock to grow as an incentive pay tool.

Union Planters, according to IRRC, allowed about 185 executives to exchange their underwater options for restricted stock with a fair market value equal to the present value of the surrendered options.

Several companies have chosen to cancel underwater options, wait six months and one day, and then issue new options as a way around variable accounting treatment. One such company is Colonial Bancorp, IRRC reports. It canceled options carrying an exercise price above $13 a share, granting new options. IRRC says that close to all the 866,000 options eligible under the exchange program were surrendered by employees.

Hartmarx got over 80% shareholder approval to an option surrender program involving 1.6 million shares. No promise of future stock awards was made, and the company indicated that it would not grant any options before the six months and a day period was up, avoiding the variable accounting rules, IRRC says.

As part of its turnaround plan, Priceline.com allowed employees to surrender nearly 8.5 million underwater stock options. The company canceled the shares to free up a sufficient number for future grants. IRRC says the firm "committed to issue" some 4.6 million new options six months and a day after the cancellation.

IRRC's Hambly says that institutions will be "far from thrilled" about the pickup in activity once they realize the extent it grew in 2001. He believes that institutions didn't file resolutions this year because of the low number of companies repricing in 2000. With the number like to be more than doubled once companies report their actions in 10-Q reports due August 15, institutions will probably become more aggressive in their activism, according to Hambly.

To avoid SEC issues and take advantage of the newley granted exemptive order, companies repricing options by implementing option exchanges will have to **comply** with the issuer tender offer rules.

the company will incur a fixed compensation expense, taken over the vesting period of the restricted stock, based on the difference between the stock price on the date of grant and any purchase price paid.

- Companies may implement option exchanges, provided employees agree to surrender their underwater options today and the company agrees to grant them new options in six months and one day at a new exercise price. The new options should not be subject to variable accounting. This is the approach taken by many companies, including Ariba, Commerce One, FutureLink, i2 Technologies, Lante, TIBCO Software, and Wireless Facilities.

When Repricings Become Tender Offers

Does exchanging options or issuing new ones constitute a tender offer? If so, it is subject to the issuer tender offer rules under Section 13(e) of the Securities Exchange Act of 1934, as amended, and all related substantive and procedural rules. A Schedule TO, requiring disclosure about the company and offering, must be filed with the Securities and Exchange Commission simultaneously with the offering's commencement. Once filed, the SEC may elect to review the TO, and the offer must remain open for at least 20 business days. Satisfying the tender offer rules is time-consuming and burdensome, and does not fit the compensatory purposes of an option exchange.

Before the SEC officially weighted in on this issue, companies reached opposite conclusions as to whether their option exchanges constituted issuer tender offers. An eight-factor test set forth in Wellman v. Dickson, 475 F. Supp. 783 (S.D.N.Y. 1979), which focuses primarily on whether stockholders are pressured to tender their securities, is generally used to determine if a tender offer exists. However, this test is not particularly helpful in analyzing option exchanges, because it is designed to deal with typical tender offers made to public stockholders. In contrast to these typical tender offers, option exchanges are not intended to pressure stockholders to participate and are offered to a limited universe of stockholders, namely employees who hold options.

In addition, there is little threat of abusive practices surrounding option exchanges, and employees generally have greater access to information about the company in making their investment decisions. Nonetheless, some companies, including Lante Corporation and Amazon.com, Inc., concluded that their option exchanges were issuer tender offers subject to the tender offer rules. Other companies, including Sprint, apparently came to the opposite conclusion, determining that their option exchanges were not issuer tender offers.

The SEC has ruled on the debate, responding to several recent option exchanges and differing views on the question. Initially, the commission indicated informally to counsel of certain companies that their exchanges would likely constitute issuer tender offers, considering the large number of option holds that would be affected. In March 2001, when granting exemptive relief from two of the issuer tender offer rules (discussed below), the SEC stated explicitly that "these exchange offers as commonly structured are subject to the issuer tender offer rule."

Therefore, to avoid SEC issues and take advantage of the newly granted exemptive order, companies repricing options by implementing option exchanges will have to comply with the issuer tender offer rules.

The SEC issued an order exempting option exchanges from two of the tender offer rules — the "all holders" and "best price" rules [Rules 13e-4(f)(8)(i) and (ii)]. In its finding, the SEC stated that option exchanges do not present the concerns regarding discriminatory treatment that these rules were meant to address. Indeed, according to the commission, the all holders and best price rules would most interfere with option exchanges as companies typically desire to structure them.

The all holders rule requires that a tender offer be open to all holders of a particular class of securities. In the context of an exchange, the all holders rule would prohibit a company from excluding directors or executive officers from its option exchange, even if the company believes those persons should be held accountable for the fall in the stock price precipitating the need for the exchange.

The best price rule prohibits a company from offering different consideration to different securities holders. In the context of an exchange, the best price rule would prohibit a company from issuing one employee new options with an exercise price of $3 per share and another employee new options with an exercise price of $5 per share, even if the options surrendered for cancellation by these employees had different exercise prices.

Through the SEC's exemptive order, these limitations are eliminated, allowing companies to structure their option exchanges in ways consistent with their compensation policies and practices so long as certain other requirements are met. The order and an explanation of the exemption can be found at www.sec.gov/divisions/corpfin/repricings.htm.

Companies implementing option repricings should carefully consider these stockholder concerns, accounting considerations, and securities laws issues in structuring their repricings. SV

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