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February 9, 2009

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NEWSLETTER OF THE TAX LAW PRACTICE OF MANATT, PHELPS & PHILLIPS, LLP

The Re-Emergence of Stock Option Repricing

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Introduction

As the equities markets continue to deteriorate, companies are taking proactive measures to put some value back into management and employee stock options made worthless by the recent declines in their share prices. These so-called "underwater options" are afflicted with an exercise price that is, in many cases, vastly in excess of the underlying stock's current fair market value. One potentially effective solution to this problem is to reprice the options by lowering the exercise price. However, the rules governing option repricing have changed since the last significant wave of repricings in 2001-2002, and companies must now be mindful of the new regulatory environment to properly effect an option repricing.

The New Model for Repricing: The Value-for-Value Exchange

In the past, traditional option repricing was relatively straightforward. A company basically lowered the exercise price of its underwater options to the then prevailing market price of its common stock. Today, the preferred alternative to the one-for-one exchange, known as the "value-for-value exchange," has become the most acceptable method of repricing for the reasons described below.

A value-for-value exchange works as follows: the optionee is offered the opportunity to cancel his or her underwater options in exchange for the grant of new options or other equity, at a ratio of less than one-for-one, with an exercise price equal to the market price of such shares. If accepted, the optionee would hold a lesser total number of options, but such options would bear an exercise price at the then fair market value of the company's underlying common stock.

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Because the value-for-value exchange is less dilutive and generally does not result in any additional compensation expense, it is more acceptable than a one-for-one exchange and therefore more likely to gain approval from shareholders and proxy advisors. Under Financial Accounting Standard No. 123R ("FAS 123R"), the accounting cost of a repricing is measured by the difference between the options issued after the repricing and the value of the options relinquished immediately before the repricing. This "incremental" cost is then amortized over the remaining vesting period.

Regulatory and Related Considerations

A. Applicable Accounting Rules

Until fairly recently, unfavorable accounting treatment resulted if the cancellation and repricing of options occurred within six months of each other. With the adoption of FAS 123R in 2005, the six-month look-back/look-forward period is no longer of concern when repricing options. Under the new accounting rules, companies are no longer subject to variable accounting treatment for repriced options and, therefore, are not required to wait six months and a day to replace cancelled options in order to avoid unfavorable accounting treatment. Instead, FAS 123R applies the "fair value" method of accounting to repriced options and treats a cancellation of an award accompanied by the concurrent grant of a replacement award as a "modification." As a result, companies must recognize a cost on their books equal to the incremental cost resulting from the repricing. This incremental cost fixes at the time of the repricing and is amortized over the remaining vesting period. By way of example, if the aggregate Black-Scholes fair value of outstanding options is equal to the fair value of the options received, as is the case in a value-for-value exchange (even though the exercise price may change with respect to a lesser number of shares exercisable), there will be no incremental accounting charge to the company under generally accepted accounting principles.

In sum, the new accounting rules should make option repricing substantially easier to effect.

B. Obtaining Shareholder Approval

Generally, publicly traded companies must seek shareholder approval to complete a value-for-value exchange. The NYSE and Nasdaq have adopted rules requiring shareholder approval for any material amendment to an equity incentive plan. Thus, for NYSE or Nasdaq-listed companies, unless the equity incentive plan under which the relevant options were issued expressly permits the company to reprice its outstanding option grants, the company will be required to obtain shareholder approval of the proposed repricing.

Additionally, leading proxy advisors, most notably, Riskmetrics Group ("RMG," formerly known as "Institutional Shareholder Services" or "ISS") have taken a firm stance on option repricing. In its 2009 policy updates, RMG explicitly states that it will recommend voting against an equity incentive plan if the plan permits repricing of stock options without prior shareholder approval. With respect to determining which repricing proposals submitted to shareholders it would likely support, RMG states that all proposals will be evaluated on a case-by-case basis, subject to certain minimum requirements. Those minimum requirements include (i) 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), (ii) repricing rationale (the stock price decline should be beyond management's control), (iii) a value-for-value exchange (as opposed to a one-for-one exchange), (iv) share replenishment, (vi) term of replacement option (must be substantially similar), (vii) exercise price (must be fair market value), and (viii) participation (executive officers and directors should, in most cases, be excluded). Finally, in its 2009 policy update, RMG notes that it would not view market deterioration, in and of itself, as an acceptable rationale for companies to reprice stock options or reset goals under an equity incentive plan.

To maximize the likelihood of gaining shareholder approval, companies should be mindful of RMG's minimum requirements and design their option repricing proposals accordingly.

C. Applicable Federal Income Tax Considerations

There are a handful of federal income tax considerations with respect to repricing options. Such considerations are summarized briefly, as follows:

i. *Incentive Stock Options*

If the repriced options are incentive stock options ("ISOs") the repricing will be treated as a grant of a new ISO and the concomitant rules governing ISO grants will apply. As a result, the disqualifying disposition holding period also will restart the date the option is repriced.

It should be noted that the IRS has taken the position that an offer to exchange an option that is open less than 30 days is not, in itself, a "modification" of an option. As a result, voluntary repricing programs involving ISO holders should run less than 30 days to avoid tainting the ISO status of any nonparticipating options.

ii. *Code Section 409A*

To the extent that the repricing occurs with respect to nonqualified stock options, Section 409A of the Internal Revenue Code (the "Code") is potentially implicated. However, the final regulations under Code Section 409A make clear that a reduction in option price that is not below the fair market value of the underlying stock value on the date of repricing should not cause the option to become subject to Code Section 409A. Instead, such repricing is treated as an award of a new option that is otherwise exempt from Code Section 409A.

iii. *Code Section 162(m)*

Under Code Section 162(m), which generally caps the deduction of certain executive compensation to $1 million unless the compensation is performance-based, options are generally considered performance-based compensation if they are granted pursuant to a shareholder-approved equity incentive plan and they are granted with an exercise price not less than the fair market value of the underlying stock on the date of the grant. A repriced option will not be considered "performance-based" for purposes of Code Section 162(m) because the repricing is deemed a new grant with an excercise price less than fair market value.

D. Applicable Securities Law Requirements

A repricing is likely to trigger the tender offer rules under the Securities Exchange Act of 1934, which apply when a holder of a security is required to make an investment decision in connection with a purchase, modification, or exchange of such security. In the context of an option repricing, the tender offer rules will be implicated by a value-for-value exchange where the option holder is required to decide whether to accept fewer options or a reduction in the exercise price of an incentive stock option (the latter is considered a "modification" resulting in a new equity grant for federal income tax purposes).

Conclusion

A wave of option repricing appears to be looming in light of current adverse market conditions. Companies are strongly urged to consider a value-for-value exchange as part of their ongoing equity incentive plans. Several notable public companies have successfully repriced underwater options in such a manner, but only after co-opting the support of shareholders and complying with current securities, tax, and accounting rules. It is recommended that companies in the process of issuing proxies contact their legal advisors to explore appropriate repricing strategies.

Should you have any questions concerning option repricing strategy or implementation, please do not hesitate to contact a corporate, tax, or executive compensation professional at Manatt, Phelps & Phillips, LLP.

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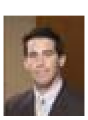

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