TroyGould ATTORNEYS

Client Alert

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STOCK OPTION REPRICINGS – CERTAIN CONSIDERATIONS

The sharp decline in stock prices in 2008 led to a wave of stock option repricings by many publicly held companies. As stock prices have continued their slide into 2009, a second wave of repricings seems to be upon us. The *Los Angeles Times* reported recently that more repricings were undertaken in January 2009, alone, than in all of 2007. At this pace, repricings in 2009 will exceed the level in 2008.

Repricing stock options may become necessary or advisable when a company's outstanding stock options are "underwater"; that is, when the exercise prices of the stock options exceeds the market price of the underlying stock. When this occurs, the stock options may no longer afford employees and others who hold the company's stock options sufficient incentive to remain with the company and to work hard to increase the market price of the stock. "Repricing" generally refers to a reduction of the exercise prices of outstanding stock options, either by means of an amendment to the exercise price (and perhaps other terms) of the outstanding stock options or by an exchange of new, lower-priced options for the outstanding, underwater options.

However repricings are accomplished, they present some important legal and other considerations, some of which are discussed below:

Stockholder Approval
Repricings can be authorized by action of the company's Board of Directors, or by the committee that administered the stock option plan, alone, without stockholder approval, if the applicable stock option plan so provides. In this regard, however, the NYSE and Nasdaq interpret their listing standards to require stockholder approval of an option repricing unless the stock option plan under which the underwater options were originally granted *specifically* authorizes the company to reprice outstanding options. *A plan provision authorizing amendments to the plan, generally, or modifications of the terms of outstanding options, will not suffice.*

The NYSE and Nasdaq listing standards require stockholder approval of all "material" stock option plan amendments, which includes any change to the plan to permit a repricing or any decrease in the exercise price of outstanding options. The NYSE and Nasdaq define "repricing" to include (i) lowering the exercise price of an option after it is granted; (ii) canceling an option at a time when its exercise price exceeds the fair market value of the stock underlying the option, in exchange for another option or other equity interest (except in connection with a merger, acquisition or under similar corporate transaction), as well as any other action that is treated as a repricing under generally accepted accounting principles.

As a consequence of these listing requirements, many NYSE-listed and Nasdaq-listed companies will be required to obtain stockholder approval of any repricing program. For example, Starbucks' recently announced option repricing program will require the approval of its stockholders. On the other hand, Google's recent option repricing did not require stockholder approval, because Google's option plan expressly contemplated the possibility of repricings.

There is no rule or regulation barring or restricting a company's directors or executive officers from participating in an option repricing, but directors and executive officers are sometimes excluded by companies out of concern for the stockholder voting guidelines of proxy advisors and possible adverse reaction of institutional stockholders. These concerns are not so prevalent among smaller public companies, however, and even at many large public companies directors and executive officers may hold a large amount of options, so it may not be feasible to exclude them altogether.

Tender Offer Rules

The SEC's tender offer rules are implicated whenever the holders of a company's outstanding equity securities, which includes stock options, must make an investment decision with respect to the purchase, modification or exchange of their securities. Unilateral action by a company to merely reduce the exercise price of outstanding stock options would not involve any investment decision on the part of the option holders, and so would not implicate the SEC's tender offer rules. As a practical matter, however, repricings usually are accompanied by other changes in the terms of the outstanding options, such as surrendering more stock options than are received in return and adding or extending vesting requirements of the options, which cannot be accomplished without the agreement or consent of the option holders.

Under the SEC's tender offer rules, a repricing that requires the consent of the option holders generally will constitute a "self-tender offer" by the company of the options involved. Among other things, the SEC's tender offer rules strictly regulate the company's correspondence and other communications relating to the repricing. The tender offer rules also regulate the form and content of the written offer made to option holders and require the filing with the SEC of a Schedule TO Tender Offer Statement. The SEC, however, has adopted some exceptions to its usual tender offer rules in the option repricing context. It is important to note in this regard that the SEC's tender offer rules in Regulation 14E apply to *all* tender offers, even those made by private companies.

Certain Tax Matters

For U.S. federal income tax purposes, the repricing of so-called incentive stock options, or ISOs, will be deemed to constitute the grant of a new option on the repriced terms. As such, the repricing will restart the holding periods for ISO treatment (stock purchased under the option must be held for two years from the option grant and one year from the option exercise). The repricing also will require an analysis of the $100,000 limit on the maximum fair market value of stock as to which ISOs may first become exercisable in any year.

If the repricing involves nonqualified stock options, the new price of the options must be not less than the fair market value of the underlying stock on the date of the repricing in order to avoid running afoul of the deferred compensation rules under Section 409A of the I.R.C.

Exchange Act Section 16

An option repricing generally will involve a disposition of the repriced option and an acquisition of a new option for purposes of the reporting requirements under Section 16 of the Securities Exchange Act of 1934 applicable to directors, officers and 10 percent or more beneficial owners of public companies. (For an option holder who is a 10 percent or more beneficial owner, a repricing also may require an amendment to the option holder's Schedule 13G or 13D.) Normally, however, any disposition of the repriced option and acquisition of a new option will be exempt from short-swing trading liability under Section 16(b) of the Exchange Act, because the repricing transaction will have been approved in advance by the company's board of directors or an appropriate board committee.

Accounting Matters

It is important to review and understand in advance the financial accounting treatment of a proposed option repricing. For example, where the repricing will be subject to approval by the company's stockholders, the repricing generally is deemed to occur for financial accounting purposes when the requisite stockholder approval has been obtained rather than the earlier date when the repricing was authorized by the company's board of directors. Since the stock price at the time of shareholder approval is likely to be different than the price at the time of the prior board approval, the company will not be able to know in advance the exact accounting impact of the repricing.

Proxy Advisors and Institutional Shareholders

If an option repricing will require stockholder approval, the company must consider structuring the repricing in order to optimize the chances of obtaining the necessary approval. Before undertaking to reprice options, therefore, many companies will want to consult a compensation consultant and consider the effects of institutional stockholder guidelines on approval of repricings.