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To Cash Out, Or Not To Cash Out: That Is The Question

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When a company is acquired in an all-cash merger, it is commonplace to cancel the stock options granted to employees. In consideration, the holders of the stock options receive the "intrinsic value" of the options, which is equal to the excess, if any, of the per-share cash consideration paid to the company's stockholders in the merger less the per-share exercise price of an individual option. As a result, those who hold an option that has a per-share exercise price greater than the per-share cash consideration, a so-called "out-of-the-money" option, will receive no consideration in exchange for the option's cancellation.

Many stock option plans permit this treatment of options in an all-cash merger. Typically the plan allows the company's board of directors or the compensation committee to adjust options in connection with capital events or mergers. However, the language in some plans regarding the treatment of stock options in this situation is ambiguous, while other plans expressly prohibit such treatment. In such a situation, cancellation may be properly achieved by obtaining the consent of the option holder.

In *Lillis v. AT&T*, the Delaware Chancery Court took a narrow view on the ability to cancel out-of-the-money options by stating that cancellation depends on the specific language of governing stock option plan and ambiguous language will not be interpreted against the holders of stock options.

In the *Lillis* case, the stock option plan provision at the center of the controversy stated that in the event of a merger, the terms of the options "shall be appropriately adjusted . . . provided that each Participant's economic position with respect to the Award shall not, as result of such adjustment,

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be worse than it had been immediately prior to such event." The court found that such language was a "mandatory adjustment provision" that required the options to be adjusted to preserve the options' economic position. The court determined that the term "economic position" referred to the "true economic value" of the options as compared to their intrinsic value. Notwithstanding the fact that the options had a negative intrinsic value, the court concluded that the economic value of the option included a component relating to time value. As a result, the court awarded the option holders the Black-Scholes value of their options immediately prior to the merger.

In addition, the court made clear that the ability of a company to cancel stock options in a corporate transaction must be determined by the express language in the contract under which the option was granted, usually a stock option, or other equity incentive plan. The court also stated that as a general rule, adjustment provisions in stock option plans are interpreted to permit the adjustment of options into the right to receive the difference between the per-share merge consideration and the per-share exercise price of the options, which in turn would permit the cancellation of out-of-the-money options for no consideration.

Unfortunately, the disputed provision in the *Lillis* case was ambiguous and poorly drafted. This enabled the court to interpret the provision as requiring an adjustment to the options and a guarantee to option holders of the true economic value of their options rather than their intrinsic value.

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