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JUNE 6, 2011

The Treatment of Stock Options in the Context of a Merger or Acquisition Transaction

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A principal issue in merger and acquisition transactions is whether, and to what extent, outstanding options will survive the completion of the transaction and whether and when the vesting of options will be accelerated. It is critical for a properly drafted equity incentive plan to include clear, unambiguous provisions for the treatment of outstanding awards in connection with these types of transactions, which include a company's consolidation with or acquisition by another entity in a merger or consolidation, or a sale of all or substantially all of a company's assets (hereinafter referred to as a "Corporate Transaction").

Whether a change of control of a company should provide for accelerated vesting is a business decision and a separate and distinct issue from the impact the Corporate Transaction will have on the outstanding options. Equity incentives have significant implications in the negotiation of a Corporate Transaction, as their treatment can affect the value of the Corporate Transaction and the consideration to be received by stockholders.

Corporate Transactions

To avoid unintended consequences and unwelcome constraints in the negotiation of a Corporate Transaction, equity incentive plans should provide the maximum flexibility for a company to equitably adjust awards under its plan and should permit a company's board of directors in its discretion to determine at the time of the Corporate Transaction whether outstanding options should be (1) assumed or substituted by the acquirer, (2) cancelled at the time of the acquisition if not previously exercised, or (3) cashed out in exchange for a cash payment equal to the difference between the exercise price of the option and the price per share of the underlying stock to be received in the Corporate Transaction. In a well drafted plan, options do not need to be treated uniformly. For example, in a cash transaction it would be most desirable to cancel "out of the money" options for no consideration and provide for a cash payment for "in the money" options.

Assumption vs. Substitution

An acquirer may want to assume the target company's options instead of substituting them to avoid depleting the acquirer's existing equity incentive plan pool and to avoid inadvertent modifications to the awards that would convert an option intended to qualify as an incentive stock option into a nonqualified stock option or cause application of Section 409A of the Internal Revenue Code of 1986 (the "Internal Revenue Code"). In addition, if the acquirer is a public company, subject to certain limits and rules, the stock exchanges permit the issuance of shares remaining under the target company's assumed plan pool without additional shareholder approval.

In contrast, an acquirer may decide to substitute instead of assume the target company's options because the acquirer wants all of its options to have uniform terms and conditions, assuming this can be done without the optionee's consent and under applicable provisions of the Internal Revenue Code. In addition, if the acquirer is a public company, the acquirer will not have to register the shares underlying the substituted options under the securities laws because a registration statement would already be in effect, which is not the case with respect to assumed options.

Cancellation

An acquirer may not want to assume the options because their terms or the depth to which the company grants options within its workforce may be inconsistent with its compensation culture. If the acquirer is not paying cash for the underlying stock in the Corporate Transaction, it may be unwilling to cash out the stock options. Therefore, the plan must provide the flexibility to terminate options in order for the target company to satisfy the acquirer's position as how to best compensate the target company's employees going forward, which may or may not include the use of options. In a cancellation, the optionees are provided the opportunity to exercise their vested options up until the time of the Corporate Transaction. In addition, in recent years as underwater stock options have become more prevalent, the ability to cancel underwater options unilaterally—and avoid post-closing dilution and compensation income expense to the acquirer—has allowed the target company to reallocate, among its stockholders and employees, the "cost" of these options in a Corporate Transaction in a more productive manner.

Cash Out

Cashing out options provides similar benefits to an acquirer as terminating options does, including no post-closing administration, compensation expense, or increased potential dilution. It provides a simple way for employees to receive cash for their equity without having to first go out-of-pocket to fund the exercise price. It simplifies the administrative and tax reporting process of the option exercise, as the optionee will receive a cash payment and the company does not have to go through the stock issuance procedure. Private company option holders favor cashing out because it finally provides optionees with liquidity without having to make an investment.

Acceleration of Vesting upon a Change of Control

A separate issue that must be assessed, at either the time of the option grant or at the time of the Corporate Transaction, is whether the vesting of any options should be accelerated if the Corporate Transaction also constitutes or results in a change of control of the company. Acceleration provisions may be set forth in the equity incentive plan or other agreements outside of the plan, such as the agreement evidencing the award, employment agreements, or severance and retention agreements. Generally, change of control acceleration is in the form of either a "single trigger" or a "double trigger." Some plans and arrangements contain a hybrid of the single and double trigger approach, such as providing for the partial vesting of awards upon a change of control event, with additional vesting if a second triggering event occurs; or vesting that depends upon the treatment of the options in the Corporate Transaction, such as providing for accelerated vesting only in the event that awards are not assumed by the acquirer, since the optionee will no longer have the opportunity post-transaction to continue to earn the option through vesting, even if he or she remains employed.

Single Trigger

Under a single trigger provision, the vesting of options is accelerated and awards become exercisable immediately prior to a change of control.

Advantages

- Aligns the interests of option holders and stockholders by allowing the option holders to share in the value they have created
- Provides for equitable treatment of all employees, regardless of their length of employment (assuming all options are fully accelerated)

- Provides for a built-in retention award, allowing the target company to deliver an intact management team to the acquirer, which can eliminate the need for a cash retention arrangement through the date of a Corporate Transaction
- No affect on earnings as vested equity awards are treated as an expense of the target company
- Beneficial when acquirer is going to terminate the existing equity plan or will not be assuming or substituting the unvested options

Disadvantages

- Can be viewed as a windfall for option holders who will be terminated by the acquirer or who were recently employed by the target company
- No retention or motivational value after the change of control
- Will require the acquirer to issue its own equity post-transaction to newly incentivize employees of the target company
- The payment in respect of the acceleration will be taken from the consideration that would otherwise go to the stockholders of the target company
- The acquirer must deal with the fact that its acquired workforce has fully vested equity awards, while its pre-existing employees do not, which may present integration issues
- Viewed negatively by stockholders and investors, and specifically by governance groups, as a problematic pay practice

Double Trigger

Under a double trigger provision, the vesting of awards accelerates only if two events occur. First, a change of control must occur. Second, the option holder's employment must be terminated by the acquirer without "cause" or the optionee leaves the acquirer for "good reason" within a specified period of time following the change of control.

Advantages

- Aligns option holder and stockholder interests more fully
- Provides a key retention tool for senior executives who are instrumental to the integration process
- Alleviates the need for additional retention incentives by the acquirer in the form of cash or additional equity
- Provides protection for the option holder in the event of termination of employment due to a change of control
- Viewed by corporate governance and stockholder advisory groups as the preferred approach to acceleration of vesting

Disadvantages

- Option holders, unlike stockholders, may not immediately share in any tangible increase in value of the company's stock (or the acquirer's stock)
- Loss of value if the unvested options are not assumed or substituted by the acquirer, since a double trigger is useless if awards are terminated at closing
- If the acceleration provides a substantial payment, it provides a disincentive for employees to be retained by the acquirer and a motivation for those who continue to be employed to be

asked to leave the acquirer

Steps to Consider

In preparation for the negotiation of a Corporate Transaction, companies should consider taking the following steps:

1. Review the company's existing equity incentive plans to determine and understand what ability (or lack of ability) the company has to determine the treatment of its stock options and other awards in connection with a Corporate Transaction, and consider whether the plan or agreement can be amended to fix problem grants.
2. Confirm that the company's existing equity incentive plans expressly and unambiguously permit without the optionee's consent the assumption, termination, and cash out of options, including the cancellation of underwater options without consideration.
3. Review any and all agreements containing change of control provisions to ensure that the provision governing the treatment of the award in a Corporate Transaction and change of control protection (if any) are consistent.
4. Periodically review the equity incentive plans and forms of agreement in light of continuing changes in the law and market practices in compensation arrangements and corporate transactions.

If you have any questions about this alert, please contact the authors or your Mintz Levin attorney.

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1170-0511-NAT-COR