

February 19, 2009

## Underwater Options: Practical Guidance

As the market continues to flounder, stock prices underlying options for many companies have fallen far below their strike prices, effectively blocking employees from realizing the value of their equity compensation. As of mid-December 2008, 72% of Fortune 500 companies were facing the problem of underwater options, a significant jump from the already discouraging 40% estimated by Financial Week in August 2008.<sup>1</sup> This decline in the value of options threatens to compromise the incentive and employee retention that such equity compensation is intended to generate.

In order to revive wilting options, many companies are planning for option repricings and/or exchanges. In January 2009 alone, more companies have offered to exchange or reprice stock options than in all of 2007.<sup>2</sup> Compared to 58 companies in 2008, 18 companies have already announced option exchanges or repricings this year.<sup>3</sup> Both Google Inc., with nearly 17,000 employees holding more than 8 million underwater stock options,<sup>4</sup> and Starbucks Corp. recently unveiled plans to allow their employees to swap underwater options for new

ones with exercise prices reflecting the current lower stock price.

This Client Alert briefly summarizes several methods for dealing with underwater options, including repricings and exchanges, and evaluates them in light of market conditions, securities exchange regulations and other practical considerations.

### Potential Methods for Addressing Underwater Options

#### *Repricing*

In a repricing, a company will reduce the per share exercise price of existing options to the fair market value (“*FMV*”) of the underlying shares as of the date of the repricing. This is essentially equivalent to the cancellation of the outstanding options followed by the issuance of replacement options. While this offers a fix for outstanding options with unattainable strike prices, it is not quick and may not endure. Under certain circumstances, both the New York Stock Exchange (“*NYSE*”) and Nasdaq rules require shareholder approval for repricings (discussed below). In addition, given current market conditions, a company that opts for a repricing risks having the repriced options end up underwater again. Repricing underwater options at the current FMV of a company's stock is only a valuable endeavor insofar as the company's stock has hit bottom. Should the price of a company's stock drop below the new exercise price, the company and its option holders will have gained little from the repricing.

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<sup>1</sup> See Michael Liedtke, "Gadgets and Tech: Others could follow Google's move to reset options," *The San Francisco Examiner*, January 24, 2009. See also Mark Bruno, "Glub, glub, glub: 40% of options are underwater," *Financial Week*, August 25, 2008, available at <http://www.financialweek.com/apps/pbcs.dll/articles?AID=20080825/REG/860774>.

<sup>2</sup> Martin Zimmerman, "More companies to offer to reprice, exchange 'underwater' options," *Los Angeles Times*, January 24, 2009.

<sup>3</sup> *Id.*

<sup>4</sup> See Liedtke.

### *Disclosed Backdating*

As mentioned above, repricing options can be problematic as the stock price may decline further, causing replacement options to go underwater again, and any follow-up repricing will likely require shareholder approval. One possible way for a company to avoid chasing its declining stock price with multiple repricings is for a company to commit to its employees that it will grant options at the average stock price over a prior period (*i.e.*, the meltdown) once the market begins to recover.<sup>5</sup> However, this method would likely require a shareholder approved amendment to most option plans, which typically provide for exercise prices based on the date of grant, and proxy disclosure would be problematic if named executive officers (“*NEOs*”) were included. In addition, the FAS 123(R) charge would include the value of the discount. Moreover, these would be discounted options for purposes of Internal Revenue Code Section 409A with the related adverse tax consequences, as well as for ISO purposes.

### *Exchange*

Companies seeking to reprice options may also undertake an “option-for-option” or a “value-for-value” exchange. In an option-for-option exchange, a company offers to exchange underwater options for the same number of replacement options with a lower strike price. Google, for example, has opted for a one-for-one option exchange with a delayed vesting date. In a value-for-value exchange, such as Starbucks has proposed, option holders may elect to cancel underwater options in exchange for a re-grant of new options at a ratio of less than one-for-one and with a lower exercise price. While a value-

for-value exchange may be an easier pill for shareholders to swallow in the short term as it simply equalizes the fair value of the options by exchanging them for a smaller number of options with a FMV exercise price, a one-for-one exchange for options with a delayed vesting date, like Google's exchange, may prove to be more valuable in the long run as it may increase employee retention. A company may also choose to exchange outstanding underwater options for shares of restricted stock or restricted stock units (“*RSUs*”). Shareholder approval is required for an exchange for new options, restricted stock or RSUs where it would be required for a repricing. Compliance with the SEC's tender offer rules, discussed below, is also implicated.

### *Repurchase*

In a repurchase, a company will buy back options from option holders for cash at a price based on predetermined option pricing methodology. In a cash repurchase, it is unlikely that obtaining shareholder approval is necessary.

### *Change in Timing and/or Form of Future Grants*

A company faced with an underwater option problem may accelerate its 2009 grants of options so that the exercise price for the options is set earlier, at the current lower FMV of the underlying shares. This past December, following the exodus of several top executives, Liz Claiborne Inc. accelerated the grant date for a portion of its equity grants as “a show of uniform and unanimous support to motivate and retain.”<sup>6</sup> Rather than sticking with the single grants executives were to get in December

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<sup>5</sup> “A Suggested Alternative to Repricing Melted Down Stock Options,” *The Corporate Counsel*, November/December 2008, at 10.

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<sup>6</sup> Rachel Dodes and Joann S. Lublin, “Liz Claiborne Takes Steps to Retain Top Executives,” *The Wall Street Journal*, December 4, 2008, available at <http://online.wsj.com/article/SB122844510124682049>.

2009, Claiborne divided the '09 grant into four quarterly installments ending in September.

As an alternative to acceleration, a company may also choose to change future grants to grants of restricted stock or RSUs in lieu of options. Because restricted stock and RSUs have no strike price, they should always retain some value and the concern that repriced options will again fall underwater is eliminated.

### *Future-Pricing Options*

A company could elect to grant additional options now with an exercise price to be determined at some date in the future. This future pricing could also be done in tranches so that the exercise price for a given grant would be set on several different dates in the future for a certain portion of the total grant. While this approach would accommodate any further decline in share price and would result in less dilution, granting new options will deplete the pool of shares available under the company's plan and may prompt the criticism that the company is doubling up on equity compensation as the employees retain their existing, albeit underwater, options which could regain their value in the future. In addition, it could be perceived as providing a temporary negative incentive to keep the stock price low until the future grants are made.

## **General Considerations**

### *Shareholder Approval and Stock Exchange Regulations*

A significant obstacle to employing many of the above solutions for underwater options may be shareholder approval requirements. Both the NYSE and Nasdaq require that a listed company obtain advance approval from its shareholders for a repricing.

NYSE Listed Company Manual Rule 303A.08 states that "[a] plan that does not contain a provision that specially *permits* repricing of options will be considered for purposes of this listing standard as *prohibiting* repricing." In addition, the NYSE interprets the term "repricing" broadly as: (i) lowering the strike price of an option after it has been granted; (ii) any action treated as a repricing under US GAAP; or (iii) canceling an option at a time when its strike price exceeds the FMV of the underlying stock, in exchange for another option, restricted stock, or other equity, unless the cancellation and exchange occurs in connection with a merger, acquisition, spin-off or other similar corporate transaction. As such, a repricing may only be employed by a NYSE-listed company with a plan that explicitly permits it. Where it is not expressly permitted by the company's plan, the repricing or option exchange must be approved by the shareholders, even if the company offers to exchange the underwater options for restricted stock or RSUs.

Nasdaq Rule 4350(i)(1)(A) requires shareholder approval for any "material amendment" to a stock option plan. Included in the definition of "material amendment" is any material change to permit a repricing (or decrease in exercise price) of outstanding options. As with the NYSE rules, should the plan explicitly permit a repricing without shareholder approval, no shareholder approval will be required. Of Starbucks and Google, for example, both of which are Nasdaq-listed companies, only Starbucks has put its proposed exchange program to a shareholder vote.<sup>7</sup> According to

<sup>7</sup> Under the terms of the 2005 Long-Term Equity Incentive Plan of Starbucks Corp., shareholder approval is required to reprice outstanding options. "Reprice" is defined as the adjustment or amendment of the exercise price of options previously awarded whether through amendment, cancellation, replacement of grants or any other means. Starbucks Corp., Quarterly Report (Form 10-Q), Exhibit 10.1 (2/10/2006).

Google Inc.'s 2004 Stock Plan, the company is permitted to initiate an exchange program without the approval of its shareholders.

Voluntarily requesting shareholder approval for a repricing when it is not explicitly required may still be strategically advantageous. Shareholders may hold management (and employee option holders) partially responsible for the loss they suffered when the stock price dropped. Any action taken to recoup the value of underwater options may be viewed as an undeserved reward for poor performance as shareholders do not get a "do-over." In addition, an option exchange may drive the stock price even lower if it sends a message to the market that the company doubts that the stock price will rebound to where it was when the options were granted. Ultimately, mere compliance with exchange rules may not be enough.

#### *Institutional Investor Firms*

In a statement released in November 2008, the Council of Institutional Investors ("CII") stressed that it remains strongly opposed to "bolstering executives' diminished pay packages by adjusting undervalued stock options [or] granting fresh dollops of stock."<sup>8</sup> Despite CII's unwavering stance, given the current economic environment, some proxy advisor firms like ISS Riskmetrics have become more amenable to repricings and option exchanges on a case-by-case basis. However, these firms still emphasize that launching such programs should not be taken lightly and should exclude NEOs or at least limit their participation.

In addition, in its 2008 guidelines, ISS Riskmetrics asserts that, in addition to excluding NEOs, an acceptable options exchange program

should limit the eligibility of options for exchange. More specifically, ISS stresses that in order to be eligible for exchange, options must (i) be more than one-year old and (ii) have an exercise price at or above the 52-week high trading price of the exchanging company's stock, measured from the start date of the exchange program. Starbucks' proposed option exchange program has limited option eligibility in accordance with these ISS requirements, likely in hopes of garnering support for the program come its shareholders' meeting.

#### *Tender Offer Requirements*

As most option exchanges are voluntary, they require participants to make an investment decision that triggers the SEC's tender offer rules. The tender offer rules require that the exchanging company, among other things, (i) keep the offer open for at least 20 days, (ii) issue a formal offer of exchange and (iii) issue a letter of transmittal for option holders to use to tender their options. The company must also file a Schedule TO with the SEC before the offer is launched, which must include items (ii) and (iii) above as well as any materials used to communicate with employees regarding the exchange. Following the exchange, the company must file an amendment to the Schedule TO disclosing the total number of options exchanged in the tender offer. The tender offer requirements necessitate advance planning and will result in additional expense.

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<sup>8</sup> Council of Institutional Investors Statement on Executive Pay, November 25, 2008.

**Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:**

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