

## Bringing Underwater Stock Options Back to the Surface

Many companies saw their stock price significantly decline in 2008. As the result of these declines, employees of these companies may now hold stock options that are severely underwater—that is, the exercise price of the stock option exceeds the fair market value of the underlying stock.

These underwater stock options may create multiple problems for companies. For example, underwater stock options may not provide a meaningful retention tool or performance incentive for employees, as the value of the underlying stock may have to substantially increase before the stock options are “in the money.” In addition, allowing unvested underwater stock options to remain outstanding is a poor use of a company's resources, as the company must continue to recognize an accounting charge for stock options that likely provide no value to the company.

Historically, one solution that was widely used to deal with the problems caused by underwater stock options was to “reprice” the stock options. Repricing simply involves lowering the exercise price of the stock option, generally to equal the current fair market value of the underlying stock. However, because of changes to accounting and stock exchanges rules as well as increased scrutiny from proxy advisory firms, repricing underwater stock options is no longer a viable alternative for most public companies. Instead, many companies are now offering their employees the chance to exchange their underwater stock options for other forms of consideration, such as new stock options, restricted stock, restricted stock units (“RSUs”), or cash.

This update briefly describes underwater stock option exchanges as well as some of the hurdles that companies will face in implementing these exchanges.

### Underwater Stock Option Exchanges

#### Option-for-Option Exchanges

In an option-for-option exchange, an option holder will surrender his or her underwater stock options in exchange for new stock options. If this exchange is structured as a value-for-value exchange (i.e., an exchange in which the value of the consideration received by the option holder equals the value of the stock options surrendered), the option holder will always receive less stock options than he or she surrendered. Some surveys have shown that the exchange ratio in a value-for-value stock option exchange may be as high as 1:5 (that is, one new stock option is issued for every five stock options that are surrendered). Because the net result of such an exchange is a reduction in the number of outstanding stock options, the exchange will have the effect of improving the company's stock option “overhang”—a measurement used to determine the dilutive effect of stock options that is calculated by expressing the sum of the number of stock options granted

and the number of stock options available for future grant as a percentage of total outstanding shares.

### Option-for-RSU and Option-for-Restricted Stock Exchanges

In option-for-RSU and option-for-restricted stock exchanges, an option holder will surrender his or her underwater stock options in exchange for RSUs or shares of restricted stock. Because the value of both RSUs and shares of restricted stock is based solely on the company's stock price, and not on the appreciation in its stock price after the grant date, there will never be a future underwater equity problem with respect to the newly granted RSUs or shares of restricted stock if the company's stock price declines following the exchange, as there may be in an option-for-option exchange. An additional advantage of these exchanges is that no cash outlay is needed to acquire RSUs or shares of restricted stock, as is the case when exercising stock options.

Because RSUs and shares of restricted stock are taxed immediately upon vesting—unlike stock options, which are generally not taxed until they are exercised—a recipient of RSUs or shares of restricted stock generally does not have the ability to control when the value of his or her new equity will be taxed. However, if restricted stock is received in an option exchange, the recipient may make an election under section 83(b) of the Internal Revenue Code to immediately be taxed on the difference between the value of the restricted stock and the amount actually paid for such restricted stock.

### Option-for-Cash Exchanges

In an option-for-cash exchange, an option holder will surrender his or her underwater stock options in exchange for cash. An option-for-cash exchange has the advantage of providing option holders with immediately realizable value for their underwater stock options, unlike an option-for-option exchange. However, unless the cash payment received in the exchange is subject to a clawback in the event of a termination of employment within a certain period of time following the exchange, an option-for-cash exchange will not have any retention value. In addition, an option-for-cash exchange does not align the interests of the option holders with those of the company's shareholders, as the option holders are being "cashed out" with respect to all or a portion of their stake in the company.

## Shareholder Approval

Option-for-equity exchanges are considered to be a "repricing" for purposes of NASDAQ and NYSE rules. Accordingly, shareholder approval of any such exchange is required unless the applicable equity plan explicitly permits repricing without shareholder approval. An option-for-cash exchange, on the other hand, is not considered to be a "repricing," and accordingly shareholder approval is not required by these securities exchanges. However, even where shareholder approval of an underwater stock option exchange may not be required, Institutional Shareholder Service ("ISS"), a leading proxy advisory firm, will recommend a no-vote or will withhold its vote for members of a public company's compensation committee if the company institutes an underwater stock option exchange without obtaining shareholder approval. ISS focuses on certain factors when recommending whether shareholders should approve an underwater stock option exchange. These factors include:

- **Proximity to a decline in stock value.** At a minimum, the exchange should occur twelve months after the decline in stock value.
- **Participants.** Executive officers and directors should be excluded from participating in the exchange program.
- **Grant date of exchanged stock options.** Only stock options that were granted at least two years prior to the exchange should be eligible for the exchange.
- **Exercise price.** The exercise price of new stock options should be equal to or greater than the fair market value of the stock, and the exercise price of surrendered stock options should be above the stock's highest price during the preceding 52 weeks.
- **Value.** The value of the consideration received in the exchange should be no greater than the value of the surrendered stock options.

ISS will also evaluate the intent, rationale, and timing of the exchange program, and will require a company's board of directors to clearly articulate why it has decided to implement the exchange program.

## Accounting Treatment and Stock Option Valuation

The accounting treatment of stock options is governed by FAS 123R. Under FAS 123R, a stock option is expensed over the service term associated with the stock option—that is, the company expenses the grant date value of the stock option over the stock option's vesting period. A stock option exchange is treated as a modification of the original stock option, rather than the grant of a new stock option. Accordingly, when a company grants a new equity award (e.g., a stock option, an RSU, or restricted stock) in exchange for the surrender of a stock option, the company is generally required to recognize the incremental compensation cost of the new equity award (i.e., the difference between the fair value of the new equity award over the fair value of the surrendered stock option measured as of the date of the exchange) over the vesting period of the new equity award. The company must also recognize any grant date value with respect to the surrendered stock options that has not been recognized as of the exchange.

In order to avoid recognizing additional accounting charges in an underwater stock option exchange, companies should structure the exchange as a value-for-value exchange—that is, the value of the consideration received in the exchange will equal the value of the stock options surrendered. Although such an exchange results in the option holder receiving consideration having an equivalent accounting value to his or her surrendered stock options, these exchanges provide real economic value to option holders, as they will receive either cash, full-value equity awards (i.e., awards that have a value equal to a share of the company's stock, such as RSUs and restricted stock), or new stock options that are not underwater.

To determine the value of a stock option, a company may use the Black Scholes option pricing method or any other generally accepted option pricing method. The Black Scholes method considers several variables in determining the value of a stock option, such as the price, volatility, and dividend rate of the underlying stock; the exercise price and expiration date of the stock option; and the risk-free interest rate. Because more than just the share price and the exercise price are considered in valuing stock options, even stock options that are severely underwater may have some exchange value.

## Tender Offer Requirements

An underwater stock option exchange must generally comply with the tender offer rules under the U.S. securities laws, regardless of whether the company is publicly traded or privately held. These rules require public companies to, among other things, make certain filings with the SEC. However, because of a special SEC exemption, eligible public companies are not required to permit all option holders to participate in the exchange (e.g., officers and directors may be excluded) or to provide each option holder with the highest consideration provided to other option holders, as is required in a typical public company tender offer. To be eligible for this exemption, certain requirements must be met. For example, the stock options surrendered and the equity received in the exchange must both be issued under an employee benefit plan, and the exchange must be for compensatory purposes. The tender offer rules also require that the exchange offer remain open for at least 20 business days.

The SEC has suggested that a stock option exchange made available to only a small group of executives will likely not be treated as a tender offer, but instead will be seen as individually negotiated offers. The SEC has not provided any guidance on the number of offerees that would be permitted to participate in the exchange before it would be considered a tender offer, but the SEC has stated that sophistication of the offerees is an element to consider.

## Miscellaneous Considerations

In addition to complying with the tender offer rules and structuring an underwater stock option exchange in a manner that increases the likelihood of receiving shareholder approval, there are other considerations that a company should take into account when designing an underwater stock option exchange program. These considerations include:

- Any consideration received in the exchange will be counted towards the Internal Revenue Code's limitation under Section 162(m) on the deductibility of executive compensation. This includes the "performance-based" compensation limit that restricts the number of awards that may be received during a specified period.
- Individuals who are subject to Section 16 of the Securities Exchange Act of 1934 ("Section 16") may have reporting obligations on both the

surrender of underwater stock options and the receipt of new equity. In addition, such transactions may be subject to the short-swing profit rules under Section 16, unless the exchange is approved by the company's board of directors, an independent committee, or the company's shareholders.

- Disclosure regarding the exchange may be required in the company's Compensation Discussion and Analysis section of its annual proxy statement.

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## Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at [www.dechert.com/employeebenefits](http://www.dechert.com/employeebenefits).

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