CHAPTER

7

Repricing Underwater Stock Options

Colin Diamond and Henrik Patel

Contents

7.1 Structuring Repricings 240
- 7.1.1 One-for-One Exchanges 240
- 7.1.2 Value-for-Value Exchanges 241
- 7.1.3 Use of Restricted Stock or RSUs 242
- 7.1.4 Repurchase of Underwater Options for Cash 243
- 7.1.5 Treatment of Directors and Officers 244
- 7.1.6 Key Repricing Terms 244

7.2 Shareholder Approval 245
- 7.2.1 NYSE and Nasdaq Requirements 245
- 7.2.2 Proxy Advisors and Institutional Investors 246
- 7.2.3 Treatment of Canceled Options 249
- 7.2.4 Proxy Solicitation Methodology 249

7.3 Tender Offer Rules 251
- 7.3.1 Application of the Tender Offer Rules 251
- 7.3.2 Requirements of the U.S. Tender Offer Rules 252

7.4 Certain Other Considerations 256
- 7.4.1 Tax Issues 256
- 7.4.2 Plan Grant Limitation 258
- 7.4.3 Accounting Treatment 258
- 7.4.4 Section 16 258

7.5 Foreign Private Issuers 259
- 7.5.1 Relief from Shareholder Approval Requirement 259
- 7.5.2 Relief from U.S. Tender Offer Rules 259

7.6 Alternative Strategies 260

7.7 Summary 262

AT THE HEIGHT of the last economic downturn, a significant number of publicly traded companies had underwater stock options. (A stock option is considered to be "underwater" when its exercise price is higher than the market price of the underlying stock.) For example, by mid-December 2008, 72% of Fortune 500 companies were reported to have underwater options.[1] Almost 100 companies repriced underwater options from 2008 through March 2009, including a number of high-profile companies, such as eBay, Google (now called Alphabet), Intel, Motorola, Starbucks, and Williams-Sonoma.[2] Between 2004 and 2009, there were a total of 264 stock option repricings announced.[3] As a result of that wave of repricings and improved market conditions, the specter of underwater stock options as a widespread problem has, at the moment, largely receded. For example, three option repricings were announced in 2014, seven option repricings were announced in 2015 and in 2016, and ten option repricings were announced through September of 2016.[4] Very few repricings were reported in 2017, although Fitbit implemented a stockholder-approved option exchange program in which eligible employees could exchange underwater stock options for RSUs.[5]

Indeed, Institutional Shareholder Services (ISS), a leading proxy advisory firm, noted in 2014 that "[w]ith the market rebound, fewer companies are seeking shareholder approval for option exchange programs."[6] Nevertheless, experience shows that the need to reprice underwater options arises from time to time as general market conditions fluctuate or

1. See Phred Dvorak, "Firms Jump to Salvage 'Underwater' Stock Options," *Wall Street Journal,* December 22, 2008, http://online.wsj.com/article/SB122990523912125271.html.

2. See Tomoeh Murakami Tse, "Firms Refloat Underwater Stock Options," *Washington Post,* March 7, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/03/06/AR2009030603384.html.

3. See David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Proxy Advisory Firms and Stock Option Repricing," *Journal of Accounting and Economics* 56 (November–December 2013): 149–169.

4. See Alix Stewart, "Firms Jump to Salvage 'Companies Move to Reprice Employees' Stock Options," *Wall Street Journal,* September 13, 2016, https://www.wsj.com/articles/companies-move-to-reprice-employees-stock-options-1473721243.

5. See Schedule TO filed June 21, 2017, https://www.sec.gov/Archives/edgar/data/1447599/000144759917000044/fitbitschedto-i002.htm.

6. Institutional Shareholder Services, *2014 Comprehensive US Compensation Policy, Frequently Asked Questions,* March 28, 2014, http://www.issgovernance.com/file/2014_Policies/ISSUSCompensationFAQs03282014.pdf.

due to the situation of a particular company. Under those circumstances, one of the most important strategic issues companies can face is how to address the fact that their stock option plans, which are intended to incentivize employees, can lose a critical element—incentive. For example, according to one survey of equity plan proposals submitted between 2007 and 2012, approximately 4,800 equity plan proposals have been submitted to shareholders of Russell 3000 Index companies. Of the 54 equity plan proposals that failed, one-third failed because they were inconsistent with ISS's repricing policy.[7]

There are many methods for addressing the problem of underwater options, each with its own benefits and drawbacks. The most common method traditionally was to "reprice" the options by lowering their exercise price. As discussed below, repricings now generally take the form of a wide variety of different exchange programs, including programs that involve the issuance of different forms of equity compensation, such as restricted stock or restricted stock units (RSUs), in exchange for underwater options. What all repricings have in common is the goal of reestablishing an incentive component for continued hard work and commitment, as well as restoring the retention capability of an employer's equity compensation plan.

The issue of option repricings increases in importance as companies consider items for inclusion in annual proxy statements. If shareholder approval is required to undertake a repricing (as is generally the case), a company will need to consider its strategy for addressing this challenge in connection with its annual meeting, as it would be extremely uncommon to hold a special meeting to approve a repricing. Sufficient time should be allowed to obtain advice from compensation consultants, advance review of option repricing proposals by proxy advisors, and requisite compensation committee and board approvals. Companies may also want to consider how to address underwater options so that they can condition their grants of options (or other securities) on employees relinquishing their underwater options. This approach will not remove the need for shareholder approval (if required) and a tender offer as described below, but it will likely reduce the compensation expense associated with the annual grant and will likely result in a larger number of underwater options being canceled.

Finally, the last two waves of repricings in 2001–2002 and 2009 were both followed by significant rebounds in stock prices. Many of the

---

7. Alliance Advisors, *Equity Plan Proposal Failures: 2007–2012*, https://www.exqty.com/Media/Publications/EP%20Proposal%20Failures%202007-2012_20130107.pdf.

market and regulatory developments that took place after 2001–2002 resulted in part from a perception that some companies implemented option repricing programs too quickly after stock price declines. By mid- to late 2010, the share price of a large number of companies that exchanged options in 2009 had rebounded to levels above the exercise price of the exchanged options. While it is easy to second-guess the decision to reprice after the fact, there seems little doubt that this experience will cause other companies and investors to view future repricings with greater skepticism.

7.1 Structuring Repricings

7.1.1 One-for-One Exchanges

Option repricings were traditionally effected by lowering the exercise price of underwater options to the then-prevailing market price of a company's common stock. Mechanically, this result was achieved either by amending the terms of the outstanding options or by canceling the outstanding options and issuing replacement options. The majority of repricings that occurred during the 2001 and 2002 market downturn were one-for-one option exchanges. At that time, the majority of new options had the same vesting schedule as the canceled options, and only a minority of companies excluded directors and officers from repricings.

Two subsequent developments have made one-for-one option exchanges the exception rather than the norm:

- In 2003, the New York Stock Exchange (NYSE) and the Nasdaq Stock Market adopted a requirement that public companies must seek shareholder approval of option repricings. As a result, companies must now ask (often unhappy) shareholders to provide employees with a benefit that the shareholders themselves will not enjoy. This development, coupled with the significant influence exerted on shareholder votes by institutional investors and proxy advisors, has made it almost impossible for companies to gain shareholder approval of a one-for-one option exchange due to perceived unfairness to shareholders.
- Before Financial Accounting Standards Board Accounting Standards Codification Topic 718 (ASC 718) and its predecessor (Statement of Financial Accounting Standards No. 123(R)) became effective for years beginning on or after December 15, 2005, stock option grants

were not accounted for as an expense on a company's income statement. As a result, provided a company waited six months and one day, there was a limited accounting impact from a significant grant of replacement stock options, giving stock options a distinct advantage over other forms of equity compensation. ASC 718 now requires the expensing of employee stock options over the implied service term (the vesting period of the options). As a result, ASC 718 increased the accounting cost of a one-for-one option exchange.

7.1.2 Value-for-Value Exchanges

Companies seeking to reprice their options now generally undertake a "value-for-value" exchange.[8] A value-for-value exchange affords option holders the opportunity to cancel underwater options in exchange for an immediate regrant of new options at a ratio of less than one-for-one with an exercise price equal to the market price of such shares.

Value-for-value exchanges are more acceptable to shareholders and proxy advisors than one-for-one exchanges. A value-for-value exchange results in less dilution to public shareholders than a one-for-one exchange because it allows the reallocation of a smaller amount of equity to employees, which shareholders generally perceive as being fairer under the circumstances. In addition, the accounting implications of a value-for-value exchange are significantly more favorable than a one-for-one exchange. Under ASC 718, the accounting cost of new options (amortized over their vesting period) is the fair value of those grants less the current fair value of the canceled (underwater) options. As a result, companies generally structure an option exchange so that the value of the new options for accounting purposes—based on Black-Scholes

---

8. A one-for-one exchange may still be appropriate under certain circumstances. For example, the board of VMware, Inc., which undertook the largest IPO by a technology company in 2007, approved in August 2008 an exchange offer for the options it granted after its IPO. The exchange ratio for U.S. employees was one-for-one. The plan called for non-U.S. employees to receive RSUs in exchange for their options. Similarly, Google's exchange program in February 2009 enabled a one-for-one exchange of underwater options for new options with extended vesting provisions. While directors and executive officers were excluded from the VMware exchange program, executive officers were permitted to participate in the Google exchange program. However, as discussed below in section 7.2.2, a one-for-one exchange is an adverse factor that affects whether not proxy advisors will recommend in favor of an option exchange program.

or another option pricing methodology—approximates or is less than the value of the canceled options, thereby making it "value-neutral." If the fair value of the new options exceeds the fair value of the canceled options, that incremental value is recognized as an expense over the remaining service period of the option.

7.1.3 Use of Restricted Stock or RSUs

A common variation of the value-for-value exchange is the cancelation of all options and the grant of restricted stock or RSUs with the same or a lower economic value than the options canceled. Restricted stock is stock that is subject to a substantial risk of forfeiture at grant but vests upon the occurrence of continued employment. Restricted stock is nontransferable while it is forfeitable. RSUs are economically similar to restricted stock but involve the promise to issue the shares or an equivalent cash value at a time that is concurrent with or after vesting.

The U.S. tax rules applicable to restricted stock are different from those applicable to RSUs. Although the taxation of restricted stock is generally postponed until the stock becomes vested (with the grantee treated as receiving ordinary income equal to the fair market value of the underlying stock on the vesting date), the grantee of restricted stock may elect to be taxed in the year of grant rather than waiting until vesting. If this election is made pursuant to Section 83(b) of the Internal Revenue Code (the "Code"), the grantee is treated as receiving ordinary income equal to the fair market value of the underlying stock on the date of the grant, rather than on the date of vesting. Future appreciation is taxed as capital gain (rather than as ordinary income) when the grantee disposes of the shares after vesting. There is no ability to make Section 83(b) elections with respect to the grant of RSUs, which are taxed upon delivery of the shares following vesting of the RSUs. Outside the United States, many companies grant RSUs to their non-U.S. employees because RSUs generally permit deferral of taxation until delivery of shares of stock underlying the RSU, whereas there may be different tax consequences for restricted stock in non-U.S. jurisdictions upon grant.

One benefit of both restricted stock and RSUs is that such awards ordinarily have no purchase or exercise price and provide immediate value to the grantee. Consequently, the exchange ratio will generally result in less dilution to existing stockholders than an option-for-option exchange. In addition, at a time when institutional investors and proxy advisors may advocate greater use of restricted stock and RSUs, either alone or together with stock options and stock appreciation rights (SARs),[9] such an exchange can be part of a shift in the overall compensation policy of a company. Finally, because restricted stock and RSUs ordinarily have no exercise price, there is no risk that they will subsequently go underwater if there is a further drop in a company's stock price. This is an important consideration in a volatile market.

Income that certain officers recognize from the new restricted stock and RSU grants will be subject to the annual deduction limit of Section 162(m) of the Code, to the extent applicable. Section 162(m) in general terms limits to U.S. $1 million per year the deductibility of compensation to a public corporation's CEO, CFO, and the next top three highest-compensated officers who served at any time during the corporation's taxable year, as well as employees who were subject to Section 162(m) in a tax year beginning after 2016.[10]

7.1.4 Repurchase of Underwater Options for Cash

Instead of an exchange, a company may simply repurchase underwater options from employees for an amount based on Black-Scholes or another option pricing methodology. The repurchase of underwater options generally involves a cash outlay by the company, the amount of which will vary based on the extent that the shares are underwater and to the extent that such repurchase is limited to fully vested options. Such a repurchase would reduce the number of options outstanding as a percentage of the total number of common shares outstanding (referred to as the "overhang"), which is generally beneficial to a company's

9. SARs are essentially net options, and provide for the delivery, in cash or shares (as applicable), of an amount equal to the spread (i.e., the excess of fair market value of the stock over exercise price) upon exercise. Broker-assisted cashless exercises of options have an economic effect similar to that of SARs but technically involve the payment of the exercise price to the issuer with a loan or other assistance from the broker.

10. Before the enactment of the Tax Cut and Jobs Act of 2017 (the "2017 Tax Act"), "covered employees" subject to Section 162(m) included a public corporation's CEO and its three highest-paid officers (other than the CEO and CFO) who were serving as of the last day of the tax year. The 2017 Tax Act expanded the group of covered employees and provided that for tax years beginning on or after January 1, 2018, covered employees include the CEO, CFO, the three highest-paid officers serving at any time during the tax year, and any employee who was a covered employee for a tax year beginning after 2016. The 2017 Tax Act also eliminated the performance-based compensation exemption for equity awards granted after November 2, 2017.

capital structure. If a company repurchases its underwater options for cash rather than replacing them with other equity awards, the company will also need to consider how to provide future retention value to the employees.

7.1.5 Treatment of Directors and Officers

Due to the guidelines of proxy advisors and the expectations of institutional investors, directors and executive officers are often excluded from participating in repricings that require shareholder approval. Nevertheless, because directors and executive officers often hold a large number of options, excluding them can undermine the goals of the repricing and may lead to executive retention and motivation issues. As an alternative to exclusion, companies could permit directors and officers to participate on less favorable terms than other employees and could consider seeking separate shareholder approval for the participation of directors and officers to avoid jeopardizing the overall program. Where the method of repricing or the intention behind the implementation of a new program reflects a shift in the overall compensation policy of a company, such as the exchange of options for restricted stock or RSUs, proxy advisors and institutional investors are more likely to acquiesce in the inclusion of directors and executive officers.

7.1.6 Key Repricing Terms

The following are key terms that a company conducting a repricing will need to consider. It is advisable to retain a compensation consultant to assist with these matters and implementation of the program:

Exchange Ratio. The exchange ratio for an option exchange represents the number of options that must be tendered in exchange for one new option or other security. This must be set appropriately to encourage employees to participate and to satisfy shareholders. In order for a repricing to be value-neutral, there will usually be a number of exchange ratios, each addressing a different range of option exercise prices.

Option Eligibility. The company must determine whether all underwater options, or only those that are significantly underwater and/or were granted before a certain date, are eligible to be exchanged. This will depend on shareholder perceptions as well as the volatility of the company's stock and on the company's expectations of future increases in share price. In addition, if employees in countries other than the U.S. hold underwater options, the company will need to consult with its advisors to determine if there are any issues (e.g., adverse tax consequences to either the company or the employee) that would result if such employees were eligible to participate in the exchange, and it may elect to exclude employees in certain non-U.S. countries.

New Vesting Periods. A company issuing new options in exchange for underwater options must determine whether to grant the new options based on a new vesting schedule, the old vesting schedule, or a schedule that provides some accelerated vesting between these two alternatives.

7.2 Shareholder Approval

7.2.1 NYSE and Nasdaq Requirements

Under NYSE and Nasdaq rules requiring shareholder approval for any material amendment to an equity compensation program, a company listed on the NYSE or Nasdaq must first obtain shareholder approval of a proposed repricing unless the equity compensation plan under which the options in question were issued expressly permits the company to reprice outstanding options.[11] NYSE and Nasdaq rules define a material amendment to include any change to an equity compensation plan to "permit a repricing (or decrease in exercise price) of outstanding options…[or] reduce the price at which shares or options to purchase shares may be offered."[12] A plan that does not contain a provision that specifically permits repricing of options will be considered to prohibit repricing for purposes of the NYSE and Nasdaq rules.[13] Therefore, even if a plan itself is silent as to repricing, any repricing of options under that plan will be deemed to be a material revision of the plan requiring shareholder approval. In addition, shareholder approval is required

11. The New York Stock Exchange Listed Company Manual, Section 303A.08; Nasdaq Stock Market Listing Rules, Rule 5635(c); and Nasdaq Interpretive Material IM-5635-1. See also the NYSE MKT LLC Company Guide Section 711 and related commentary.
12. Id.
13. Id.

before deleting or limiting a provision in a plan prohibiting the repricing of options.[14]

The NYSE and Nasdaq define a repricing as involving any of the following:[15]

1. lowering the strike price of an option after it is granted;
2. canceling an option at a time when its strike price exceeds the fair market value of the underlying stock, in exchange for another option, restricted stock or other equity, unless the cancelation and exchange occurs in connection with a merger, acquisition, spin-off or other similar corporate transaction; and
3. any other action that is treated as a repricing under generally accepted accounting principles.

It should be noted that neither the NYSE nor Nasdaq rules prohibit the straight repurchase of options for cash. Nasdaq has provided an interpretation stating that the repurchase of outstanding options for cash by means of a tender offer does not require shareholder approval even if an equity compensation plan does not expressly permit such a repurchase.[16] In reaching this conclusion, Nasdaq noted that the consideration for the repurchase was not equity. As noted below, however, some proxy advisors still require shareholder approval for a cash repurchase program.

Shareholder approval of a repricing will likely be required for most domestic companies listed on the NYSE or Nasdaq since few companies' equity incentive plans expressly permit a repricing. A discussion regarding the exception available to foreign private issuers is provided below.

7.2.2 Proxy Advisors and Institutional Investors

Leading proxy advisors, such as ISS and Glass, Lewis & Co. ("Glass Lewis"), have taken a clear position on repricing provisions in equity compensation plans. The detailed voting guidelines published by ISS

14. Id.
15. The New York Stock Exchange Listed Company Manual Section 303A.08; Nasdaq OMX Listing Center, Nasdaq "Frequently Asked Questions," https://listingcenter.nasdaqomx.com/MaterialHome.aspx?mcd=LQ.
16. Nasdaq Staff Interpretive Letter 2004-21, available at https://listingcenter.nasdaqomx.com/Material_Search.aspx?cid=71&mcd=SI&sub_cid=114,109,101,97,103.

and by Glass Lewis have remained stable over the last several years with respect to option repricings. ISS uses an "equity plan scorecard" model that considers a range of positive and negative factors to evaluate equity incentive plan proposals.[17] Under this approach, ISS will recommend a case-by-case vote on equity plans, depending on a combination of certain plan features and equity grant practices. However, the ISS guidelines indicate that certain "egregious" features will trigger an outright negative recommendation on the plan. Specifically, it will recommend a vote against a proposal if the plan would permit the repricing or cash buyout of underwater options without shareholder approval, either by expressly permitting it (for NYSE and Nasdaq listed companies) or by not prohibiting it when the company has a history of repricing (for non-listed companies).[18] ISS considers the following to constitute a repricing: (1) the amendment of outstanding options or SARs to reduce the exercise price of such outstanding options or SARs; (2) the cancellation of outstanding options or SARs in exchange for options or SARs with an exercise price that is less than the exercise price of the original options or SARs; (3) the cancellation of underwater options in exchange for stock awards; or (4) cash buyouts of underwater options. ISS will recommend against the equity plan if the company undertakes such arrangements without shareholder approval. Glass Lewis will consider the company's past history of option repricings and express or implied rights to reprice when making its voting recommendations in connection with an equity plan and will recommend a vote against all members of a company's compensation committee if the company repriced options without shareholder approval within the past two years.[19] Against this background, it is likely that most companies will seek shareholder approval for a repricing even if it is not required under their equity compensation plans.

Glass Lewis explicitly notes that it has great skepticism with respect to option repricings, indicating that a repricing or option exchange program may only be acceptable if macroeconomic or industry trends, rather

17. Institutional Shareholder Services, *United States Proxy Voting Guidelines Updates, Benchmark Policy Recommendations,* January 4, 2018, https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

18. Id.

19. Glass Lewis & Co, *Proxy Paper Guidelines, 2018 Proxy Season, An Overview of the Glass Lewis Approach to Proxy Advice, United States,* http://www.glasslewis.com/wp-content/uploads/2018/01/2018_Guidelines_UNITED_STATES.pdf.

than specific company issues, cause a stock's value to decline dramatically, and the repricing is necessary to retain and motivate employees. In such a circumstance, Glass Lewis will support a repricing if:

- Officers and board members cannot participate in the program;
- The stock decline mirrors the market or industry price decline in terms of timing and approximates the decline in magnitude;
- The exchange is value-neutral or value-creative to shareholders using very conservative assumptions and with a recognition of the adverse selection problems inherent in voluntary programs; and
- Management and the board make a cogent case for needing to motivate and retain existing employees, such as being in a competitive employment market.[20]

Similarly, ISS indicates that an option exchange "creates a gulf between the interests of shareholders and management, since shareholders cannot reprice their stock" and therefore it "should be the last resort for management to use as a tool to re-incentivize employees."[21] According to ISS, only deeply underwater options should be eligible for an exchange program.[22] Therefore, as a general matter, the threshold exercise price for eligible options should be the 52-week high for the stock price.[23] ISS cautions that this general rule should be considered along with other factors, such as the timing of the request, whether the company has experienced a sustained stock price decline that is beyond management's control, whether grant dates of surrendered options are far enough back (e.g., two to three years) so as not to suggest that a repricing is being done to take advantage of short-term price declines, and the company's current stock price, among other factors.[24]

---

20. Id.
21. See note 6 above.
22. Id.
23. Institutional Shareholder Services, *United States Proxy Voting Guidelines Updates, Benchmark Policy Recommendations, January 4*, 2018, https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.
24. Id.

7.2.3 Treatment of Canceled Options

Upon the occurrence of a repricing, equity compensation plans generally provide for one of two alternatives: (1) the shares underlying repriced options are returned to the plan and used for future issuances or (2) such shares are redeemed by the company and canceled so as to no longer be available for future grants. A company's equity compensation plan should make clear which alternative it will use. In the case of an option repricing that results in the return of canceled shares to a company's equity incentive plan, ISS considers the total cost of the equity plan and whether the issuer's three-year average burn rate is acceptable in determining whether to recommend that shareholders approve the repricing.[25]

7.2.4 Proxy Solicitation Methodology

Companies seeking shareholder approval for a repricing face a number of hurdles, not the least the fact that shareholders have suffered from the same decrease in share price that caused the options to become underwater. It should also be noted that brokers are prohibited from exercising discretionary voting power (i.e., to vote without instructions from the beneficial owner of a security) with respect to implementation of, or a material revision to, an equity compensation plan.26 Therefore, the need to convince shareholders of the merits of a repricing is magnified, as is the influence of proxy advisors and institutional shareholders.

The solicitation of proxies from shareholders by a domestic reporting company is governed by Section 14(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the rules thereunder. Item 10 of Schedule 14A contains the basic disclosure requirements for a proxy statement used by a domestic issuer to solicit approval of a repricing. Pursuant to these requirements and common practice, issuers generally include the following items of disclosure:

- A description of the option exchange program, including a description of who is eligible to participate, the securities subject to the exchange offer, the exchange ratio, and the terms of the new securities.

25. Institutional Shareholder Services, *United States Proxy Voting Guidelines Updates, Benchmark Policy Recommendations,* January 4, 2018, https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

26. See NYSE Rule 452.

- A table disclosing the benefits or amounts, if determinable, that will be received by or allocated to (1) named executive officers, (2) all current executive officers as a group, (3) all current directors who are not executive officers as a group, and (4) all employees, including all current officers who are not executive officers, as a group.
- A description of the reasons for undertaking the exchange program and any alternatives considered by the board.
- The accounting treatment of the new securities to be granted, and the U.S. federal income tax consequences.

It is important that companies ensure that their disclosure includes a clear rationale for the repricing to satisfy the disclosure requirements sought by proxy advisors and necessary to persuade shareholders to vote in favor of the repricing.[27]

Rule 14a-6 under the Exchange Act permits a company that is soliciting proxies solely for certain specified limited purposes in connection with its annual meeting (or a special meeting in lieu of an annual meeting) to file a definitive proxy statement with the Securities and Exchange Commission (SEC) and commence its solicitation immediately. The alternative requirement would be to file a preliminary proxy statement first and wait 10 days while the SEC determines whether it will review and comment on the proxy statement. While there is some room for interpretation, the authors believe that the better position is that a proxy statement containing a repricing proposal should generally be filed with the SEC in preliminary form and then in definitive form after 10 days if there is no SEC review. This is because the purposes for which a proxy statement can be initially filed in definitive form are limited to the following solely in connection with an annual meeting: (1) the election of directors; (2) the election, approval, or ratification of accountants; (3) a security holder proposal included pursuant to Rule 14a-8; (4) the approval, ratification, or amendment of a "plan"("plan" is defined in Item 402(a)(6)(ii) of Regulation S-K as "any plan, contract, authorization or arrangement, whether or not set forth in any formal document, pursuant to which cash, securities, similar instruments, or any

27. It is worth noting that Item 402 of Regulation S-K requires that any repricing of an option held by a director or named executive be disclosed in a company's annual proxy statement for the election of directors. See also Securities and Exchange Commission, Division of Corporation Finance, *Current Issues and Rulemaking Projects Quarterly Update* (March 31, 2001), Part II, http://www.sec.gov/divisions/corpfin/cfcrq032001.htm.

other property may be received"); (5) certain specific proposals related to investment companies and Troubled Asset Relief Program financial assistance recipients, and (6) an advisory vote on executive compensation, or for the vote on the frequency of the advisory vote on executive compensation. Most repricing proposals could be viewed as seeking approval of an amendment to a company's plan to permit the repricing and approval of the terms of the repricing itself. The better interpretation seems to be that approval of the terms of a particular repricing is separate from an amendment to the plan to permit repricing since the repricing terms would generally still be submitted for shareholder approval due to proxy advisor requirements even if the plan permitted repricing. Accordingly, companies should consider initially filing proxy statements for a repricing in preliminary form.

7.3 Tender Offer Rules

7.3.1 Application of the Tender Offer Rules

U.S. tender offer rules are generally implicated when the holder of a security is required to make an investment decision with respect to the purchase, modification, or exchange of that security. One might question why a unilateral reduction in the exercise price of an option would implicate the tender offer rules since there is no investment decision involved by the option holder. Indeed, many equity incentive plans permit a unilateral reduction in the exercise price of outstanding options, subject to shareholder approval, without obtaining the consent of option holders on the basis that such a change is beneficial to them. In reality, however, the likelihood of a domestic company being able to conduct a repricing without implicating the tender offer rules is minimal for the following reasons:

- Because of the influence of proxy advisors and institutional shareholders, most option repricings involve a value-for-value exchange consisting of more than a mere reduction in exercise price. A value-for-value exchange requires a decision by option holders to accept fewer options or to exchange existing options for restricted stock or RSUs. This is an investment decision requiring the solicitation and consent of individual option holders.
- A reduction in the exercise price of an incentive stock option (ISO) would be considered a "modification" akin to a new grant under

applicable tax laws.[28] The new grant of an ISO restarts the holding periods required for beneficial tax treatment of shares purchased upon exercise of the ISO. The holding periods require that the stock purchased under an ISO be held for at least two years following the grant date and one year following the exercise date of the option. The resulting investment decision makes it difficult in practice to effect a repricing that includes ISOs without seeking the consent of ISO holders since they must decide if the benefits of the repricing outweigh the burdens of the new holding periods.

The SEC staff has suggested that a limited option repricing/exchange with a small number of executive officers would not be a tender offer. In such an instance, the staff position is that an exchange offer to a small group is generally seen as equivalent to individually negotiated offers, and thus not a tender offer. Such an offer, in many respects, would be similar to a private placement. The SEC staff believes that the more sophisticated the option holders, the more the repricing/exchange looks like a series of negotiated transactions. However, the SEC staff has not provided guidance on a specific number of offerees, so this remains a facts-and-circumstances analysis based on both the number of participants and their positions and sophistication.[29]

Not all equity incentive plans involve issuing ISOs, and thus the attendant ISO-related complexities will not always apply. As a result, foreign private issuers and domestic companies that have not granted ISOs and are simply reducing the exercise price of outstanding options unilaterally may also be able to avoid the application of the U.S. tender offer rules. Foreign private issuers are discussed in more detail below.

7.3.2 Requirements of the U.S. Tender Offer Rules

The SEC views a repricing of options that requires the consent of the option holders as a "self-tender offer" by the issuer of the options. Self-

28. For ISO purposes, a modification is any change in the terms of the option that gives the optionee additional benefits under the option, regardless of whether the optionee actually benefits from such change. Treas. Reg. § 1.424-1(e)(4).

29. American Bar Association, Technical Session Between the SEC Staff and the Joint Committee on Employee Benefits, Question and Answers, May 8, 2001, http://www.thecorporatecounsel.net/member/FAQ/employeebenefits/01_JCEB.htm.

tender offers by companies with a class of securities registered under the Exchange Act are governed by Rule 13e-4 thereunder, which contains a series of rules designed to protect the interests of the targets of the tender offer. While Rule 13e-4 applies only to public companies, Regulation 14E applies to all tender offers. Regulation 14E is a set of rules prohibiting certain practices in connection with tender offers and requiring, among other things, that a tender offer remain open for at least 20 business days.

In March 2001, the SEC issued an exemptive order providing relief from certain tender offer rules that the SEC considered onerous and unnecessary in the context of an option repricing.[30] Specifically, the SEC provided relief from complying with Rule 13e-4(f)(8)(i) (the "all holders" rule) and Rule 13e-4(f)(8)(ii) (the "best price" rule). As a result of this relief, issuers are permitted to reprice/exchange options for only certain selected employees. Among other things, this exception allows issuers to exclude directors and officers from repricings. Furthermore, issuers are not required to provide each option holder with the highest consideration provided to other option holders.[31]

Pre-commencement Offers. The tender offer rules regulate the communications that a company may make in connection with a tender offer. These rules apply to communications made before the launch of a tender offer and while it is pending. Pursuant to these rules, a company may publicly distribute information concerning a contemplated repricing before it formally launches the related tender offer, provided that the distributed information does not contain a transmittal form for tendering options or a statement of how such form may be obtained. Two common examples of company communications that fall within these rules are the proxy statement seeking shareholder approval for a repricing and communications between the company and its employees at the time

30. Exemptive Order, Securities and Exchange Act of 1934, "Repricing," http://www.sec.gov/divisions/corpfin/repricing.htm.

31. An issuer must satisfy a number of requirements to be eligible for the relief: (1) the issuer must be eligible to use Form S-8, the options subject to the exchange offer must have been issued under an employee benefit plan as defined in Rule 405 under the Securities Act, and the securities offered in the exchange offer will be issued under such an employee benefit plan; (2) the exchange offer must be conducted for compensatory purposes; (3) the issuer must disclose in the offer to purchase the essential features and significance of the exchange offer, including risks that option holders should consider in deciding whether to accept the offer; and (4) except as exempted in the order, the issuer must comply with Rule 13e-4.

that proxy statement is filed with the SEC. Each such communication is required to be filed with the SEC under cover of a Schedule TO with the appropriate box checked to indicate that the content of the filing includes pre-commencement written communications.

Tender Offer Documentation. An issuer conducting an option exchange will be required to prepare the following documents:

- The offer to exchange, which is the document pursuant to which the offer is made to the company's option holders and which must contain the information required to be included therein under the tender offer rules.
- The letter of transmittal, which is used by the option holders to tender their securities in the tender offer.
- Other ancillary documents, such as the forms of communications with option holders that the company intends to use and letters for use by option holders to withdraw a prior election to participate.

The documents listed above are filed with the SEC as exhibits to a Schedule TO Tender Offer Statement.

The offer to exchange is the primary disclosure document for the repricing offer and, in addition to the information required to be included by Schedule TO, focuses on informing security holders about the benefits and risks associated with the repricing offer. The offer to exchange is required to contain a "summary term sheet" that provides general information—often in the form of frequently asked questions—regarding the repricing offer, including its purpose, eligibility of participation, duration, and how to participate. It is also common practice for a company to include risk factors disclosing economic, tax, and other risks associated with the exchange offer. The most comprehensive section of the offer to exchange is the section describing the terms of the offer, including the purpose, background, material terms and conditions, eligibility to participate, duration, information on the stock or other applicable units, interest of directors and officers with respect to the applicable units or transaction, procedures for participation, tax consequences, legal matters, fees, and other information material to the decision of a security holder when determining whether or not to participate in such offer.

The offer to exchange, taken as a whole, should provide comprehensive information regarding the securities currently held and those being offered in the exchange—including the difference in the rights and potential values of each. The disclosure of the rights and value of the securities is often supplemented by a presentation of the market price of the underlying stock to which the options pertain, including historical price ranges and fluctuations, such as the quarterly highs and lows for the previous three years. The offer to exchange may also contain hypothetical scenarios showing the potential value risks/benefits of participating in the exchange offer. These hypothetical scenarios illustrate the approximate value of the securities held and those offered in the exchange at a certain point in the future, assuming a range of different prices for the underlying stock. If the repricing is part of an overall shift in a company's compensation plan, the company should include a brief explanation of its new compensation policy.

Launch of the Repricing Offer. The offer to exchange is transmitted to employees after the Schedule TO has been filed with the SEC. While the offer is pending, the Schedule TO and all of the exhibits thereto (principally the offer to exchange) may be reviewed by the SEC staff, who may provide comments to the company, usually within five to seven days of the filing. The SEC's comments must be addressed by the company to the satisfaction of the SEC, which usually requires the filing of an amendment to the Schedule TO, including amendments to the offer to exchange. Generally, no distribution of such amendment (or any amendments to the offer to exchange) will be required.[32] This review usually does not delay the tender offer and generally will not add to the period that it must remain open.

Under the tender offer rules, the tender offer must remain open for a minimum of 20 business days from the date that it is first published or disseminated. For the reasons noted below, most option repricing exchange offers are open for less than 30 calendar days. If the consideration offered or the percentage of securities sought is increased or decreased, the offer must remain open for at least 10 business days from the date such increase or decrease is first published or disseminated. The SEC also takes the position that if certain material changes are made to the offer (e.g., the waiver of a condition), the tender offer must remain open for

32. If the terms of the offer change (e.g., the option exchange ratio is changed) or other material changes are made to the disclosure in the offer to exchange, a supplement may need to be prepared, mailed to stockholders, and filed with the SEC as part of a Schedule TO amendment. This rarely occurs in an option repricing.

at least 5 business days thereafter.[33] At the conclusion of the exchange period, the repriced options, restricted stock, or RSUs will be issued pursuant to the exemption from registration provided by Section 3(a)(9) of the Securities Act of 1933, as amended (the "Securities Act") for the exchange of securities issued by the same issuer for no consideration.

Conclusion of the Repricing Offer. The company is required to file a final amendment to the Schedule TO setting forth the number of option holders who accepted the offer to exchange.

7.4 Certain Other Considerations

7.4.1 Tax Issues

Incentive Stock Options. If the repricing offer is open for 30 days or more with respect to options intended to qualify for ISO treatment under U.S. tax laws, those ISOs are considered newly granted on the date the offer was made, whether or not the option holder accepts the offer.[34] If the period is for less than 30 days, then only ISO holders who accept the offer will be deemed to receive a new grant of ISOs.[35] As discussed above, the consequence of a new grant of ISOs is restarting the holding period required to obtain beneficial tax treatment for shares purchased upon exercise of the ISO.[36] As a result of these requirements, repricing offers involving ISO holders should generally be open for no more than 30 days.

To qualify for ISO treatment, the maximum fair market value of stock with respect to which ISOs granted to an employee may first become exercisable in any one year is U.S. $100,000. For purposes of applying this dollar limitation, all ISOs granted to the employee are taken into account, the stock is valued when the option is granted, and ISOs are taken into account in the order in which they were granted. Whenever an ISO is canceled pursuant to a repricing, any options and shares scheduled to become exercisable in the calendar year of the cancelation would continue

---

33. If such change is made at a time when more than five business days remain before the expiration of the tender offer, no extension of the tender offer would be needed. If such change is made in the five-business-day period preceding the scheduled expiration of the tender offer, an extension would be necessary.
34. Treas. Reg. § 1.424-1(e)(4)(iii).
35. Id.
36. Treas. Reg. § 1.424-1(e)(2).

to count against the U.S. $100,000 limit for that year, even if cancelation occurs before the option actually become exercisable.[37] To the extent that the new ISO becomes exercisable in the same calendar year as the cancelation, this reduces the number of shares that can receive ISO treatment (because the latest grants are the first to be disqualified).[38] Where the new ISO does not start vesting until the next calendar year, however, this will not be a concern.

Section 409A Compliance. If the repricing occurs with respect to nonqualified stock options (i.e., options that are not ISOs), such options need to be structured so as to be exempt from (or in compliance with) Section 409A of the Code. Section 409A comprehensively codifies the federal income taxation of nonqualified deferred compensation. Section 409A generally provides that unless a "nonqualified deferred compensation plan" complies with various rules regarding the timing of deferrals and distributions, all amounts deferred under the plan for the current year and all previous years become immediately taxable, and subject to a 20% penalty tax and additional interest, to the extent the compensation is not subject to a "substantial risk of forfeiture" and has not previously been included in gross income. Nonqualified stock options are usually structured to be exempt from Section 409A. One of the conditions for this exemption is that the option have an exercise price at least equal to the fair market value of the underlying stock on the option grant date. A reduction in the option exercise price that is not below the fair market of the underlying stock value on the date of the repricing should not cause the option to become subject to Section 409A. Instead, such repricing of an underwater option is treated as the award of a new stock option that is exempt from Section 409A.[39] While foreign private issuers may enjoy certain relief from the U.S. tender offer rules, as described below, there is no similar relief from U.S. tax considerations for U.S. taxpayers. This is most important where a foreign private issuer's home country rules allow for the grant of options with exercise prices below fair market value. In such cases, care should be taken to ensure that grantees who are U.S. taxpayers receive awards that comply with Section 409A.

37. Treas. Reg. § 1.422-4(b)(5).
38. Treas. Reg. § 1.422-4(b)(3); Treas. Reg. § 1.422-4(d), example 2.
39. Treas. Reg. § 1.409A-1(b)(5)(v)(A).

7.4.2 Plan Grant Limitation

It should also be noted that a repriced option will count against any per-person grant limitations (typically an annual limit on the maximum number of shares that may be granted to an individual) in the applicable equity plan.

7.4.3 Accounting Treatment

Accounting considerations are a significant factor in structuring a repricing. Before the adoption of ASC 718 in 2005, companies often structured repricings with a six-month hiatus between the cancelation of underwater options and the grant of replacement options. The purpose of this structure was to avoid the impact of variable mark-to-market charges. Under ASC 718, however, the charge for the new options is not only fixed upfront but is for only the incremental value, if any, of the new options over the canceled options. As discussed above, in a value-for-value exchange, a fewer number of options or shares of restricted stock or RSUs will usually be granted in consideration for the surrendered options. As a result, the issuance of the new options or other securities can be a neutral event from an accounting expense perspective.

7.4.4 Section 16

The replacement of an outstanding option with a new option having a different exercise price and a different expiration date involves a disposition of the outstanding option and an acquisition of the replacement option, both of which are subject to reporting under Section 16(a). However, the disposition of the outstanding option will be exempt from short-swing profit liability under Section 16(b) pursuant to Rule 16b-3(e) if the terms of the exchange are approved in advance by the issuer's board of directors, a committee of two or more nonemployee directors, or the issuer's shareholders. It is generally not a problem to satisfy these requirements. Similarly, the grant of the replacement option or other securities is subject to reporting but will be exempt from short-swing profit liability pursuant to Rule 16b-3(d) if the grant was approved in advance by the board of directors or a committee composed solely of two or more nonemployee directors, was approved in advance or ratified by the issuer's shareholders no later than the date of the issuer's next annual meeting, or is held for at least six months.

7.5 Foreign Private Issuers

7.5.1 Relief from Shareholder Approval Requirement

Both the NYSE and Nasdaq provide foreign private issuers with relief from the requirement of stockholder approval for a material revision to an equity compensation plan by allowing them instead to follow their applicable home-country practices. As a result, if the home-country practices of a foreign private issuer do not require shareholder approval for a repricing, the foreign private issuer is not required to seek shareholder approval under NYSE or Nasdaq rules.

Both the NYSE and Nasdaq require an issuer following its home-country practices to disclose in its annual report on Form 20-F an explanation of the significant ways in which its home-country practices differ from those applicable to a U.S. domestic company. The disclosure can also be included on the issuer's website, in which case, under NYSE rules, the issuer must provide in its annual report the web address where the information can be obtained. Under Nasdaq rules, the issuer is required to submit to Nasdaq a written statement from independent counsel in its home country certifying that the issuer's practices are not prohibited by the home country's laws.

A number of foreign private issuers have disclosed that they will follow their home-country practices with respect to a range of corporate governance matters, including the requirement of shareholder approval for the adoption or any material revision to an equity compensation plan. These companies are not subject to the requirement of obtaining shareholder approval. Companies that have not provided such disclosure and wish to avoid the shareholder approval requirements when undertaking a repricing will need to consider carefully their historic disclosure and whether such an opt-out poses any risk of a claim from shareholders.

7.5.2 Relief from U.S. Tender Offer Rules

Foreign private issuers also have significant relief from the application of U.S. tender offer rules if U.S. option holders hold 10% or less of the company's outstanding options.[40] Under the exemption, assuming the issuer's actions in the United States still constitute a tender offer, the issuer would be required to take the following steps:

40. 17 C.F.R. § 240.13e-4(h)(8)(i).

1. File with the SEC under the cover of a Form CB a copy of the informational documents that it sends to its option holders. This informational document would be governed by the laws of the issuer's home country and would generally consist of a letter to each option holder explaining why the repricing is taking place, the choices each option holder has, and the implications of each of the choices provided.
2. Appoint an agent for service of process in the United States by filing a Form F-X with the SEC.
3. Provide each U.S. option holder with terms that are at least as favorable as those terms offered to option holders in the issuer's home country.

A more limited exemption to the U.S. tender offer rules also exists for foreign private issuers where U.S. investors hold 40% or less of the options that are subject to the repricing. Under this exception, both U.S. and non-U.S. security holders must receive identical consideration. The minimal relief is intended merely to minimize the conflicts between U.S. tender offer rules and foreign regulatory requirements and provides little actual relief in the context of an option repricing.

7.6 Alternative Strategies

Microsoft and Google used innovative methods to seek to address the issue of underwater employee stock options, providing a viable alternative to repricing.

In 2007, Google implemented a program that afforded its option holders (excluding directors and officers) the ability to transfer outstanding options to a financial institution through a competitive online bidding process managed by Morgan Stanley. The bidding process effectively created a secondary market in which employees can view what certain designated financial institutions and institutional investors are willing to pay for vested options. The value of the options is therefore a combination of their intrinsic value (i.e., any spread) at the time of sale plus the "time value" of the remaining period during which the options can be exercised (limited to a maximum of two years in the hands of the purchaser). As a result of this "combined" value, Google believed that underwater options would still retain some value. This belief is supported by the fact that in-the-money options have been sold at a premium to their intrinsic value. Google's equity incentive plan was drafted sufficiently broadly to enable options to be transferable without the need to obtain Google shareholder approval to amend the plan. It is likely, however, that most other companies' plans limit transferability of options to family members. Accordingly, most companies seeking to implement a similar transferable option program will likely need to obtain shareholder approval to do so. Note that ISOs become nonqualified stock options if transferred. The only options Google granted following its IPO were nonqualified stock options and, accordingly, the issue of losing ISO status did not arise. Finally, notwithstanding the benefits that Google's transferable option program offers, it did not prevent the company from effecting a one-for-one option exchange and incurring a related stock-based compensation expense of U.S. $460 million over the life of the new options.

In 2003, Microsoft implemented a program that afforded employees holding underwater stock options a one-time opportunity to transfer their options to JPMorgan in exchange for cash.[41] The program was implemented at the same time that Microsoft started granting restricted stock instead of options and was open on a voluntary basis to all holders of vested and unvested options with an exercise price of U.S. $33 or more (at the time of the implementation of the program, the company's stock traded at U.S. $26.50). Employees were given a one-month election period to participate in the program, and once an employee chose to participate, all of that employee's eligible options were required to be tendered. Employees who transferred options were given a cash payment in installments dependent upon their continued service with Microsoft.

The methods used by Google and Microsoft raise a number of tax and accounting questions and require the filing of a registration statement under the Securities Act in connection with short sales made by the purchasers of the options to hedge their exposure. To date, these methods have not been adopted and seem unlikely to be adopted by other companies, and it is to be expected that most companies will continue to conduct more conventional repricings to address underwater options.

41. Comcast Corporation implemented a similar program with JPMorgan in 2004. In that case, due to the structure of the option plan, Comcast repurchased the options and issued new options to JPMorgan with exercise prices and times to maturity identical to the repurchased options.

7.7 Summary

A significant number of companies effected repricings after the financial crisis of 2008. As a result of that wave of repricings, improved market conditions, and many companies switching their compensation practices to include the grant of more full-value awards (such as restricted stock and RSUs) rather than options, presently the specter of underwater stock options has receded. Nevertheless, experience shows that the need to reprice underwater options may arise again as general market conditions fluctuate or due to the circumstances of a particular company.