STOCK OPTION REPRICINGS: FINANCIAL ACCOUNTING AND TENDER OFFER COMPLIANCE ISSUES

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In recent years, the popularity of stock options as compensation and incentive tools surged as the equity markets repeatedly reached new highs. Now as the markets have cooled significantly, more companies than ever are reassessing their stock option programs and considering stock option repricing alternatives. This memorandum describes some possible approaches to repricing employee stock options so that the new exercise price of the options will reflect the lower, current fair market value of a company's common stock. This memorandum is intended to raise ideas that a company might consider as repricing alternatives in the context of the current financial accounting rules and certain other relevant regulations, but the memorandum does not purport to be an exhaustive analysis of repricing alternatives. Before implementing a stock option repricing program, we recommend that the company seek specific legal advise with respect to legal compliance and implementation issues as well as advice from its accountants regarding the effect of a proposed repricing program on the company's financial statements. Since we are not accountants, and since the interpretation of the repricing rules is still developing, the following discussion on accounting should be treated only as the starting point of an analysis that should be further informed by consultation with a company's accountants.

BACKGROUND

Ordinarily, when a stock option is granted to an employee with an exercise price that is equal to or greater than the fair market value of the underlying common stock on the date of grant and with a time-based vesting schedule, the granting company will not be required to recognize a charge to its earnings for financial accounting purposes with respect to such grant.

Since December 15, 1998, the Financial Accounting Standards Board (the "FASB") has taken the position that a direct or indirect repricing of employee stock options will convert those options into "variable awards" for financial accounting purposes. If an option is treated as a variable award, the compensatory charge to earnings associated with that option will not be finally fixed until the time that the option is exercised (or expires unexercised). If, at the time the compensatory charge to earnings is fixed, the fair market value of the common stock subject to the option is greater than the exercise price of the option, the granting company will be required to recognize a charge to earnings equal to such spread. In addition, for options treated as variable awards that have not yet been exercised, a tentative charge to earnings is calculated and adjusted quarterly to reflect fluctuations in the value of the common stock subject to such options. Due to this treatment, option repricing could have a significant adverse impact on a company's reported earnings.

In financial markets that are increasingly less accepting of companies with no or lower than anticipated earnings, companies will be interested in identifying approaches for issuing stock-based compensation to employees that will continue to be attractive but that will carry with it a manageable charge to earnings for financial accounting purposes. A complete discussion of possible compensation alternatives (such as stock bonuses, cash awards, etc.) is beyond the scope of this memorandum. This memorandum addresses alternative approaches for delivering lower-priced stock options to employees in a manner that should allow the company to limit or avoid the risk of uncontrolled charges to earnings.

GRANT NEW OPTIONS FOLLOWED BY CANCELLATION OF EXISTING STOCK OPTIONS MORE THAN SIX MONTHS LATER

One method that may be used to avoid adverse accounting treatment of a stock option repricing is to grant new options now and then, more than six months after the grant of the new options, cancel the previously existing options. The accounting rules treat the cancellation of an existing option in exchange for the grant of a new option as a repricing unless the two events are separated by more than six months (see the discussion below under the heading "Six Month Look Back and Look Forward Periods" for how these six month periods might apply). Therefore, a company can grant new lower-priced options now, <u>without</u> any agreement by the employee to consent to the cancellation of the existing stock options in the future, and then reach agreement regarding the cancellation of the existing stock options more than six months in the future. The company could consider the employee's failure to agree to any future request for cancellation in determining the employee's future compensation, but not as to the grant of subsequent stock options. The grant of a new option and any subsequent cancellation must be independent events, and separate consideration must be provided to the optionholder at the time of any subsequent cancellation. The optionholder should not be required to make any explicit or tacit commitment to subsequently cancel an outstanding option as a condition of receiving a new option grant. In that event, even if the two events are separated by more than six months, accountants have concluded that variable award accounting will still apply.

CANCEL EXISTING OPTIONS AND GRANT NEW OPTIONS MORE THAN SIX MONTHS LATER

An alternative method that may be used to avoid the adverse accounting treatment of a stock option repricing is to cancel existing options now and commit to grant new options more than six months later (assuming that the employee continues to be employed on that later date).

The company could commit to the number of options to be granted in the future, the applicable vesting schedule, permissible payment terms and other details; however, as to price, the company may only state that the option exercise price would be at or above fair market value on the future grant date.

REPRICE OPTIONS AND SHORTEN TERM

Some companies believe that investors will not be concerned about their short-term earnings. Accordingly, some companies have considered repricing existing stock options at the same time that they shorten the terms of those options to a period of two to three years (or less) following the date of the repricing. The benefit of this approach for financial accounting purposes is that the repriced options will need to be exercised within a short time period, and thus the charge to earnings will be fixed at a time when the company believes that the charge may have less of an impact on the valuation of the company. Alternatively, if the fair market value of the underlying common stock does not increase during the short term of the repriced stock options, the stock options will expire unexercised with no ultimate charge to earnings.

An alternative approach to shortening the term of a repriced option would be to grant a new option in addition to an existing stock option and to provide that the new option will expire within a short period following the achievement of the existing option's exercise price. The FASB has indicated that, to avoid variable plan accounting, the second option would need to remain in effect for more than six months following the date that the value of the company's stock reached the designated price. The biggest shortcoming of this alternative is that an optionholder might be able to double up on stock option gains in the event of a significant increase in the value of the underlying stock that exceeds the exercise price of the existing option prior to the date on which the new option expires.

OPTION EXERCISE AS A METHOD OF REDUCING CHARGE TO EARNINGS

If a company decides to implement a repricing program, one method that can be used to reduce the accounting charge associated with such program is to encourage employees to exercise stock options (as to both vested and unvested shares) following the repricing. The accounting rules indicate that any compensatory charge associated with an option that is a variable award due to a repricing is fixed at the time of exercise. Therefore, if a repricing is immediately followed by the exercise of the repriced stock option (and assuming for the sake of illustration that the price has not gone up in the meantime), there is no charge to earnings. This approach is most effectively used in private companies with lower stock values where the magnitude of the financial commitment is smaller; however, it can be used selectively for senior executives and/or sizable optionholders in public companies. The company can make this alternative more palatable to optionholders by allowing payment of the exercise price with promissory notes (that are full recourse and bear a commercial market rate of interest) so as to limit the amount of cash required to be paid by optionholders at the time of exercise. (It should be noted that an office of one major accounting firm would require that the option in question be vested; otherwise, they assert that variable plan accounting should continue until vesting of the stock).

SIX MONTH LOOK BACK AND LOOK FORWARD PERIODS

The accounting rules for repricings require that if an option is cancelled, a company must first consider as replacement awards that are subject to variable accounting all awards granted within the period six months before and then all awards granted within the period six months after the option cancellation. The following example may help to understand this rule:

Grant Date	**Options Granted**	**Exercise Price**
01/01/97	1,000	$50 (FMV)
10/01/00	750	$21 (FMV)
01/31/01	500	$21 (FMV)
08/01/01	500	$21 (FMV)

On January 31, 2001, the company and the employee agree to the cancellation of the 1,000 options previously granted on January 1, 1997. Under the company's repricing program, an employee is offered the opportunity to have the January 1, 1997 grant cancelled in exchange for which the employee will receive on January 31, 2001 an option for 500 shares at a fair market value exercise price ($21) that are immediately vested and have a term of one year. In addition, the company will commit to grant to the employee on August 1, 2001, an option for an additional 500 shares subject to two year vesting and having an exercise price of fair market value on the grant date (which turns out to be $21).

The cancellation of 1,000 options puts at risk of variable accounting those options granted within six months before or after the date of option cancellation if the options granted within those periods had lower exercise prices than the cancelled options. In this case, the 750 options granted on October 1, 2000, had a lower exercise price than the cancelled options. As a result, those 750 options are accounted for as variable from January 31, 2001 until the date they are exercised, are forfeited or expire unexercised.

Because 1,000 options were cancelled, and only 750 options were identified as variable awards in the six month look back period, the company also must look forward six months to see if any awards with lower exercise prices than the cancelled awards were granted during this period. In this case, 250 of the 500 awards granted on January 31, 2001, are so identified and are accounted for as variable from the date of grant until they are exercised, are forfeited or expire unexercised.

In this case, the company might consider whether it should require the cancellation of the October 1, 2000 grants (particularly if they have the typical ten year term) if the January 1, 1997 grants are to be cancelled. Since the January 31, 2001 new grants have a short term, the potential accounting charge associated with these options should be relatively limited. The grants made on August 1, 2001 are outside of the look forward period and so should qualify for fixed accounting.

STOCK OPTION REPRICINGS AS ISSUER TENDER OFFERS

The Securities and Exchange Commission (the "SEC") issued an order on March 21, 2001 concluding that many option exchange programs extended by issuers to their employees constitute issuer tender offers and therefore generally need to comply with Rule 13e-4, the rule under the Securities Exchange Act of 1934, as amended (the "Exchange Act") governing issuer tender offers. The SEC indicated that issuer stock option exchange programs frequently involve securities issued through broad-based plans, are open to a large number of employees, are not limited to executive or senior officers of the issuers, are not privately negotiated compensation arrangements, have fixed terms, and are open for a limited period of time. In such circumstances, and in contrast to repricing programs where the issuer unilaterally reprices its options, the SEC has concluded that the optionholder's decision as to whether to accept the offer is an investment decision and not merely a compensation decision. Accordingly, the SEC has concluded that such issuer repricing programs constitute issuer exchange offers subject to Rule 13e-4 in circumstances where the relevant issuer has a class of equity securities registered under Section 12 or is required to file reports under Section 15(d) of the Exchange Act.

The SEC announced this position in the context of an exemptive order which, subject to certain conditions, exempts issuers from compliance with two provisions of Rule 13e-4, namely the "all holders" provision and the "best offer" provision. Absent exemptive relief, the "all holders" provision of Rule 13e-4 would require that an issuer extend the option exchange program to all of its optionholders, even though in some circumstances the issuer may wish to exclude certain holders such as officers and directors or holders of options with exercise prices close to the underlying security's fair market value. Absent exemptive relief, the "best offer" provision of Rule 13e-4 would require that an issuer extend to all optionholders participating in the program the best terms provided to any single holder, regardless of differences in the terms of the options being cancelled, such as different exercise prices, remaining vesting schedules, remaining maximum term, different forms of payment and other material terms. In recognition of the fact that the protections of these provisions of Rule 13e-4 were unnecessary or inappropriate in the context of issuer exchanges of new options for old options, the SEC issued an order exempting issuers from compliance with the "all holders" and the "best price" provisions of Rule 13e-4, subject to the following conditions:

1. The issuer must be eligible to use Form S-8. This requires that the issuer be a reporting company under the Exchange Act and that the issuer have filed all

reports and other materials required to be filed under the Exchange Act during the preceding 12 months (or such shorter period that the issuer was required to file such reports and materials).

2. 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 must be issued under such an employee benefit plan.

3. The exchange offer must conducted for compensatory purposes.

4. 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.

5. Except as exempted by the order, the issuer must comply with Rule 13e-4. In order to comply with the other provisions of Rule 13e-4, the issuer must, among other things, prepare and file with the SEC a Tender Offer Statement on Schedule TO concurrent with the commencement of the offer and afford optionholders who are offerees in the offer withdrawal rights expiring not earlier than the expiration of the offer.

In addition to complying with the other requirements of Rule 13e-4, to the extent that an issuer stock option repricing program constitutes an exchange offer, such offer must also comply with the applicable provisions of the general tender offer rules contained in Regulation 14E. These other provisions require, among other things, that the offer remain open for a period of at least 20 business days (which is substantially longer than the periods often used in the past in connection with stock option repricing programs).

Considering that issuers have designed their stock option repricing programs in response to the changes in the financial accounting rules discussed previously, and that the single most popular variation on these programs currently being used involves the cancellation of options by the holders in exchange for a subsequent grant, satisfying these requirements has the undesirable consequence of delaying the time before which any replacement options may be granted. As a practical matter, optionholders will have to wait an additional month, and perhaps longer, in order to receive a replacement grant since the cancellation of the original option cannot occur until the tender offer has expired. While the SEC has signaled that it is willing to discuss its position further with issuers and their counsel, it would seem unlikely that the SEC would reconsider in the near term the conclusion expressed in the exemptive order that many issuer stock option repricing programs constitute exchange offers.

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