Underwater Stock Options and Repricing Strategy: Is Your Company Drowning in Confusion?

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An estimated 7 to 10 million employees in the United States currently hold stock options.[1] With the recent downturn in the U.S. economy, many companies are discovering that their employees are holding options whose exercise price is higher than the value of their underlying shares. These "out-of-the-money" options are commonly referred to as underwater stock options. High-tech startups have been hit particularly hard by underwater stock options due to their widespread use of stock options in lieu of cash compensation.[2] Stock options that remain underwater for a significant period are essentially worthless to the optionee and, therefore, cannot serve the company's intended purpose of providing an incentive to spur an employee to ever-greater heights of performance. Consequently, such options will likely fail to retain the company's key employees, much less attract new talent.

This article provides a blueprint for companies that are interested in developing an effective strategy in response to the problem of underwater options. Repricing, along with its accounting, tax and securities ramifications, is considered, as well as shareholder fairness and the importance that timing plays in the decision to reprice. The relative advantages and disadvantages of alternatives to repricing are also examined. The two checklists at the end of the article are designed to assist companies through the analytical process of determining the most effective strategy to adopt consistent with a company's circumstances.

A great deal of public attention has been focused over the past decade upon the use of stock options to compensate employees instrumental to a company's future success. Although stock options have been part of the compensation package of members of the highest reaches of management for quite some time, particularly in public companies, it has been the cash-starved Internet startups and emerging high-tech companies who have led the way in making broad-based stock options popular among rank-and-file employees in more recent years. One of the lasting effects that these compa-

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nies, including the dot-coms, may have had on the workplace is a greater awareness, if not understanding, of the role that stock options play in the total compensation package of employees and independent contractors.[3] In fact, the reality today is that many rank-and-file employees consider stock options to be an essential part of their total compensation package. From a company's perspective, stock options have been particularly attractive as a compensation device under Financial Accounting Standards Board (FASB) APB (Accounting Principles Board) Opinion 25 ("APB 25"), where the compensation cost, if any, is measured when the exercise price and the number of shares are "fixed and determinable." Typically, this cost would be fixed and determinable when the option is granted. If a company reports stock-based compensation under APB 25, the option grant does not result in a compensation charge to the income statement if the exercise price is not less than the fair market value of the underlying stock on the date of grant.[4]

Although the problem of underwater options is widespread and easily understood, an appropriate solution may not at all be clear for many companies that are now faced with considerable pressure to develop an effective strategy to revive their option programs before losing valuable talent to a competitor. Until recently, most employees were able to exercise their vested options at a market price that was greater than its exercise price. However, due to a downturn in the U.S. economy, in many cases this is no longer true, and companies that issued options that are now underwater are often confused in their quest to find the most effective solution. Companies that have historically resorted to "repricing" their underwater stock options may no longer be willing to undertake this approach due to adverse accounting treatment that repricing entails today.[5] However, the alternatives to repricing may carry their own baggage. Therefore, if a company is to develop and implement an effective strategy that deals with the problem, then the advantages and disadvantages of repricing and its alternatives must be clearly understood and carefully considered.

Repricing

What Is Stock Option Repricing?

Stock option repricing generally refers to a company's decision to effectively lower the exercise price of its outstanding options whose underlying shares have declined in value. In addition to amending the existing options to lower the exercise price, a repricing also may be accomplished by means of a cancellation of the existing option and granting to the optionee one or more new options at a lowered exercise price.[6] Under a recent interpretation of the accounting rules, a repricing will be deemed to have occurred if the

grant of a new option at a lower exercise price and cancellation of the underwater option occurs within six months of each other.[7] This six-month look-back/look-forward period cannot be avoided by otherwise agreeing to compensate the employee for any stock price increases until a new stock option is granted. If the company takes any action that has the effect of either lowering the exercise price on the underwater option, such as payment of a cash bonus to the optionee upon exercise of the option or a below-market interest loan to facilitate option exercise, a repricing will be deemed to have occurred for accounting purposes.[8] Furthermore, an effective cancellation will be deemed to have occurred if the stock option is modified or an agreement is reached to reduce the likelihood of option exercise. This would include a modification of the outstanding stock option to reduce the exercise period, restart or extend the vesting period, increase the exercise price, or reduce the number of shares of the award.[9] Of course, any adverse change to the outstanding option would require the optionee's consent.

Accounting Treatment of Stock Options after FIN 44, and the Consequences of Repricing

Until recently, companies simply repriced their underwater stock options in order to permit optionees to "profit" by any subsequent increase in share value. The repricing did not entail any adverse accounting treatment until FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN 44"), was adopted by FASB on March 31, 2000.[10] Under FIN 44, which applies retroactively to December 15, 1998, repricing causes the exercise price to be treated as "variable" for the life of the option, resulting in "variable accounting treatment" for the remaining life of the repriced option.[11] When the exercise price is subject to variable accounting treatment, the difference between the revised (lower) exercise price and the value of the underlying stock when the repriced option is exercised (or forfeited or expires unexercised) must be recognized as a compensation expense for financial reporting purposes. Under variable accounting, as the company's stock price increases, a periodic charge to earnings must be reported.[12] This new accounting treatment alone has discouraged many companies from repricing their underwater stock options and has caused them to consider alternatives that may hold relatively less onerous consequences.

Federal Income Tax Considerations

The federal income tax rules treat a repriced stock option as an option exchange, i.e., a cancellation and regrant, regardless of the actual form of re-

pricing.[13] Generally, there are no federal income tax consequences for option holders on their exchange of underwater stock options because repricing is not a taxable event. However, the decision to reprice may still involve several significant income tax considerations for the five highest officers of a public company as well as holders of incentive stock options.

Five Highest Paid Officers Under Section 162(m) of the Internal Revenue Code (the "Code"), a publicly held company may deduct no more than $1 million in compensation paid to any of its five highest paid officers unless the options are considered to be "performance-based compensation" that has been approved by at least two "outside directors" of the company's full board of directors.[14] Therefore, if the five highest paid officers of a public company participate in an option repricing, Code Section 162(m) most likely will be triggered.[15] Stock options are treated as compensation and will be included for purposes of this limitation under Section 162(m).[16] For repriced options to continue to be exempt from the deduction limits of Section 162(m), they must also be approved in this same manner.

For the Section 162(m) exemption to apply, the option plan must specify the maximum number of shares for which options may be granted to any employee during a specified period of one or more years.[17] If the option is repriced during the same period in which it was granted, in order to be able to determine the maximum number of shares for which options may be granted to an employee during the specified period, the plan would include the number of shares subject to the option after the repricing as well as the number of shares subject to the option before the repricing.[18] If repricing causes the individual limit to be exceeded, the exemption would no longer apply to that individual.

Incentive Stock Options (ISOs) Whether publicly or privately held, companies repricing their incentive stock options must consider the holding period and share value dollar limitations of Code Section 422. To retain their status as incentive stock options, repriced options will be required to satisfy the two-years-after-grant and one-year-after-exercise holding period applicable to incentive stock options for such options to continue to defer tax recognition.[19] Repricing will start over the capital gains tolling period again. Therefore, to obtain incentive stock option treatment, shares subject to the option may not be disposed of within two years from the date of the repricing, nor within one year from the date of exercise of the repriced option. Also, to retain incentive stock option treatment, the aggregate fair market value (determined as of the grant date) of stock that is bought by exercising an incentive stock option may not exceed $100,000 in a calendar year.[20] Repricing may cause the number of shares subject to the option to increase.

These additional shares would be counted against the $100,000 limit when the repriced options are exercisable.[21] Any repriced options exceeding this limit would be treated for tax purposes as nonqualified stock options.

Securities Law Issues

The securities laws treat option repricing as an option exchange. In the case of a repricing where the exercise price of stock options held by "named executive officers" (generally the five highest-paid executives) was revised during the preceding fiscal year, the company must disclose (in reasonable detail) the repricing and its basis in its proxy statements.[22] Additionally, the repricing may trigger extensive 10-year reporting for all officers and directors in proxy statement.[23] As part of this report, the company must describe repricing of options held by any executive officer during the last 10 fiscal years.[24] Therefore, companies should consider whether to include "named executive officers" in a repricing of the company's stock options.

On March 21, 2001, the SEC issued an order under the Exchange Act "for issuer exchange offers that are conducted for compensatory purposes." The effect of this order is stricter advance filing requirements for public companies that reprice their stock options because exchange plans are considered to be tender offers (bids to by company shares, usually at a premium), requiring added disclosure.[25] However, they are exempt from the tender-offer requirement that must be offered to all stockholders as long as the stock options are issued under the company's employee plans and are used for compensation purposes.[26]

In addition to the foregoing, the securities laws provide that the repricing of options is to be treated as a disposition of the existing options and the acquisition of new ones for purposes of Section 16 of the Exchange Act.[27] As such, repricing will trigger short-swing liability on gains, unless at least two "Non-Employee Directors" or the full board approved both the cancellation and regrant.[28] Repricing must also be reported by a person subject to Section 16 as the disposition of the existing option and the acquisition of new options.[29]

A repricing effected by an options exchange may trigger the registration requirements of Section 5 of the Securities Act, if the repriced option includes terms that are less advantageous than the original option (such as a new vesting schedule or a decrease in the number of shares subject to the new options).[30] An exemption from this registration may be available under Section 3(a)(9) of the Securities Act if no commission or other remuneration is paid or given for the exchange of options.[31] Notice filings may also be necessary in connection with repriced options under some state blue-sky laws.[32]

Timing the Repricing: Pooling of Interests and Excess Parachute Payment Considerations

When contemplating a repricing, its timing is another important factor that a company must take into consideration insofar as it may preclude the use of the "pooling of interests" method of accounting and may also trigger the excess parachute payment rules. Under the pooling rules, the combined entity of merging companies is permitted to base its financials on those of the merging parties without further adjustment. However, adjustments made to outstanding options of the combining companies for any reason within a two-year period before the merger may preclude use of this attractive method of accounting for business combinations. As an adjustment to outstanding options, repricing would adversely affect a company's ability to use the pooling-of-interests method of accounting.[33] However, FASB has recently decided to discontinue use of this method, and thus any adverse impact resulting from a repricing will no longer likely be of significant consideration.[34]

When a company is in a "change of control" situation, a repriced stock option may also be treated as a "change-in-control stock option" for purposes of the excess parachute payment rules under Code Section 280G.[35] A change in control stock option is usually granted during the one-year period preceding the event.[36] As a result of the repricing, the entire option spread might be treated as a parachute payment, subjecting the company to loss of a tax deduction and the optionee to additional tax payments.[37]

Is Stock Option Repricing Fair to Shareholders?

An often-stated rationale for issuance of stock options is its ability to foster an "ownership" culture among employees. By aligning their interests with those of the company, employees benefit by any increase in the value of the company as a result of their individual and collective performance. During an economic downturn that depresses the value of the company's stock, however, it may be logical to presume that these same employees might also be expected to suffer the declining share values along with the company's shareholders. At least this is the thinking of many shareholders, in particular institutional shareholders, who believe that option holders should be subject to the same risks in the volatility of the underlying share price as the shareholders themselves.[38] Since the shareholders do not in any way benefit from the repricing, they feel that repricing allows option holders to "change the rules" of the game when the game itself changes, an advantage they obviously do not enjoy. Companies that undergo an option repricing should anticipate shareholder protest and therefore may want to avoid putting this issue up for a shareholder vote.

The Alternatives to Repricing: How Viable Are They?

How can a company effectively deal with their underwater stock options without incurring the problems and complexities of repricing? Although there is no one sure-fire approach, a company may find that one of the following alternatives to repricing provides an appropriate solution. These alternatives have advantages because they return value to the option holders, but they must be carefully considered because they may contain their own drawbacks.

Extend the Expiration Date of the Underwater Options

By extending the option exercise period, a company allows additional time for the share price to bounce back in order to self-correct the problem. The extension may be implemented by amending the underwater options without incurring adverse accounting treatment. However, if incentive stock options are involved, due to statutorily imposed restrictions under the Internal Revenue Code, an amendment of the expiration period to permit exercise of the option beyond three months following termination of employment will cause the option to be treated as a nonqualified stock option for tax purposes.[39]

Grant/Cancellation of Options More Than Six Months Apart

The grant of new options and cancellation of underwater options in two separate and independent transactions spaced more than six months apart is a popular alternative to repricing among many companies. With this six-months-and-a-day approach ("six-and-one"), if the higher priced option is cancelled with the optionee (foregoing any increase in the share price of the cancelled option) and a new option is granted six months and one day later at the current fair market value, repricing will not be deemed to have occurred and, therefore, variable accounting treatment is avoided.[40] The exchange ratio may be 1:1, but it often is less, allowing the company to lessen shareholder dilution by having the new grant issue fewer options than the number of underwater options that were exchanged. The company cannot compensate the optionee for any appreciation in the stock price during the six-month period.[41] Option holders who terminate their employment with the company prior to the six-month waiting period before receiving reissued options will not be eligible to receive the new grant.

This approach clearly puts the optionee at risk, in that the value of the shares, and hence the exercise price of the new options, may increase over the six-month period, perhaps to a point that is even higher than the previ-

ously cancelled options. To offset this risk, the company may provide for a shorter vesting period or larger grant when the new options are granted. Before using this approach, a company should be mindful that it might actually create a disincentive for employees to want the stock price to rise before they get their new grant in six months. As with any option exchange program, the option holder must agree to the cancellation of his option. A grant/cancellation that is spaced more than six months apart may be appropriate for companies whose options are so deeply underwater that there is little likelihood that the share value will recover or that a change of control will occur within six months. However, if the value of the shares is volatile, the "six-and-one" approach may not be the most effective approach to use.

Accelerate Next Grant or Make Additional Grant

A company may issue a grant of options at current fair market value either as a new grant ahead of schedule or as an extra grant of options. The optionee gets the advantage of a low exercise price, and since the additional grant involves issuance of fixed options, there is no adverse accounting treatment for the company under APB 25. This may be the simplest alternative. However, the danger of this approach is two-fold: (1) a continued downturn in the economy or volatile market conditions may effectively strip the additional grant of any increased incentive if it joins the old options underwater, and a rapid stock price rebound may result in an unexpected and unintended windfall for the option holders who receive this additional grant; and (2) the grant of additional options will increase shareholder dilution,[42] perhaps beyond competitive levels, may accelerate depletion of the pool of reserved shares under the shareholder approved option plan, and may also result in an excessive option overhang.[43] Therefore, this strategy is most appropriate when the company has sufficient shares in the option plan and dilution and potential windfall gains are not major considerations for the company. The frequent grant of options periodically throughout the year may be particularly appropriate for volatile stock, in that it reduces the problem of fixing an exercise price based solely on the value of the shares on the grant date.

Increase Option Grant Frequency and Decrease Size of Option Grants

Companies may be able to minimize the effects of a volatile stock market by increasing the frequency of its option grants while decreasing the size of each grant. Each grant would be having the exercise price fixed to the pre-

vailing market conditions. Of course, if the stock's value continues to decline, the employee may still be holding underwater stock options, though the total impact may tend to minimize the number of options that are underwater as well as the degree of disparity between the exercise price and current fair market value when the pool of options granted over the course of the year is "averaged" for market value and exercise price. In conjunction with an increase in stock option grants, a company may also consider shortening the option term.

Grant "Paired" Options with Six-Month-Plus Expiration Period

Companies may want to grant options that expire at least six months and a day after the market value of the stock reaches the exercise price of the original options. Due to use of the "six-and-one" approach, this would not be considered a repricing and therefore would not trigger variable accounting treatment.[44] Although the additional grant has the negative effect of increasing share dilution, if the value of the company's shares increase to the original exercise price, the dilution caused by issuance of "paired" options will be limited due to the relatively short period for exercise of the additional grant. This is an effective way of restoring value to holders of underwater options while minimizing shareholder dilution.

Issue Restricted Stock in Exchange for Cancelled Options

This alternative requires the company to issue restricted stock in exchange for the cancelled underwater options. In such cases, fixed accounting applies to the new stock award, and the compensation expense that is recognized for accounting purposes will equal the value of the restricted shares on the grant date, less the price paid for the shares, allocated over the vesting period.[45] Under this approach, the company cannot grant options to the same optionees (within six months of cancellation) at a price lower than the exercise price of cancelled options.[46] Absent a prior election under Code Section 83(b),[47] as the restrictions on such shares lapse, the grantee would be subject to income tax measured by the difference between the price paid for the shares and their value at the time the restriction lapses.[48]

A complication may arise if the exchange ratio used is less than a 1:1 ratio of new shares to canceled options. The excess of options that were issued within the six-month look-back/look-forward period over restricted shares granted may receive variable accounting treatment if those options were granted at a lower exercise price within six months before or after the cancellation.[49] This approach may be most useful where the value of the shares has dropped significantly since the options were issued and would

result in a reduction of the company's option overhang. Shareholders may protest the company's decision to grant restricted stock insofar as such an award has immediate value, notwithstanding the restrictions. Perhaps not surprisingly, few companies to date have opted for this alternative.

Buy Out Options with Cash

This alternative requires the company to buy out the underwater options with cash, perhaps at a discount from its Black-Scholes value.[50] For accounting purposes the payment will be recognized as an expense on the company's financial statements. To avoid variable accounting treatment, the company must not make any option grants to the same optionees within six months of the cancellation (before or after) that have a lower exercise price than the bought-out options.[51] The company could make a new, fair-value option grant after a six-month waiting period; however, as with canceling and replacing, the company cannot compensate the employees for increases in the market price of the stock. This approach may be most feasible for companies willing to spend cash and incur a fixed accounting expense that the payment entails. The employee receives compensation for surrendering the options, which offset the risk of waiting for six months before receiving a new option grant. By redeeming the options, the company helps control stock dilution. This approach may be the most effective solution for a company that decides to no longer offer stock options as compensation.

Sell Options to a Third Party

An employee may sell the underwater options to a third party, provided that the option plan or agreement permits it.[52] In this fashion, the employee recoups some value from the sold option, but permitting this alternative will create a new class of non-employee option holders. Obviously, this alternative would not be possible if incentive stock options are involved.[53] However, for nonqualified options, this approach might work if the company is willing to have outside investors holding their stock options. A company willing to consider this approach should have other incentives to use to attract, motivate and retain employees.

Offer Non-Stock Incentives

A company may want to consider offering its key employees who are holding underwater stock options additional cash, in the form of a lump-sum bonus or increased salary, as compensation for their loss. In addition, employers should not overlook the value of non-cash perks (such as flextime,

increased vacation benefits, and other similar benefits) as viable ways to "re-incentivize" a work force. Under this approach, neither additional stock dilution nor excessive option overhang is likely to occur. Furthermore, the scope of eligibility for this program (whether cash, non-cash or a combination of the two) may be as broad or as limited as company expense may allow.

As previously discussed, the decline in stock prices has forced companies with underwater stock options to address how they will retain top talent, appease shareholders, and avoid potential regulatory traps. Any company in search of an appropriate solution should be prepared to address the considerations outlined in the following checklists. The first addresses repricing considerations while the second considers repricing alternatives.

Checklist of Repricing Considerations

___ **Mechanics of Repricing:** Are there any impediments under state law to option repricing? Does either the option plan or agreements restrict repricing? Will the company amend existing options or cancel existing options and grant new options? The grant of new options may entail a new vesting schedule and expiration date.

___ **Exclusion of Officers:** Should repricing include or exclude company officers? This is a reporting consideration for securities law purposes. Repricing of the options held by the top five executives of the company may trigger extensive 10-year reporting for all officers and directors in the company's proxy statement.

___ **Repriced Option Terms:** Should the repriced options include new vesting schedules, set the exercise price above current fair market value, or grant fewer options in exchange for the cancelled options?

___ **Optionees Subject to Repricing:** The company should determine whether senior executives and directors would participate in a repricing. Institutional shareholders may have less opposition to repricing that excludes options held by company's senior executives or directors. Note that extensive proxy statement disclosure obligations may be avoided if the repricing is not applicable to options granted to any executive officer named in the proxy statement.

___ **Timing of Repricing:** When should repricing occur? What should be the new exercise price of repriced options—current fair market value or less? How long is the downturn in the market expected to last?

___ **Exercise Moratorium:** Should there be a moratorium on exercising after an option repricing? What "black-out" period is most appropriate?

___ **Ramifications of Repricing:** Consider the accounting, tax and securities law issues when repricing, as well as the pooling of interests and excess parachute payment considerations.

___ **Company Performance:** Determine why the options are underwater. Has the depressed market price for company stock occurred because of a general downturn in the economy, because of company performance, or both?

___ **Share Dilution:** What impacts will the repricing have on shareholder dilution? Should you anticipate negative shareholder reaction to repricing?

___ **Communicating the Repricing to Option Holders:** How best can the repricing be communicated to optionees and other shareholders? What impact will a repricing have on morale of option holders or on the company's ability to retain key personnel?

Checklist of Repricing Alternatives for Consideration

___ **Self-Correction:** Will the value of the shares be expected to bounce back in the foreseeable future? If so, perhaps a simple extension of the expiration date for the underwater stock options will effectively address the problem. This approach anticipates that the company is fairly certain of a rebound of the value of the company's shares.

___ **Six Months and a Day for Option Exchange:** Will the new grant and cancellation be spaced more than six months apart? Are these transactions independent of each other or tied together in some fashion? Will the option exchange occur in a ratio of 1:1 or something less? Be careful about inadvertently creating a disincentive for option holders to increase the value of the shares before setting the exercise price on the new option grant. This approach may work best when the company believes that the share value is not likely to rebound at any time in the foreseeable future.

___ **Grant of Additional Options:** If the company grants additional options at current fair market value, how will this affect shareholder dilution?

Will such an additional grant accelerate the depletion of the option plan's share reserve? How will the option overhang be affected? What will be the overall effectiveness of this approach if the shares have not yet bottomed out in value? If the company has sufficient shares and is not concerned with share dilution or option overhang, this approach may be effective—and perhaps particularly appropriate if the share price is volatile.

___ **Increase Grant Frequency and Decrease Grant Size:** In a volatile market, this approach may be an attractive course of action, since it tends to minimize the effects of a stock's decline in value. By combining an increase in frequency with a decrease in size, the company may also be able to minimize the dilutive effects of this approach as well as the danger of an excessive option overhang.

___ **Grant Paired Options with Six Months-Plus Expiration Period:** The company may "pair" a new option with the original grant, causing the former to expire when the exercise price of the latter recovers. To avoid variable accounting treatment, the new option must expire more than six months after the share value reaches the exercise price of the original option. This approach works best when share dilution is not a principal concern.

___ **Issue Restricted Shares in Exchange for Cancellation of Options:** This approach may be appropriate where share dilution is not a concern and the company is willing to accept a compensation expense measured by the value of the restricted stock on the date of issue. Will an option exchange occur in a ratio that is 1:1 or less? The company may be required to exercise special care if it intends to avoid variable accounting treatment when issuing restricted stock in a ratio that is less than 1:1 ratio with cancelled options. Unlike options, restricted shares have immediate value, notwithstanding their restrictions. Therefore, the company that adopts this approach should anticipate and be prepared to address potential shareholder objections.

___ **Buy Out Options with Cash:** A company purchase of the options with cash will require the payment to be recognized as an expense on the company's financial statements. Does the company have sufficient liquidity to adopt this approach? Is the company willing to accept the charge to earnings that this approach entails? Does the company have an issue with excessive shareholder dilution? If the company is not going to offer options as compensation in the future, a buyout with cash would appear

to make the most sense. A company must be mindful not to issue a new grant with a lower exercise price within six months preceding or following the buyout if it wants to avoid variable accounting treatment.

___ **Sell Options to Third Party:** A sale of the options to a third party must be permitted by the option plan or agreement for this alternative to be a viable one. Does the company's option plan or agreements permit such a sale since it creates a new class of optionees (and potential shareholders) who are not employees? A sale would allow the optionee to recoup some value for a non-qualified option. This approach would not work for incentive stock options that cannot be transferred as a matter of law.

___ **Offer Non-Stock Incentives:** A company should not overlook the value of making cash payments (whether in the form of a salary increase or cash bonus or non-cash perks, such as flextime or increased vacation benefits) to make up for the lost value of underwater stock options. What are the cash incentives and non-cash perks that the company can offer in lieu of additional options or restricted shares? Is stock dilution and/or excessive overhang a problem? These non-stock incentives avoid stock dilution and option overhang concerns. The company may restrict the total cost of this approach by limiting program participation to key employees holding underwater stock options.

Conclusion

Stock options will continue to be a major component of compensation for employees in many companies. These companies will once again face the problem of underwater stock options during the next downturn in the U.S. economy. Such companies will need to develop and implement an effective stock option strategy that is based upon a thorough understanding of the ramifications of repricing and its alternatives. The sooner a company can rid itself of the confusion as to what must be done to effectively respond to the difficulties posed by underwater stock options, the greater its chances will be that it can retain talent critical to its success in today's competitive business environment.

Notes

1. This information is based upon an estimate of the National Center for Employee Ownership as to the number of employees actually holding options in 2000.
2. In November 2000, iQuantic Inc. found that 80% of the dot-coms and technology firms that it had surveyed had underwater stock options.

3. Employees are eligible to receive either incentive stock options or nonqualified stock options. Non-employee service providers, such as independent contractors, however, are eligible to receive nonqualified stock options, but are not eligible under the requirements of Code Section 422 to receive incentive stock options.
4. Under APB 25, compensation cost is measured using the "intrinsic value method." Since the adoption of Statement No. 123, "Accounting for Stock-Based Compensation," in October 1995, FASB requires that all companies that continue to use APB 25 disclose in a footnote to their financial statement net income and earnings per share as if they had implemented Statement No. 123.
5. See FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN 44"), which was adopted by FASB on March 1, 2000. According to a recent survey conducted on behalf of PricewaterhouseCoopers, almost 43% of 113 companies had repriced their options since 1988.
6. The grant of a new option in tandem with the cancellation of the underwater option may involve more than just a lowering of the exercise price, and may also affect the vesting and expiration terms of the new option.
7. FIN 44.
8. Ibid.
9. Ibid.
10. Ibid.
11. Ibid. Variable accounting occurs when the exercise price at grant is not certain. The grant must be expensed against the company's earnings in each quarter, based on the spread between the exercise and market price of the stock.
12. FIN 44. If the company's stock price decreases rather than increases after repricing, variable accounting treatment may result in periodic credits to earnings as the stock price decreases.
13. Treas. Reg. 1.162-27(e)(2)(vi)(B). For the purposes of this article, "options exchange" refers to a repricing by means of a cancellation of outstanding underwater options in exchange for the regrant of a new option at the then-current fair market value.
14. Code Section 162(m), Treas. Reg. 1.162-27(e)(2). The definition of an "outside director" for this purpose differs from that used for Section 16 of the Securities Exchange Act of 1934.
15. Ibid. Code Section 162(m)(3) refers to "covered employees," which would include the chief executive officer as well as the other four highest compensated officers of the company for the taxable year. Section 162(m)(3)(A)(B).
16. Under Code Section 162(m)(4)(E), remuneration would include fixed stock options.
17. Treas. Reg. 1.162-27(e)(2)(vi)(A) requires that the plan under which the option is granted state the maximum number of shares that may be granted during a specified period to any employee in order for the performance-based compensation Section 162(m) exception to apply.
18. Treas. Reg. 1.162-27(e)(2)(vi)(B) provides that in the case of a repricing, "both the option that is deemed to be canceled and the option that is deemed to be granted

reduce the maximum number of shares for which options may be granted to the employee under the plan."

19. See Temp. Reg. 14A.422A-1.
20. Code Section 422(d) provides that to the extent that the aggregate fair market value of the underlying shares of stock are exercisable by the optionee in any calendar year exceeds $100,000, such options are not be treated as incentive stock options.
21. Code Section 422(d)(2) discusses the ordering rule for purposes of applying the $100,000 per year limitation.
22. See Item 402 of Regulation S-K issued by the Securities Exchange Commission.
23. Ibid.
24. Ibid.
25. See Press Release 2001-32 at *www.sec.gov/news/press/2001-32.txt*.
26. See Rule 13e-4 of the Securities Exchange Act of 1934.
27. See "Option Exchange Offers" discussed at *www.sec.gov/divisions/corpfin/repricings.htm.*
28. Rule 16b-3(d)1. A "non-employee director" is defined as a director who: (a) is not currently an officer or otherwise employed by the issuer or a parent or subsidiary of the issuer; (b) does not receive within the fiscal year compensation in excess of $60,000 for services as a consultant or in any capacity other than as a director of the issuer, or a parent or subsidiary of the issuer; (c) does not have an interest in any other transaction for which disclosure would be required in the issuer's proxy statement; and (d) is not engaged in a business relationship that would require disclosure under Item 404(b) or Regulation S-K. Rule 16b-3(b)(3)(i).
29. Section 16(a) of the Securities Exchange Act of 1934.
30. Section 5 of the Securities Act of 1933.
31. Section 3(a)(9) of the Securities Act of 1933.
32. The state blue-sky laws should always be checked for each state where the stock option plan is offered.
33. See FASB Opinion No. 16, Business Combinations.
34. The pooling-of-interests method for accounting purposes refers to the method by which business combinations were accounted for using FASB Opinion No. 16. However, for all business combinations initiated after June 30, 2001, the pooling-of-interests method will no longer be allowed, and FASB requires that all business combinations after such date use the purchase method of accounting. FASB Statement No. 141, issued June, 2001.
35. Code Section 280G(b)(2).
36. Code Section 280G(b)(2)(C).
37. Code Section 280G(a). An excise tax of 20% of an "excess parachute payment" is imposed on the person who receives such a payment, as provided under Code Section 4999(a). For this purpose, an "excess parachute payment" is defined under the rules that deny a deduction to the corporation that makes an excess parachute payment. Code Section 4999(b).

38. Institutional shareholders may insist upon no repricing if additional option grants are issued and may actually seek to add language that prohibits a repricing of new grants.
39. Code Section 422.
40. FIN 44.
41. Ibid.
42. Shareholder dilution generally refers to the effect that the grant of stock options has upon the other shareholders. When options are issued, an existing shareholder's ownership interest is potentially reduced to the extent that the value of the stock is greater than the exercise price of the option.
43. Option overhang refers either to the stock reserved for stock option plans or to unexercised options outstanding as a percentage of total company shares outstanding. Excessive overhang dilutes earnings per share and may result in shareholder opposition to new or amended stock option plans. Overhang is determined by a fraction whose numerator is option shares reserved or actually granted and the denominator is the number of total company shares outstanding.
44. FIN 44.
45. APB No. 25.
46. FIN 44.
47. An election under Code Section 83(b) must be filed within 30 days of the date the options was exercised. No special form is required.
48. Code Section 83(a).
49. FIN 44.
50. Companies must establish the current "fair value" of their options when they are granted. FASB requires that companies use an option pricing model for valuing employee stock options that takes into consideration six specific variables. The most common option pricing model used by public companies is the Black-Scholes method, a mathematical formula that considers such factors as the volatility of returns on the underlying securities, the risk-free interest rate, the expected dividend rate, the relationship of the option price to the price of the underlying securities, and the expected option life.
51. FIN 44.
52. Option plans and agreements may and often do restrict the transfer of options. Code Section 422(b)(5) generally prohibits incentive stock options from being transferred during the optionee's lifetime.
53. Code Section 422(b)(5).