

PROBLEMS WITH STOCK OPTION EXERCISES

BY: JAMES BROPHY AND LIZ CRAMPTON

Officers, directors, and 10% shareholders of publicly traded corporations are subject to strict laws concerning the purchase or sale of shares ("insider trading"). Section 16(b) of the Securities Exchange Act of 1934 provides that these "insiders" may not buy and sell the issuer's securities within a six-month period. Those who do must disgorge any profits they derive from the short-swing transactions. Liability is automatic and does not depend upon whether the insider was actually in possession of material insider information or on whether the insider intended to trade on that information. The insider trading rules are a special concern for those officers and directors who are compensated with stock options. Fortunately, the Securities and Exchange Commission ("SEC") has promulgated rules exempting certain transactions from the Section 16(b) rules.

The governing rule is that the grant of an option under a plan that has been approved by shareholders is a transaction exempt from Section 16(b), if the grant of the option is approved by the board of directors, or a committee of the board, usually the compensation committee, comprised solely of independent directors. The grant of an option is also exempt from Section 16(b) if the officer or director grantee holds the option for at least six months after the date of grant until "disposition" (i.e., exercise). These rules are set forth in SEC Rule 16b-3(d). These rules only exempt from Section 16(b) the grant of the option, not the subsequent disposition of the underlying security. For example, if a senior executive is issued an option and holds the option for at least one year and then elects to exercise the option through a "cashless exercise" with a broker, the executive would have disposed of the option by exercising it. The sale of some of the shares to pay the option price is not a transaction exempt from Section 16(b). Frequently the option price is provided through a loan from the broker and is repaid when the broker sells a sufficient number of shares to repay the loan. This is a so-called "cashless exercise." The officer or director is left with a net number of shares. Shares sold for an insider in a "cashless" transaction can be matched against a purchase or sale within six months of the non-exempt sale. Many officers and directors do not realize this. Consequently, if an officer or director purchases shares within six months before or after a cashless exercise, the officer or director will likely face Rule 16(b) liability because the purchase or sale will be reported in Form 4 and 5 filings made with the SEC and will be matched against a "cashless" option exercise. A group of plaintiffs' attorneys carefully monitors these transactions through Form 4 and 5 filings and will bring a lawsuit if the profit is not repaid. Attorneys' fees may also be recoverable. There is a solution to this conundrum, however.

Under Rule 16b-3(e), transactions involving the disposition to the issuer of issuer equity securities are exempt from Section 16(b), provided that the terms of such disposition are approved in advance in the prescribed manner. One type of disposition of issuer securities to the issuer is sometimes referred to as an "immaculate" cashless exercise; in this transaction, the optionee exercises the option by directing the issuer to retain as payment some of the underlying stock that the optionee would otherwise have received upon that exercise, and to deliver the net balance of the stock to the optionee. This form of cashless exercise has the same effect as a sale through a traditional broker's cashless exercise; however, the transaction is exempt from Rule 16(b) because it involves a disposition of securities to the issuer.

To take advantage of the “immaculate” cashless exercise, a corporation’s Stock Option Plan must provide for it. If a stock option plan does not currently provide for the “immaculate” cashless exercise, it can be amended, but certain issues should be considered.

Although the addition of an "immaculate" exercise feature is not a material amendment of the terms of an outstanding option for SEC purposes, it may be material for tax purposes, and certain tax consequences must be considered.

Under current tax law, a material change of the terms of the option is considered the grant of a new option. An option amendment that provides more favorable payment terms for the stock purchased under the option is likely a material modification. A material modification will likely adversely affect the qualification of an incentive stock option (ISO), and it is unlikely the option will continue to meet ISO requirements because, for tax purposes, the amendment of the stock option will be treated as the grant of a new option. To qualify as an ISO, the option price at the time of grant must equal fair market value of the underlying security. If an immaculate exercise feature is added and the option is not repriced, ISO status could be lost.

If an option was originally issued with an "immaculate" exercise feature and is also an ISO, the cashless "immaculate" exercise also has tax consequences. When an ISO is exercised, the optionee/owner must hold the underlying stock for a specific period to remain eligible for ISO treatment. In an “immaculate” cashless exercise, the stock is immediately sold to the issuer, when the option is exercised. Thus, the minimum holding period is not met for the stock that is immediately sold to the issuer. Loss of ISO status, however, only applies to those shares that are sold to pay the exercise price; the shares retained by the optionee may still qualify as ISOs. The optionee will recognize gain or loss as ordinary income for those shares of the ISO paid to satisfy the exercise price of the option.

Not only is the “immaculate” cashless exercise a convenient way for an officer or director to exercise options, but this type of option exercise allows an officer or director to avoid Section 16(b) liability. Contact James Brophy or Liz Crampton for more information on the stock option exercises and their complexities.