

Plenty of Options

The Recorder
By Amanda Royal
August 31, 2009

SAN FRANCISCO — Some big-firm lawyers are busier than others nowadays, but it's not just the bankruptcy guys getting work. Options exchanges have been a boon to benefits and executive compensation lawyers, filling a void in their workload left by the lull in M&A activity.

Baker & McKenzie's Valerie Diamond said options exchanges — in which companies turn underwater options into better-priced options, restricted stock or cash for the benefit of shareholders or employees — are taking up 70 percent of her time. A couple of years ago, they rarely popped up at all.

Her 20-attorney group has done about 50 options exchanges in the past year, for clients including eBay Inc. and Polycom Inc.

The boom is a result of two things: plummeting stock prices and a 2005 accounting rule change that made the exchanges more immediately available.

"There's really been an explosion of these things in the past year," Diamond said. "I didn't expect there were going to be so many companies doing it. From the employees' standpoint, if they can't exercise [an option] and realize that cash, they feel that they have nothing of value. It's essentially trying to make sure employees stick around and feel compensated."

Diamond, chairwoman of Baker & McKenzie's equity services group, specializes in the international side of the exchanges. For each country where employees are located, they must receive a disclosure on the tax consequences of the exchange, which translates to a lot of work for lawyers. Most of the companies Diamond has advised have offices in at least 30

countries, and she says she just finished an exchange for a company with offices in 65 countries.

Legal fees can add up fast. An exchange can easily cost a company upward of \$100,000, she said.

Joseph Yaffe, an executive compensation lawyer who moved from Latham & Watkins to Skadden, Arps, Slate, Meagher & Flom on Wednesday, said that about a third of his time is now taken by options exchange work.

"These option exchanges have come close to filling up the void left by the downturn in transactional work," Yaffe said. "There have been fewer deals, but there have been more option exchanges. My group would generally be supporting M&A transactions and has been doing a lot more of this work at the same time the M&A market has been slower."

Yaffe's six-person team had done about 20 exchanges, some of them for private companies. His clients have included eBay, Advanced Micro Devices Inc. and NetApp. (Diamond did the international aspect of the eBay exchange.)

The last boom in options exchanges was during 2001 and 2002, and most of those involved technology companies. After the 2005 accounting change, there's been a steady uptick in exchanges, starting with 12 in 2005, according to consulting firm Radford, which tracks the exchanges at Underwaterexchange.com.

In 2008, about 50 companies exchanged underwater options. That number is on track to triple this year. About 70 companies have already completed tender offers with the SEC, and another 70 or 80 have signaled an intention to do an exchange through their proxy statements, according to Jon Burg, vice president at Radford.

Of the 120 completed exchanges from 2008 and 2009, half were technology companies, 10 percent were biotech or life sciences companies and the other 40 percent were general industry, according to Burg. That's a change from the first wave, which mostly included technology companies.

And, following a general trend away from granting options as compensation, almost half of exchanges now involve turning the options into restricted stock

units or cash. Seven years ago, all exchanges were options for options, Burg said.

"It depends on the company's compensation philosophy and strategy going forward," Yaffe said. "Over the last couple of years, there's been a steady increase in the use of RSU as compared to stock options."

Yaffe said that while he expects to do more exchanges in the coming year, he thinks the current wave has crested, now that the market has improved.

Diamond said she still has a number in the pipeline and is putting together fee estimates for future exchanges.

"I think that as companies' stock prices go up, then we can expect at least some of these companies to rethink going forward with the exchange," Diamond said. "I believe that there will be exchanges through year end but if the market continues to rise, I would expect we would not see the trend continue next year."

Burg said it depends on where the market goes from here. Three months ago, he expected the activity to continue strong into 2010. Now, many companies' stocks have rallied to healthy territory. However, if you look at options granted, say, over the past five years, many will still be substantially underwater, even with the 20 to 30 percent recovery experienced by many companies over the summer.

"The rebound is going to leave a majority of those options far underwater," Burg said. "Ultimately, it comes down to the total pool of outstanding options, and what portion are underwater and how far they are underwater."