Underwater Stock Options and Repricing Strategy

Daniel N. Janich

In the 1990s, the widespread use of broad-based stock option plans resulted in many employees as well as some independent contractors holding stock options, particularly in Internet startups and emerging high-tech companies. When the tech bubble burst and the U.S. economy declined, many companies that had issued stock options discovered that their option grants were "underwater"—i.e., the options' exercise price(s) had become higher than the value of their underlying shares. Stock options that remain underwater for a significant period of time are essentially worthless and therefore fail to provide an incentive to the optionee for achieving ever-greater heights of performance. Consequently, such options will likely fail to retain the company's key employees, much less attract new talent.

The fall 2001 issue of this journal included an article on "Underwater Stock Options and Repricing Strategy" that addressed these issues and offered companies a blueprint for addressing this situation. This update is a comprehensive revision of that piece, dealing with the issues as they exist in the changed legal and accounting climate of 2006. Among other things, this article discusses the revised accounting rules introduced by FAS 123(R) and the deferred compensation rules of Internal Revenue Code Section 409A and their implications for companies developing a strategy for dealing with underwater options.

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 com-

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panies who have led the way in making broad-based stock options popular among rank-and-file employees in more recent years. As a result of the popularity of these broad-based plans, stock options have assumed a major role as incentive-based compensation available to employees and independent contractors.[1] In fact, the reality today is that many such workers consider compensatory stock options to be an essential part of their total compensation package. Until recently, favorable accounting treatment made stock options particularly attractive to use as a compensatory device because the compensation cost was allowed to be largely unrecognized on the issuing company's financial statements.[2]

When the U.S. economy declined after bursting of the tech bubble in the late 1990s, many companies that had issued stock options found their grants "underwater," that is, with an exercise price above the current fair market value of the underlying shares, thereby stripping the option of its purpose as an incentive or its value as compensation. During those dark days, few companies were undertaking any meaningful hiring, and even fewer workers felt the time was right to leave their current employment. However, in more recent years, as the economy has slowly improved, and the job market along with it, these same companies are beginning to face increasing pressure to develop an effective strategy to revive their option programs before losing valuable talent to a competitor.

This article is an update to an essay from the fall 2001 issue of this journal, titled "Underwater Stock Options and Repricing Strategy: Is Your Company Drowning in Confusion?" that discussed stock option repricing and its alternatives. Since its publication, the Financial Accounting Standard Board (FASB) issued Statement No. 123 (revised 2004), *Share-Based Payment* ("FAS 123(R)"), which repealed the "intrinsic value" method of accounting for equity compensation and replaced it with a mandated "fair value" method for all equity awards granted to employees. Congress was no less busy comprehensively revising the deferred compensation rules under Section 409A of the Internal Revenue Code ("the Code"), which was enacted in 2004 as part of the American Jobs Creation Act.[3] These recent developments and, in particular, the changed accounting rules, prompt us to take another look at the issue of repricing and its alternatives. Is repricing still subject to adverse accounting treatment that renders its use inadvisable? Are there alternatives to repricing that are still viable today? What additional concerns presented by the new accounting rules and Section 409A compliance requirements must companies consider when developing an effective strategy to fix their underwater stock option problem? These and other questions are addressed below.

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 was also accomplished by cancelling the existing option and granting to the optionee one or more new options at a lowered exercise price.

Until recently, unfavorable accounting treatment resulted if the cancellation and new grant of options occurred within six months of each other.[4] This six-month look-back/look-forward period was far-reaching in scope, covering any action that either had the effect of 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, or had the effect of cancelling the option, such as modifying the 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, or otherwise reach any other agreement with the optionee that would reduce the likelihood that the option would be exercised.[5] With the adoption of FAS 123(R), the six-month look-back/look-forward period is no longer of concern for repricing purposes, as discussed below.

Accounting Treatment

Until December 1998, companies desiring to do so simply repriced their underwater stock options in order to permit optionees to "profit" by any subsequent increase in share value.[6] The repricing did not entail any adverse accounting treatment. Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation* ("FIN 44"), which was adopted by FASB on March 31, 2000, and applied retroactively to December 15, 1998, changed all of that by requiring 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.[7] 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. This approach made the amount of expense to be recognized difficult to predict. To make matters worse, under variable accounting, as the company's stock price increased, a periodic charge to earnings was required to be reported.[8] Needless to say, the accounting treatment for repricing of options under FIN 44 discouraged companies from using repricing to address their underwater stock option problems, and caused them to seek out alternatives with relatively less onerous consequences.

The accounting conundrum raised by variable accounting treatment for repriced options may no longer be of as much importance as it was previously.[9] Companies are no longer subject to variable accounting treatment when they reprice their options and, therefore, no longer need to wait six months and a day to replace cancelled options in order to avoid unfavorable accounting treatment, as previously was the case.[10] Rather than impose variable accounting treatment, FAS 123(R) applies the "fair value" method of accounting to repricing and treats a cancellation of an award accompanied by the concurrent grant of a replacement award (or other valuable consideration) as a modification.[11] For purposes of measuring the recognized expense, FAS 123(R) compares the fair value of an award immediately before and immediately after a modification, as of the modification date.[12] If the fair value of the replacement award is higher, the company must recognize the incremental value of the modified award over the remaining service period.[13] However, that expense will be fixed at the time of repricing. As a result, option repricing has become easier.

The new accounting standard is effective for reporting periods that start after June 15, 2005, for public companies, except for small businesses with revenues of less than $25 million, which have until the first reporting period that starts after December 15, 2005. Nonpublic companies must begin using the new accounting standard in fiscal years that begin after December 15, 2005.[14] FAS 123(R) applies to all equity compensation granted, modified, repurchased, or cancelled after the applicable effective date, and to the nonvested portion of equity compensation outstanding as of the effective date, provided the awards were granted, modified, or settled in cash during fiscal years beginning after the original December 15, 1994, effective date of FAS 123.[15]

Federal Income Tax Considerations

Deferred Compensation Rules. Code Section 409A has introduced sweeping new rules affecting the operation of deferred compensation arrangements, including equity compensation plans such as stock options. However, where the exercise price of an option is not less than the fair market value of the underlying stock on the grant date and there are no other deferral features involved that would delay recognition of income on the award beyond the exercise date, the stock option will generally be treated as exempt from the requirements of Section 409A.[16] Certain modifications made to an existing stock option may cause the option to be treated, for purposes of Section 409A, as a new grant.[17] Although the repricing of an outstanding option will be treated as a new grant, the new grant may still continue to qualify for the Section 409A exemption if that grant does not have a below-market exercise or base price at the time of repricing.

Multiple repricings of the same option may indicate that the exercise price or base price is actually a floating or adjustable price, with the result that the option will fail to qualify for the Section 409A exemption from the date of the original grant.[18] The importance of ascertaining whether the option grant is subject to Section 409A should not be overlooked, because a failure to comply with its requirements will result in immediate recognition of taxable income, measured by the spread between the exercise price and the value of the underlying stock at the date of grant, as well as the imposition of additional tax penalties.[19]

Nontaxable Event. 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 repricing.[20] 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-paid officers of a public company as well as for holders of incentive stock options.

Five Highest-Paid Officers. In many instances, the participation in a repricing by the five highest-paid officers of a public company will trigger Code Section 162(m) considerations. Under Section 162(m), a publicly held company may deduct no more than $1 million in compensation paid to any of its five highest-paid officers. Stock options are treated as compensation includible for purposes of this limitation under Section 162(m) unless the options are considered to be "performance-based compensation" and have been approved by at least two "outside directors" of the company's full board of directors.[21] Repriced options must also be approved in this same manner to be exempt from the Section 162(m) deduction limits.

For the Section 162(m) exemption to apply, the option plan must also specify the maximum number of shares for which options may be granted to any employee during a specified period of one or more years.[22] If the option is repriced during the same period in which it was granted, then, to allow one 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.[23] If repricing causes the individual limit to be exceeded, the Section 162(m) exemption would no longer apply to that individual.[24]

Incentive Stock Options. 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.[25] Repricing will start over again the capital gains tolling period. Therefore, to obtain incentive stock option treatment, shares subject to the repriced option may not be disposed of within two years from the date of the repricing or 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.[26] 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.[27] Any repriced options exceeding this limit would be treated for tax purposes as nonqualified stock options.

Securities Law Issues

The securities laws, like the federal income tax rules, 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.[28] Additionally, the repricing may trigger extensive 10-year reporting for all officers and directors in the proxy statement.[29] As part of this report, the company must describe repricing of options held by any executive officer during the last 10 fiscal years.[30] 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 buy company shares, usually at a premium), which require added disclosure.[31] However, they are exempt from the tender-offer requirement that they must be offered to all stockholders as long as the stock options are issued under the company's employee plans and are used for compensatory purposes.[32]

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.[33] 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.[34] Repricing must also be reported by a person who is subject to Section 16 as the disposition of the existing option and the acquisition of new options.[35]

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).[36] 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.[37] Notice filings may also be necessary in connection with repriced options under some state blue sky laws.[38]

Timing the Repricing: Excess Parachute Payment Considerations

When a company is in a "change of control" situation, a repriced stock option may be treated as a "change-in-control stock option" for purposes of the excess parachute payment rules under Code Section 280G.[39] A change in control stock option is usually granted during the one-year period preceding the event.[40] 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.[41]

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 who receive options benefit by any increase in the value of the company as a result of their individual and collective performance. Should these same employees suffer alongside shareholders when an economic downturn causes share values to decline? Many shareholders think so. In particular, institutional shareholders believe that option holders should be subject to the same risks in the volatility of underlying share price as shareholders.[42] Suffice it to say that companies expecting to undergo an option repricing should anticipate and prepare for negative feedback by shareholders.

Alternatives to Repricing

The repricing decision is easier to make today than several years ago as a result of the changes introduced by FAS 123(R). However, there are myriad considerations that come into play in addition to accounting treatment that must be addressed in devising an effective strategy to deal with underwater stock options. Do any viable alternatives to repricing exist? Several alternatives that were popular before FAS 123(R) will no longer be preferable to straight repricing and, in fact, may be less so. The discussion below revisits these alternatives in light of recent developments.

Extension of the Expiration Date for 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. However, a company using this strategy must be careful in ascertaining the length of extension that will be required because a disqualifying extension will result in Section 409A coverage retroactive to the original grant date.[43] A disqualifying extension will not be deemed to occur if the exercise period is not extended beyond the later of (1) the end of the calendar year in which the grant would have expired in the absence of such extension or (2) the 15th day of the third month following that normal expiration date.[44] If incentive stock options are involved, an extension of the exercise period beyond three months following termination of employment will cause the option to be treated as a nonqualified stock option for tax purposes.[45] For these reasons, this alternative may be appropriate when only a short-term extension is needed.

Grant/Cancellation of Options More Than Six Months Apart

Under FIN 44, as discussed above, the grant of new options and cancellation of underwater options in two separate and independent transactions spaced more than six months apart was a popular means of avoiding repricing, and thus variable accounting treatment. Under FAS 123(R), the cancellation of an out-of-the-money option results in recognition on the cancellation date of any still-unrecognized compensation cost, and the subsequent grant is treated as a new grant that will be recognized at its full cost rather than incremental cost.[46] As a result, under FAS 123(R) the six-month waiting period is no longer relevant; therefore, "six months and a day" exchange programs are no longer favored over straight repricing.

Acceleration of Next Grant or Issuance of Additional Grants

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. However, with the mandatory recognition of compensation cost under FAS 123(R), such new or additional grants are treated as additional expense. As such, this alternative, which was designed to mitigate the effects of underwater options without incurring variable accounting treatment that was attendant to repricing, no longer offers any advantages over a straight repricing and, due to the difference in recognition between full and incremental cost, may actually entail the recognition of more expense than what would occur under straight repricing.

Increasing Option Grant Frequency and Decreasing Size of Option Grants

The effects of a volatile stock market may be minimized by increasing the frequency of option grants while decreasing the size of each grant. Each grant would have the exercise price fixed to the prevailing market conditions. This alternative usually works best in conjunction with the shortening of the option term, which, under FAS 123(R), would be considered a "modification" resulting in the recognition of an expense measured by the difference between the estimated fair value of the modified award and the original award at the modification date.[47] As such, this alternative today provides no accounting advantage over repricing.

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

Under FIN 44, to avoid variable accounting treatment, companies would avoid repricing by granting options that expired at least six months and a day after the market value of the stock reached the exercise price of the original options. Like the "six months and a day" approach discussed above, this variation of it is also rendered obsolete under FAS 123(R).

Issue Restricted Stock in Exchange for Cancelled Options

This alternative requires the company to issue restricted stock in exchange for the cancelled underwater options. Under FAS 123(R), the cancellation of an award accompanied by the concurrent grant of a replacement award is accounted for as a modification.[48] Since variable accounting is no longer a concern, this alternative offers no accounting advantage over repricing under FAS 123(R). However, companies wishing to avoid the underwater stock option problem in the future may want to consider issuing restricted stock or restricted stock units, at least on a selective basis, as part of an exchange program.

Buy Out Options with Cash

This alternative requires the company to buy out the underwater options with cash, perhaps at a discount from the options' Black-Scholes value.[49] Under FAS 123(R), cancellation of an award not accompanied by the concurrent grant of a replacement award is accounted for as a repurchase for no consideration.[50] There is no reversal of previously recognized compensation cost, and any previously measured but unrecognized cost is accelerated at the cancellation date.[51] Rather than avoiding recognition of expense, the cash award causes the entire compensation charge to be recognized in the year of the cash-out.

Sell Options to a Third Party

An employee may decide to sell his or her nonqualified stock options that are underwater to a third party, provided that the option plan or agreement permits it.[52] This alternative is not possible with incentive stock options.[53] This alternative, though it allows the employee to recoup some value from the sold option, would create a new class of non-employee option holders. Many companies restrict transferability of their nonqualified stock option grants to prevent this from happening because they choose not to have outside investors holding their stock options.

Offer Non-Stock Incentives

A company may offer employees holding underwater options some cash compensation, either as a bonus or in the form of increased salary or a non-cash perk, without cancelling the worthless options, as a means to "re-incentivize" its work force. This additional compensation would likely result in the recognition of expense. Each company considering this alternative must determine whether the additional compensation that would be required to achieve the intended effect in lieu of a new option grant is feasible.

Conclusion

For many companies, stock options will continue to play a significant role as an incentive to attract and retain the best employees. Recent accounting and tax rule changes will likely make the repricing decision easier and, perhaps, preferable to the various earlier alternatives that were designed to avoid the adverse accounting treatment that previously made repricing unacceptable. In a broader context, the mandatory recognition of stock options as an expense levels the playing field, thereby allowing companies to reconsider the use of other forms of equity compensation, including restricted stock, as part of an overall equity compensation program. The reduced popularity of stock options will lessen the impact of any future underwater stock option problem and perhaps make repricing an issue of less importance than what it once was. However, companies that continue to offer stock options as an integral part of their employees' compensation should anticipate their need for an effective repricing strategy to deal with the problem of underwater stock options during the next economic downturn.

Notes

1. The requirements of Code Section 422(b) restrict incentive stock options to employees. Therefore, non-employee service providers, such as independent contractors, are eligible to receive only nonqualified stock options, and employees are eligible to receive incentive stock options and nonqualified stock options.
2. Before 2005, many companies accounted for their stock options using APB Opinion No. 25 ("APB 25"), under which compensation cost was measured using the "intrinsic value" method of accounting. This method

allowed companies to avoid recognition of their compensation cost as an expense. Under Statement No. 123(R), "Share-Based Payment" ("FAS 123(R)"), APB 25 has been repealed and replaced with a mandate that all equity awards granted to employees be accounted for by using a "fair value" method of accounting. This fair value is measured at grant for stock-settled awards, and at subsequent exercise or settlement for cash-settled awards.

3. The American Jobs Creation Act of 2004 was enacted into law on October 22, 2004. See Public Law No. 108-357, 118 Stat. 1418.

4. See FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN 44"), which FASB adopted on March 31, 2000.

5. FIN 44.

6. Id.

7. Id.

8. Id. 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.

9. FAS 123(R) applies only to stock-based awards to employees and to non-employee directors. The revised standard does not apply to stock-based compensation issued to non-employees, such as independent contractors or other non-employee service providers. Share-based payment transactions with non-employees continue to be accounted for under FAS 123. FASB intends to consider these accounting standards for non-employees at a later date.

10. The six-month look-back/look-forward strategy was not without risks. The company was not allowed to compensate the optionee for any appreciation in the stock price during the six-month period, and option holders who terminated their employment with the company before the six-month waiting period before receiving reissued options were not eligible to receive the new grant.

11. FAS 123(R).

12. Under FAS 123(R), "fair value" for unvested stock options is estimated using an option-pricing model, such as Black-Scholes or binomial lattice model. A "modification" is broadly defined to include any change to an award's terms, including number of shares, exercise price, transferability, settlement provisions, and vesting conditions, and certain "inducements" to exercise and exchanges of awards or changes to award terms in connection with a business combination or an "equity restructuring," such as a stock dividend, stock split, spin-off, rights offering, or large nonrecurring cash dividend. See FAS 123(R).

13. Under FAS 123(R), companies can only recognize increases in award value. There are no modifications for reductions in value. FAS 123(R) treats most types of award modifications in the same manner and, in doing so, perhaps encourages companies to make a "value-for-value exchange" with little, if any, accounting effect when the award's fair value remains essentially unchanged.
14. FAS 123(R).
15. Id.
16. Prop. Reg. 1.409A-1(b)(5)(i)(A), (b)(5)(ii); Notice 2005-1, Q&A-4(d)(ii),(iii). An option to purchase stock other than the common stock of the corporation that is a service recipient (or its controlled group members) generally will provide for a deferral of compensation under Section 409A. See Prop. Reg. 1.409A-1(b)(5)(i)(C). The right to receive all or part of the dividends declared and paid on a number of shares underlying the stock right between the date of grant and the date of exercise of the stock right constitutes an offset to the exercise price of the stock option unless the right to the dividends is explicitly set forth as a separate arrangement. Prop. Reg. 1.409A-1(b)(5)(i)(E). The existence of a separate arrangement to receive dividends does not cause a stock right to fail to satisfy the requirements of the exclusion from the definition of deferred compensation under Code Section 409A. Id.
17. Prop. Reg. 1.409A-1(b)(5)(v).
18. Id.
19. Section 409A(a)(1)(A), (B); 409A(b)(4).
20. 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.
21. 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.
22. 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 Section 162(m) performance-based compensation exception to apply.
23. 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 cancelled 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."
24. Treas. Reg. 1.162-27(e)(2)(vi)(B).
25. See Temp. Reg. 14A.422A-1.
26. 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.

27. Code Section 422(d)(2) discusses the ordering rule for purposes of applying the $100,000 per year limitation.
28. See Item 402 of Regulation S-K issued by the Securities Exchange Commission.
29. Id.
30. Id.
31. See Press Release 2001-32 at *www.sec.gov/news/press/2001-32.txt*.
32. See Rule 13e-4 of the Securities Exchange Act of 1934.
33. See "Option Exchange Offers" at *www.sec.gov/divisions/corpfin/repricings.htm.*
34. Rule 16b-3(d)1. A "non-employee director" is defined as a director who: (1) is not currently an officer or otherwise employed by the issuer or a parent or subsidiary of the issuer; (2) 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; (3) does not have an interest in any other transaction for which disclosure would be required in the issuer's proxy statement; and (4) 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).
35. Section 16(a) of the Securities Exchange Act of 1934.
36. Section 5 of the Securities Act of 1933.
37. Section 3(a)(9) of the Securities Act of 1933.
38. The state blue sky laws should always be checked for each state where the stock option plan is offered.
39. Code Section 280G(b)(2).
40. Code Section 280G(b)(2)(C).
41. 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).
42. 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.
43. Prop. Reg. 1.409A-1(b)(5)(v).
44. Prop. Reg. 1.409A-1(b)(5)(v)(C).
45. Code Section 424(h)(3); Reg. 1.424-1(e)(4)(i).

46. FAS 123(R).
47. Id.
48. Id.
49. 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. Under Code Section 409A, the cash-out of a grant for an amount equal to that otherwise payable upon exercise would not cause the existing grant to be treated as a modification. However, a cash-out of a grant at less than full value would cause the grant to be treated a modification, subjecting it to the 409A compliance rules.
50. FAS 123(R).
51. Id.
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).