

Equity Compensation Plans Should Be Amended to Include Mandatory Antidilution Adjustment Provisions

July 27, 2006

We recommend that clients review their equity compensation plans immediately to determine whether the plans' antidilution adjustment provisions should be amended as a result of changes made by FAS 123(R).

Reasons for Review

Most equity compensation plans include a provision that permits the company's board of directors to modify options and other equity grants in the event of an equity restructuring such as a stock dividend, stock split, spinoff or recapitalization. However, practice in this area is not uniform – some plans call for a mandatory adjustment in all cases, while other plans call for a mandatory adjustment in the case of relatively straightforward transactions (such as stock splits) but do not address more complex transactions (such as spinoffs).

In recent months, accounting firms have begun to focus on the effect of the new FASB accounting standard for equity compensation (FAS 123(R)) on adjustments made to equity grants pursuant to plan provisions that permit the board to make adjustments at the board's discretion. Under the old accounting standard (APB 25), this sort of discretionary adjustment did not result in an adverse accounting result, as long as the economic result to the optionee was not improved in the adjustment.

Under FAS 123(R), an adjustment that is made pursuant to a discretionary adjustment provision is considered a modification of the equity grant when such discretion is exercised and may result in accounting charges. An adjustment made pursuant to a mandatory adjustment provision will not produce the same result, because the adjustment is contractually required under the plan. Accounting firms are suggesting that the language used to effect the mandatory adjustment provision should include the provision that the adjustment will be made "in an equitable manner" or "proportionately," and that the amendment should result in equity compensation holders having an enforceable legal right to an adjustment.

A plan may be amended to add a mandatory adjustment provision. However, FAS 123(R) makes a distinction between plan amendments that are made before an equity restructuring is anticipated and those that are made when an equity restructuring is anticipated. If an equity plan is amended to add a

mandatory adjustment provision before an equity restructuring is anticipated, FAS 123(R) does not require that the company measure the incremental compensation cost, and no compensation cost is incurred as a result of the plan amendment (or as a result of the subsequent adjustment). However, if an equity plan is amended when an equity restructuring is anticipated, the modification generally will result in accounting charges for outstanding equity grants.

Example

A company adjusts stock options as a result of a stock split under a discretionary plan provision. If the discretionary adjustment is made at the time of the stock split (or when the stock split is anticipated), the company must make a FAS 123(R) calculation of the value of the options immediately before the split and the value of the options after the split. The company must take a compensation charge on its profit and loss statement equal to the difference between the value of the presplit and postsplit options for financial accounting purposes. Please note that under FAS 123(R), an accounting charge must be taken for options when granted. As a result, under FAS 123(R), the likely effect of a discretionary adjustment is an incremental charge to earnings. If the plan is amended to cause such adjustments to be mandatory and the amendment occurs when no equity restructuring is anticipated, there should be no incremental compensation cost (i.e., no compensation charge will result when the amendment is made or when the adjustment occurs).

What Should Be Done Now?

Companies should review their equity compensation plans now to determine whether the plans include a mandatory antidilution adjustment provision. If the plans do not have a mandatory adjustment provision (or do not contain a mandatory provision that addresses all anticipated circumstances), companies should discuss the issue with their accountants and advisors, and the plans generally should be amended to provide for mandatory adjustments. If the plans are amended before an equity restructuring is anticipated, the company should be able to avoid accounting charges under FAS 123(R). Please note, however, that (i) the mere existence of discretionary language in the plan will not result in an accounting charge—it is the exercise of the discretion that will result in an accounting charge under certain circumstances; and (ii) given the accounting firms' apparent requirement that some enforceable equitable right be provided to plan equity rights holders, it may not be clear how the mandatory provision will function in a more complex transaction (such as a spinoff).

Other Important Mid-Year Reminders

- Internal Revenue Code Section 409A: We are expecting final regulations to be issued under section 409A (relating to deferred compensation) this fall. The deadline for amending plans and agreements to comply with section 409A is currently December 31, 2006, but we anticipate that the deadline will be extended if the final regulations are not issued until the fall.
- SEC Proxy Disclosure: The Securities and Exchange Commission has issued final rules relating to executive compensation proxy disclosure, which are effective for the 2007 proxy season; these new rules will be summarized in a separate LawFlash. Compensation committees should be preparing for the new disclosure rules now by reviewing compensation policies and practices, reviewing total compensation and considering how the various elements of compensation fit into the compensation objectives.

- **Option Backdating:** Option backdating and other option pricing issues are in the spotlight. Morgan Lewis has significant experience and expertise helping clients address option backdating issues, and we are well suited to work with audit committees; assist in internal and SEC investigations; defend companies, executives or board members who are the subject of a government investigation or private action; and assist in insurance recovery actions.

Please contact any of the following Morgan Lewis attorneys for more information about the issues discussed in this Morgan Lewis LawFlash:

Chicago

Brian D. Hector	312.324.1160	bhector@morganlewis.com
-----------------	--------------	--

Dallas

Riva T. Johnson	214.466.4107	riva.johnson@morganlewis.com
John A. Kober	214.466.4105	jkober@morganlewis.com
Erin Turley	214.466.4108	eturley@morganlewis.com

New York

Craig A. Bitman	212.309.7190	cbitman@morganlewis.com
Gary S. Rothstein	212.309.6360	grothstein@morganlewis.com

Palo Alto

S. James DiBernardo	650.843.7560	jdibernardo@morganlewis.com
Zaitun Poonja	650.843.7540	zpoonja@morganlewis.com

Philadelphia

Robert L. Abramowitz	215.963.4811	rabramowitz@morganlewis.com
Brian J. Dougherty	215.963.4833	bdougherty@morganlewis.com
I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Robert J. Lichtenstein	215.963.5726	rlichtenstein@morganlewis.com
Vivian S. McCardell	215.963.5810	vmccardell@morganlewis.com
Joseph E. Ronan, Jr.	215.963.5793	jronan@morganlewis.com
Mims Maynard Zabriskie	215.963.5036	mzabriskie@morganlewis.com
David B. Zelikoff	215.963.5360	dzelikoff@morganlewis.com

Pittsburgh

John G. Ferreira	412.560.3350	jferreira@morganlewis.com
R. Randall Tracht	412.560.3352	rtracht@morganlewis.com

San Francisco

Mark R. Boxer	415.442.1695	mboxer@morganlewis.com
Eva P. McComas	415.442.1249	emccomas@morganlewis.com

Washington, D.C.

Althea R. Day	202.739.5366	aday@morganlewis.com
Gregory L. Needles	202.739.5448	gneedles@morganlewis.com

About Morgan, Lewis & Bockius LLP

Morgan Lewis is a global law firm with more than 1,250 lawyers in 20 offices located in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Irvine, London, Los Angeles, Miami, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, and Washington, D.C. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend in emails, please see <http://www.morganlewis.com/circular230>.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as imparting legal advice on any specific matter.

© 2006 Morgan, Lewis & Bockius LLP. All Rights Reserved.

