North America

BAKER & McKENZIE

Top 10 Things You Need To Know For Option Exchanges Involving International Employees

By Valerie Diamond and Barbara Klementz

©2009 Baker & McKenzie

As most companies are painfully aware, underwater options (or SARs) are a common occurrence in today's stock market. Because underwater awards no longer provide an incentive to employees and are a drag on the company's overhang, many companies are considering (or are already in the process of) offering an option exchange program to employees, whereby employees are able to exchange their underwater options for new options (priced at current FMV) or a new type of award (e.g., a restricted stock unit which does not have an exercise price and is, therefore, somewhat immune to stock price volatility).

When thinking about an exchange program, most companies are focused on the U.S. considerations (of which there are many) and tend to assume that whatever program they decide to offer can be offered in the same manner (and without significant problems) also to their non-U.S. employees. In fact, there are many issues that need to be carefully considered before making a global exchange offer. The following is our list of the top 10 issues that companies will have to be mindful of:

1. Avoid U.S. centric Tender Offer document

Due to tax or compliance issues, the new awards may have different terms in some countries (e.g., different vesting schedule for French-qualified awards). Make sure to reflect this difference in the TO document (instead of representing that all awards will be subject to the same terms). Make sure international forms of agreements for new grants are timely updated and disclosed.

In addition, the SEC requires that the company provide a description of the material tax consequences to all offerees of the exchange, not only the U.S. offerees. Plan and budget accordingly so that international stock plan counsel can prepare (and you can review) the necessary country schedules before the TO document is filed.

Consider the inclusion of data privacy consent and labor law disclaimer language in the TO document and/or election form. Data privacy and vested rights/entitlement issues for equity awards are a big issue outside the U.S., and you may be able to protect yourself by including appropriate language.

2. Exchange may result in taxable event for some non-U.S. participants

Other than in the U.S. where the exchange itself will not be taxable (unless an employee receives immediately vested RSUs or RSAs), there are some countries where the employee will be taxed at the time of the exchange. An example is an option-for-RSU exchange in Canada where the employee will be taxed on the value of the RSUs (not of the underlying shares) at the time of the exchange (in addition, the employee may be taxed again when the RSUs vest).

Obviously, this is a burden for the employee and also for the company which will have to assist the employee with determining the value of the RSUs at the time of the exchange and

operate withholding on this amount. Companies need to think about whether they can administer the tax withholding at the time of the exchange, and also consider the impact on participation by employees in these countries. At a minimum, make sure to disclose the additional taxable event in the TO document.

Note that taxation at the time of the exchange is more likely to occur if the exchange is not a value-for-value exchange (e.g., a straight repricing where the employee receives one at-the-money option for each underwater option), because the employee is assumed to dispose of one award in exchange for a more valuable award and may be subject to tax on the difference in value.

3. Employees or local entity may have already paid tax on eligible award

In certain countries, employees are taxed at grant or vesting of their options (or SARs). For example, in Belgium, the employee has to pay tax at the time of the offer (i.e., when the grant materials are distributed to the employee), provided the employee accepts the grant within 60 days of the offer date. Similarly, in certain countries, the local entity has to pay payroll tax or social taxes at grant (e.g., Australia, France in the case of French-qualified options). In some of these countries, if the awards are later forfeited or cancelled, the employee or local entity may not be able to obtain a refund for the tax already paid.

Again, these issues will need to be evaluated because they can impact employee participation in these countries or result in increased costs to the local entity (which may be required to again pay tax at grant of the new award). Be sure to disclose the impact on the employee in the country schedules of the TO.

4. Exchange may result in loss of favorable tax treatment

If the eligible options are granted under a qualified plan (e.g., France or U.K.) or are otherwise subject to favorable tax treatment (e.g., Canada, Italy), keep in mind that such favorable treatment may be lost in the exchange, depending on the type of the new award. Or, the exchange may trigger a new holding period (if required, such as in France for qualified awards) without the ability to get a credit for the holding period which has already expired on the old award. As noted before, consider the impact of these issues on the employees and the local entities, and include appropriate disclosures in the country schedules.

5. Exchange may trigger new tax withholding/reporting obligations

Aside from tax withholding obligations at the time of the exchange (as described under 2. above), companies also need to analyze whether the new awards will result in new/different tax withholding or reporting obligations at the time of the subsequent taxable event (i.e., exercise or vesting). If the company grants the same type of award as the exchanged award, the obligations typically will remain the same (an exception could possibly apply if the company starts or stops granting tax-qualified awards in certain countries). However, if a

new type of award is granted, companies need to be aware that this may result in different withholding obligations which should be clarified in advance of the exchange. This will especially be an issue in an option-for-cash exchange because the cash payment will be subject to tax withholding/reporting (as well as social tax obligations) in most countries, even if the exchanged awards were not subject to such obligations.

6. Exchange may result in securities filing obligations

The exchange of equity awards may be seen as a new or special securities offering for which a prospectus, registration or exemption filing may be required. For example, depending upon the value and number of persons offered the right to participate in the exchange in Australia, a company may need to obtain specific relief from the prospectus requirements from the Australia Securities and Investments Commission to offer the exchange. Similarly, most publicly traded U.S. companies rely on self-executing exemptions from the Canadian provincial securities laws to offer equity to Canadian employees, but an exchange may be considered to be an "issuer bid" for which self-executing relief is unavailable. Such companies may need exemptive relief from the Canadian provincial securities authorities to ensure the exchange is not subject to a prospectus requirement.

It is critically important to identify countries where securities law exemptions, filings or approvals are necessary to offer the exchange and to seek appropriate relief as early as possible. In some countries, the securities authorities will work on a confidential basis to provide relief that is effective at the same time that the TO is filed with the SEC. However, in some instances, there may be timing issues and this could potentially delay a company's ability to offer the exchange in the country at the same time as in the U.S.

7. Exchange may trigger exchange control approval requirements

There are still a few countries which closely regulate the exchange of currency or employees holding securities in a foreign issuer. In many instances, the obligation to comply with exchange control requirements rests with the employee, not the company. However, there are a few notable exceptions, including China and Vietnam. For companies that have received approvals for equity offerings, please keep in mind that an exchange may need to be disclosed to those authorities and depending upon the nature of the exchange, a new approval or modified quota may need to be negotiated. This is something that should be considered at the time of the exchange to ensure that appropriate approvals are obtained before the new awards vest.

8. Exchange may increase labor law entitlement or acquired right exposure

If a right to equity awards is kept out of employment agreements and offer letters and it is made clear that the grants are made by the parent company as opposed to the local employer, it is generally the case that the equity awards are neither an acquired right nor subject to severance indemnities. This is very different than any cash-based award paid out by a local employer in local currency, which generally will be treated as an acquired right and included in severance calculations if an employee's employment is terminated.

Global Equity Services Contacts

Narendra Acharya
+1 312 861 2840
narendra.acharya@bakernet.com

June Anne Burke
+1 212 626 4371
june.a.burke@bakernet.com

Ed Burmeister
+1 415 576 3029
eburmeister@bakernet.com

Valerie Diamond
+1 415 576 3086
valerie.h.diamond@bakernet.com

David Ellis
+1 312 861 3072
david.w.ellis@bakernet.com

Jennifer George
+1 415 984 3848
jennifer.b.george@bakernet.com

Jennifer Kirk
+1 415 591 3232
jennifer.f.kirk@bakernet.com

Barbara Klementz
+1 415 591 3211
barbara.klementz@bakernet.com

Bonnie Levitt
+1 415 984 3833
bonnie.k.levitt@bakernet.com

Brian Wydajewski
+1 312 861 8286
brian.wydajewski@bakernet.com

For general inquiries, please contact ges@bakernet.com

For these reasons, if a company exchanges underwater options for any sort of cash-based award, labor law entitlements and acquired rights issues arise and the increased long-term exposure for entitlement claims and severance must be considered. Further, it may be the case that a local works council will need to be consulted in advance of the exchange because the employee will now be receiving cash compensation, rather than an equity award. The consultation process can take months.

For countries that consider equity awards to be earned when granted and subject to protective employee rights (Denmark and Spain come to mind), companies need to think about the effect on employees who have transferred to the country or who are on temporary assignment. It may be that the new grants will be subject to a greater degree of exposure to entitlement claims simply because the employee is residing in a country where strong employee entitlement protections exist at the moment of the exchange.

9. Exchange may raise data privacy concerns

Companies also should be careful about collecting, processing and transferring any employee personal data in connection with the exchange. As you may be aware, such employee data is protected in many countries, and the unauthorized collection, processing and transfer to a country where there is not adequate protections afforded to the data may expose the company to penalties.

We recommend that companies offering option exchanges consider the data privacy rules in the European Union and elsewhere and decide whether the company has the right to collect, process or transfer data without taking additional steps or putting special data protection procedures in place. At the very least, the employee should consent to the collection, processing and transfer of his or her data in connection with exchange and these issues should be considered in designing any election and/or withdrawal form, particularly if electronic acceptance is to be used.

10. Be well prepared and review international issues well in advance of exchange to make informed decisions!

We cannot stress enough the importance of considering international issues well in advance of any option exchange. As should be evident from this article, there are a number of key international issues that must be considered from both a legal and administrative standpoint before deciding to go forward with an exchange. We have seen companies that have had to exclude employees in certain countries from participating in the option exchange simply because there was not sufficient time to obtain the necessary tax ruling, securities law exemption or other approval. The exclusion of employees runs counter to the larger goal that the company may have of providing valuable incentives for employees and treating all employees as part of one global company. Moreover, from a global compliance point of view, companies want to know what they are getting into before they initiate these programs so they are sure to have adequate procedures in place to comply with tax, securities and other requirements.