Underwater Stock Options and Stock Option Exchange Programs

Equity-based incentive awards are intended to motivate high levels of performance and align the interests of employees with those of shareholders. However, when markets decline, many companies find that a significant portion of their employees’ outstanding stock options are “underwater” or “out-of-the-money”. Underwater stock options have a number of negative effects on a company. First, they fail to provide their intended incentive, motivational and retentive benefits. Second, they cause companies to take accounting charges for equity awards that are not providing value to employees or the company. Finally, they are an inefficient use of a company’s equity reserves as they count against a company’s share plan limits, thereby limiting the number of new awards that may be granted.

One way companies can counteract the negative effects of underwater stock options is to conduct a stock option repricing or exchange program. During the market decline in the late 1990s and early 2000s, stock option repricing and exchange programs were fairly common. In the recent past, companies have been reluctant to commence these programs due to restrictions imposed by the New York Stock Exchange (“NYSE”) and The NASDAQ Stock Market (“NASDAQ”) and due to negative perceptions of these programs held by shareholders and the media. Given recent market declines, however, a resurgence of stock option repricing and exchange programs has occurred.

Stock option repricing and exchange programs should be considered in light of a company’s past and future compensation objectives. Many companies are currently considering whether share price is an appropriate measure of employee performance and, as a result, whether they should use stock options as a component of their incentive compensation programs, or whether they should rely more heavily on restricted stock and other “full share” awards that provide employees with some value regardless of the stock price. If a company believes that the decline in its stock price is not a direct result of management’s actions, but is more likely due to general market conditions, then in assessing whether to implement a stock option repricing or exchange offer, it should consider whether employees should be rewarded upon a recovery in the stock price by granting stock options with an “undervalued” exercise price. Moreover, a company should balance its retention needs with the interests of its shareholders and consider whether it is appropriate to provide employees with a significant benefit at a time when shareholders have encountered significant losses.

In many instances, however, a stock option exchange program benefits both a company and its shareholders. Cash-poor companies that have historically relied on equity awards as a means to provide long-term incentive compensation may deplete the share reserves under their equity compensation plans. Reserving shares underlying outstanding underwater stock options may cause a
company to incur accounting expenses for a benefit that provides little retentive and incentive value. It also creates an undesirable “overhang” of a company’s shares, which impedes a company’s ability to obtain shareholder approval to increase the share limits under the plans. As a result, a company may be forced to deplete its cash resources to provide incentive compensation to its employees. By permitting a stock option exchange, shareholders can reduce overhang, potentially increase the size of the share pool under a company’s equity plans and prevent undesirable accounting consequences.

The following is a summary of various forms of stock option exchange programs and the associated issues that companies should consider in determining whether an exchange program is appropriate.

Forms of Stock Option Exchange Programs

For purposes of this memorandum, the term “stock option exchange” broadly refers to a number of practices set forth below. The primary difference among these practices is the form of consideration offered by a company in return for an employee’s participation in the program.

Stock Option-for-Stock Option Exchange Programs. In a stock option-for-stock option exchange program, underwater stock options are cancelled and replaced with new stock options that have an exercise price that is equal to or greater than the stock price at the time of the new grant. A company determines the applicable exchange ratio to be utilized in the program (which is often less than one-for-one, providing employees with fewer new stock options for each option exchanged). Companies frequently use a value-for-value exchange ratio whereby the value of new stock options equals the value of the cancelled stock options, utilizing an option valuation method, such as Black-Scholes or binomial lattice. The terms of the new stock options can differ from the terms of the cancelled stock options. Employers commonly modify the term of the new stock options and subject the new stock options to additional vesting and forfeiture conditions.

Stock Option-for-Other Security Exchange Programs. In a stock option-for-other security exchange program, underwater stock options are exchanged for a different type of equity-based award, such as restricted stock, restricted stock units or phantom stock. The amount of new equity awarded is generally determined on a value-for-value exchange basis, but this is not required. The new equity awards typically have additional vesting and forfeiture conditions.

Cash Exchange Programs – “Stock Option Buyouts”. In a cash exchange program, which is sometimes referred to as a “stock option buyout”, underwater stock options are purchased by the company for cash. The cash payment is typically determined through utilization of a stock option valuation methodology such as Black-Scholes or binomial lattice. The cash payment to employees may be made immediately or over time, and may be subject to future vesting or forfeiture conditions.

Stock Option Repricing Programs. In a stock option repricing program, the exercise price of underwater stock options is unilaterally reduced by the company.

Decisions regarding the type of program to implement are fact specific. The charts below compare some of the advantages and disadvantages of each of these programs.
Advantages of Different Types of Stock Option Exchange Programs

<table>
<thead>
<tr>
<th></th>
<th>Cash Exchange</th>
<th>Stock Option-for-Stock Option Exchange</th>
<th>Stock Option-for-Equity Exchange</th>
<th>Stock Option Repricing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retains incentive and retentive value of awards</td>
<td><em>1</em></td>
<td>✓2</td>
<td>✓3</td>
<td></td>
</tr>
<tr>
<td>Enables employees to realize value for underwater options</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Relatively easy to explain to employees</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Shares available for future issuances (depending upon share counting provisions of plan)</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Protects employees against further stock price declines</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Reduces share overhang (no new shares issued)</td>
<td>✓</td>
<td>✓4</td>
<td>✓5</td>
<td></td>
</tr>
<tr>
<td>No shareholder approval required</td>
<td>✓6</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>No public tender offer required</td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Stock option holder consent not required</td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
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Disadvantages of Different Types of Stock Option Exchange Programs

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Negatively perceived by the market</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Requires shareholder approval</td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Requires a public tender offer</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Requires consent of option holders to agree to participate</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Incentive and retentive value of awards is lost</td>
<td>✓7</td>
<td></td>
<td></td>
<td>✓8</td>
</tr>
<tr>
<td>Stock options may become underwater again</td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Employees lose the opportunity to benefit from future stock price appreciation</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Employees have less control over the timing of the taxable event</td>
<td>✓9</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Requires a cash outlay by the company</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares are not added back to the plan</td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

1 Retentive value provided only if cash payments are subject to vesting and forfeiture provisions.
2 Retentive value provided only if the new options are subject to vesting and forfeiture provisions.
3 Retentive value provided only if the new equity awards are subject to vesting and forfeiture provisions.
4 Overhang is reduced only if the exchange ratio is less than one-for-one.
5 Overhang is reduced only if the exchange ratio is less than one-for-one.
6 Shareholder approval is generally not required, unless specifically required pursuant to the terms of the applicable equity plan.
7 Incentive and retentive value of awards is maintained if cash payments are subject to future vesting.
8 Incentive and retentive value of awards is lost if the options are fully vested.
9 Employees lose control of the timing of the taxable event because they are taxed upon receipt of the cash payment.
Shareholder Approval and Terms of Stock Option Exchange Programs

When designing a stock option exchange program, a company must balance the needs of its employees with those of its shareholders. Both the NYSE and NASDAQ require shareholder approval prior to commencing a stock option exchange program (other than a stock option buyout) unless a company’s equity plans specifically permit repricings or exchange offers. Many shareholder activist groups, including RiskMetrics Group (a provider of risk management and corporate governance products and services to participants in the financial markets), provide guidelines regarding considerations to be taken into account in determining whether to approve a stock option exchange program. These guidelines include considerations regarding eligible participants, eligible stock option grants, the applicable exchange ratios, future vesting and forfeiture provisions of replacement awards and the reasons why the stock options are underwater (e.g., general market conditions or specific actions by management).

Institutional shareholder groups often prefer that stock option exchange programs exclude from participation directors and senior executives, who are largely deemed accountable for the company’s performance. Companies may consider providing less favorable terms for directors and executive officers than the terms provided for rank-and-file employees, such as higher exchange rates, lower cash payments and longer vesting requirements. Companies may also consider seeking separate shareholder approval for the program with respect to directors and executive officers, so the program for rank-and-file employees is not thwarted if shareholders reject the proposal for executive officers and directors.

In deciding which stock options will be eligible for exchange, companies should keep in mind that institutional shareholders are often reluctant to approve exchange offer programs for recently-granted stock options and are more likely to approve programs that are limited to stock options that are significantly underwater. Programs for stock options that are only slightly underwater may cause investors and employees to think that the company’s leaders have little faith in the recovery of the stock price, as these stock options continue to provide employees with retention incentives. In consideration for support of a stock option exchange program, institutional investors may compel companies to place limitations on future awards to be granted, such as: (i) setting a maximum number of shares that may be annually awarded; (ii) selecting a maximum number of shares that may be awarded to an individual; (iii) establishing minimum vesting requirements; and (iv) providing for a maximum term for which an equity award may be outstanding.

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10 Shareholder approval is not required for listed companies not organized in the United States that undertake stock option exchange programs in compliance with the corporate governance requirements of their home country, provided that they disclose the differences between United States practices and their home country practices in their Form 20-F.
RiskMetrics has published its guidelines in assessing whether to recommend approval of a stock option exchange program. Some of its material considerations are as follows:

<table>
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<th>Issue</th>
<th>Stock Option Exchange Program Recommended Terms</th>
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| **Stock Option Holder Eligibility** | - Exclude executive officers.  
|                                | - Exclude members of the board of directors.                                                                  |
| **Grant Eligibility**          | - Exclude awards that are only slightly underwater. RiskMetrics recommends that the exercise price of eligible stock options be greater than the 52-week high for the stock price.  
|                                | - Exclude awards that were recently granted, such as stock options that were granted in the prior two years. |
| **Exchange Ratio**             | - The exchange ratio should result in a value-for-value exchange.                                            |
| **Vesting Schedule**           | - The vesting schedule should be reset or a longer vesting schedule should be added (for retentive purposes). |
| **Shares**                     | - Shares recaptured through the stock option exchange program should be retired and not made available for new awards under the plan. |

Notwithstanding the stated preferences, each company has individual and unique factual circumstances. It is recommended that companies speak to their major shareholders in advance of seeking shareholder approval for a stock option exchange program.

**U.S. Accounting Treatment**

Under Statement of Financial Accounting Standards No. 123 (revised 2004) (“FAS 123R”), a stock option exchange is deemed a modification to the existing stock option. FAS 123R compares the fair value of the stock option immediately before and after modification. If there is an increase in value of the stock option, an accounting charge must be taken. Any incremental value created by the exchange (i.e., the excess of the fair value of the new securities over the value of the cancelled stock options) will result in a related compensation cost to the company and an expense will be recognized for the remaining vesting period of the replacement award. If, however, the stock option exchange program is structured as a value-for-value exchange, there should not be any impact on the company’s profit and loss statement. A straight option repricing will always result in an incremental cost. Regardless of the treatment of the modified equity, if the original stock options were not fully expensed before the stock option exchange, the company must continue to expense the associated costs of the original stock options over the remaining vesting period of either the original award or the replacement award.

**U.S. Tender Offer Rules**

Because employees must make an investment decision when electing to participate in a stock option exchange program, but not a unilateral repricing, stock option exchange programs are generally deemed “tender offers” for purposes of the U.S. Securities Exchange Act of 1934, as amended (the “Exchange Act”) and are subject to all requirements of Rule 13e-4 of the Exchange Act. On March 21, 2001, the Division of Corporate Finance of the Securities and Exchange Commission (“SEC”) issued an exemptive order (the “Exemptive Order”) granting limited relief from certain tender offer requirements.

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11 The tender offer rules only apply to companies with a class of equity securities registered under Section 12 of the Exchange Act or companies that are required to file reports under Section 15(d) of the Exchange Act. This generally includes all U.S. listed companies and foreign private issuers.
including the “all holders”\textsuperscript{12} and “best price”\textsuperscript{13} rules under the Exchange Act for stock option exchange offers that are effected for compensatory purposes. The Exemptive Order permits a company to exclude certain employees and certain outstanding stock options from the program and enables a company to provide different consideration for different stock option tranches. For example, a company can offer different exchange ratios based upon the exercise price or the remaining term of the underwater stock options.

In order to qualify for relief under the Exemptive Order, the following conditions must be satisfied:

- The company must be eligible to use Form S-8;
- The stock options subject to the exchange offer and the securities offered in the exchange offer must be issued under an employee benefit plan;\textsuperscript{14}
- The program must be conducted for compensatory purposes;
- The company must disclose the essential features and significance of the exchange offer, including risks that option holders should consider in deciding whether to accept the offer; and

- Except as set forth in the Exemptive Order, the company must comply with the tender offer rules of Rule 13e-4.

Pursuant to Rule 13e-4, upon commencement of a stock option exchange program, a company is required to file a Schedule TO with the SEC and leave the offer open for at least 20 business days. A central component of the Schedule TO is an “offer to exchange” document that outlines the terms of the stock option exchange program. The offer to exchange must be distributed to all eligible employees either electronically or by mail. Generally, a company must file with the SEC all written communications made prior to, or following, the commencement of the tender offer, including any press releases and employee communications (whether written or oral).\textsuperscript{15} Filing of these communications must be made on a Schedule TO-C “as soon as practicable on the date of the communication”.\textsuperscript{16}

Once a tender offer has commenced, it is subject to SEC review and comment. Given the compensatory nature of stock option exchange offers, in most instances, the SEC will be satisfied with additional supplemental information (which is provided only to the SEC) supporting the original disclosure or clarifying amendments to the Schedule TO. If, however, a major disclosure issue arises with the SEC, a company may be directed by the SEC to send participants in the offer a supplement to the offer to purchase in order to clarify or supplement the original disclosure.

\textbf{U.S. Securities Law Disclosure}

If shareholder approval is required to implement a stock option exchange program, a company must disclose the material terms of the exchange in the proxy statement in which approval is sought. Following completion of a stock option exchange program, disclosure will also be required in the “Compensation Discussion and Analysis”

\textsuperscript{12} The “all holders” rule requires companies to make the same offer to all shareholders of a given class of securities. Rule 13e-4(f)(8)(i); 17 C.F.R. § 240.13e-4(f)(8)(i). The Exemptive Order allows issuers to exclude specific groups of option holders (e.g., officers, directors, certain foreign option holders and former employees) and certain stock option grants (e.g., stock options below a specified exercise price, unvested stock options and stock options granted under a particular plan or on a particular date).

\textsuperscript{13} The “best price” rule requires that all participants in the tender offer be provided the same consideration for their securities. Rule 13e-4(f)(8)(ii); 17 C.F.R. § 240.13e-4(f)(8)(ii). The Exemptive Order provides relief from the requirement that all option holders be provided with the highest consideration. This permits the company to provide different exchange ratios or cash payment amounts with respect to different stock option grants based upon factors such as the original exercise price, remaining stock option term and/or vesting schedule.

\textsuperscript{14} Under Rule 405 of the Securities Act of 1933, as amended (the “Securities Act”), “employee benefit plan” means “any written purchase, savings, option, bonus, appreciation, profit sharing, thrift, incentive, pension or similar plan or written compensation contract solely for employees, directors, general partners, trustees (where the registrant is a business trust), officers, or consultants or advisors”. Consultants and advisors may participate in an employee benefit plan only if: (i) they are natural persons; (ii) they provide bona fide services to the registrant; and (iii) the services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the registrant’s securities.

\textsuperscript{15} Rule 13e-4(c) of the Exchange Act; 17 C.F.R. § 240.13e-4(c).

\textsuperscript{16} Rule 13e-4(c) of the Exchange Act; 17 C.F.R. § 240.13e-4(c).
section of the company’s next proxy statement, but only to the extent named executive officers participated in the stock option exchange program. In addition, any new equity awards granted must be disclosed in the “Grants of Plan-Based Awards” and “Director Compensation” tables, if applicable. Stock option exchanges and repricings will also trigger the need for directors and executive officers to file a Form 4 with the SEC both with respect to cancelled stock options and new equity grants.

U.S. Tax Treatment

General. The cancellation or repricing of stock options is generally treated as a nontaxable exchange under U.S. federal income tax laws. Under the U.S. Internal Revenue Code of 1986, as amended (the “Code”), employees are not required to recognize income for federal income tax purposes upon the cancellation of stock options or the grant of new stock options, restricted stock, restricted stock units or other equity awards that are subject to future vesting. Cash payments made in exchange for stock options are immediately taxable, unless they are subject to vesting or other forfeiture conditions.

Section 409A of the Code. Section 409A regulates the tax treatment of nonqualified deferred compensation paid to executives or any other employee, and restricts the ability of employers and employees to elect when income can be recognized and taxed. Stock options generally do not constitute deferred compensation for purposes of Section 409A, provided that certain conditions are satisfied and the stock options are not “modified” following the grant date. Section 409A defines a “modification” as any change in the terms of a stock option that may provide the stock option holder with a direct or indirect reduction in the exercise price of the stock option, regardless of whether the stock option holder benefits from the change in terms. A stock option repricing or a stock option-for-stock option exchange will result in a modification of a stock option unless the new exercise price is at or above the fair market value of the stock. Similarly, multiple repricings of the same stock option may be problematic, since this practice may indicate that the exercise price is adjustable. The cancellation of a stock option or the exchange of a stock option for an alternative equity security will generally not raise Section 409A implications; however, the new equity award may be subject to Section 409A.

Section 162(m) of the Code. Section 162(m) imposes a $1 million limit on the compensation that a public company can deduct for certain of its top executive officers, with an exception for performance-based compensation. Replacement stock options and performance-based equity awards must be approved by a Section 162(m) compliant committee of the board of directors to satisfy the performance-based compensation exemption. In determining the number of replacement awards to be granted, a company should consider the Section 162(m) share limits set forth in the applicable equity plan. If the number of replacement awards (when added to other awards granted during the same year) exceeds the annual plan limit, the Section 162(m) performance-based compensation exemption will not be available. If a stock option is granted and cancelled in the same calendar year, it will continue to be counted for Section 162(m) purposes.

International Considerations

A company with employees outside of the United States must ensure that any stock option exchange program is

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18 I.R.C. § 83(a)(1).
19 Treas. Reg. § 1.409A-1(b)(5)(ii)(A). Under Section 409A, a stock option does not provide for a deferral of compensation if (i) the exercise price is not less than the fair market value of the underlying stock on the date the stock option is granted and the number of shares subject to the stock option is fixed on the grant date; (ii) the transfer or exercise of the stock option is subject to taxation under Section 83 of the Code; and (iii) the stock option does not include any features for deferral of compensation, other than the deferral of recognition of income until the later of (x) the exercise or disposition of the stock option or (y) the time the stock acquired pursuant to the exercise of the stock option becomes substantially vested.
21 I.R.C. § 162(m)(4)(i).
22 I.R.C. § 162(m)(4)(i).
conducted in compliance with local laws. This requires a review of applicable securities, tax, employment and exchange control laws for each jurisdiction. The SEC's exemptive relief from the all-holders and best price rules will often permit a company to exclude non-U.S. employees from the program if the regulatory, tax or other considerations make participation in the program administratively burdensome. Moreover, companies may be permitted to vary the terms of the offer for participants in certain jurisdictions, to the extent necessary to comply with applicable laws and regulations. In certain jurisdictions, the exchange will result in an immediate taxable event to an employee who participates in the stock option exchange program.

Recent Stock Option Exchange Offers

Certain notable exchange offers that have commenced or are currently being contemplated since the beginning of 2009 include Google Inc. (“Google”), Williams-Sonoma, Inc. (“Williams-Sonoma”), Starbucks Corporation (“Starbucks”), Motorola, Inc. (“Motorola”) and eBay, Inc. (“eBay”).

**Google Inc.** On February 3, 2009, Google filed a Schedule TO with the SEC commencing a one-for-one, voluntary employee stock option exchange program. Generally, all Google employees who held underwater stock options were eligible to participate in the program, except where precluded by legal and tax issues in certain countries. Non-employee directors were not eligible to participate in the program. While Google’s executive officers were eligible to participate in the program, three of Google’s named executive officers did not hold any stock options. Approximately 85% of Google’s employees held stock options that were eligible for participation in the program.

Google was not required to obtain shareholder approval for its exchange program because the terms of the equity plan under which the options eligible for exchange were granted specifically allowed Google to implement an exchange program. Google’s exchange program was more “employee-friendly” than most exchange programs, likely due to the fact that its founders own a controlling interest in the company and the views of institutional investors were less of a concern. The replacement stock options are subject to a new vesting schedule that adds an additional 12 months to the original vesting dates, with a minimum vesting period of six months, and they retain the same expiration date as the cancelled stock options. Google offered its option holders a one-for-one exchange ratio. As a result, the program was not structured as a value-for-value exchange, and constituted a modification under FAS 123R, resulting in additional stock-based compensation expenses beginning in the first quarter in 2009. Google expects to take a modification charge of approximately $460 million over the vesting period of the new stock options.

Google’s stock option exchange program expired on March 9, 2009. 15,642 option holders participated in the program and tendered stock options to purchase 7,636,552 shares of Google’s stock, representing approximately 92.7% of the eligible stock options.

**Williams-Sonoma, Inc.** On March 16, 2009, Williams-Sonoma filed a Schedule TO with the SEC commencing a voluntary stock option and stock-settled stock appreciation right (“SAR”) exchange program. Williams-Sonoma received shareholder approval for this one-time exchange program at its annual shareholders’ meeting on June 11, 2008. Under the terms of the program, certain stock options and SARs may be exchanged for restricted stock units (“RSUs”). The program is open to all active U.S.-based employees. Members of Williams-Sonoma’s board of directors and its named executive officers are not eligible to participate in the exchange program.

To be eligible to participate in the exchange program, a stock option or SAR must (i) have been granted prior to August 9, 2007, and (ii) have an exercise price per share above $27.72 (which represents the 52-week high of Williams-Sonoma’s common stock at the commencement of the exchange program). The number of RSUs a participant will receive will have a lower value than the stock options or SARs tendered based upon the exercise
price of the exchanged award, calculated using the Black-Scholes fair value of eligible awards.

The vesting schedule of the RSUs will be determined on a grant-by-grant basis, based on the vesting schedule of the cancelled awards, with a minimum vesting period of one year. Vesting is subject to continuous employment with Williams-Sonoma or one of its subsidiaries. The Williams-Sonoma exchange program will expire on April 10, 2009.

**Starbucks Corporation.** On January 22, 2009, Starbucks announced that it would request shareholder approval to commence a value-for-value stock option exchange program (calculated using the Monte Carlo and binomial models). The program will be open to all U.S. and international option holders, other than directors and the senior leadership team.

To be eligible for the program, a stock option must (i) have an exercise price at or above the 52-week high trading price, measured from the commencement of the stock option exchange program and (ii) have been granted at least 17 months prior to the commencement date. All replacement stock options will be subject to a two-year vesting schedule and will have a maximum term of seven years (stock options that will be cancelled currently have a ten-year maximum term). New stock options will have an exercise price equal to the closing price of Starbucks’ common stock on the next business day after the close of the tender offer.

In connection with its request for shareholder approval of the stock option exchange program, Starbucks deleted the provision in its equity incentive plan permitting shares underlying unexercised stock options to be added back into the plan limits. As a result, although the program will reduce Starbucks’ stock option overhang, it will not free up shares for future issuance.

Starbucks’s shareholders approved the stock option exchange program at its 2009 annual meeting on March 18, 2009. On March 18, 2009, Starbucks filed a Schedule TO-C with the SEC announcing its intention to commence a one-time voluntary stock option exchange program. As of April 1, 2009, Starbucks’ stock option exchange program has not yet commenced.

**Motorola, Inc.** On March 3, 2009, Motorola announced that it will request shareholder approval to amend its equity plan to permit a one-time, voluntary, value-for-value stock option exchange program. The program will be open to employees worldwide, but will not be available to employees in countries where local law, expense, complexity, and administrative burdens make participation illegal or impractical. The program will exclude Motorola’s executive officers, its senior leadership team and members of its board of directors.

To be eligible for the program, a stock option must (i) have been granted prior to June 1, 2007, (ii) have an exercise price greater than $12.00 (or higher if the 52-week price high exceeds $12.00 at the start of the option exchange program) and (iii) expire after December 31, 2009. The new options will (x) vest 50% on each of the first and second anniversary of the grant date, (y) have an exercise price equal to the closing price of Motorola’s common stock on the new grant date and (z) have a term of five years.

**eBay, Inc.** On March 9, 2009, eBay announced that it will request shareholder approval to amend certain of its equity incentive plans to allow for a one-time, voluntary stock option exchange that will allow employees to exchange, at set ratios, certain underwater stock options for restricted stock units. All eBay employees, except eBay’s named executive officers and directors, will be eligible to participate in the program.

eBay is requesting shareholder approval to commence its stock option exchange program prior to April 2010. To be eligible for the program, a stock option must (i) have an exercise price equal to or above the 52-week high trading price, measured from the commencement of the stock option exchange program, (ii) have been granted at least 12 months prior to the commencement date and (iii) not expire within 12 months following the completion of the exchange. eBay will issue RSUs with approximately 90% of the fair value of the stock options that are being exchanged. The vesting of the new RSUs will be
determined based on the vesting of the cancelled stock options with a minimum vesting period of one year from the date of grant.

Conclusion

While stock option exchange programs are an effective strategy to counteract employee incentive, motivational and retentive concerns that arise in connection with a company’s low stock price, the creation, implementation and administration of these programs introduce a myriad of legal, regulatory and shareholder issues that companies must consider before commencing such a program.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

John J. Cannon III  
New York  
+1.212.848.8159  
jcannon@shearman.com

Jeffrey P. Crandall  
New York  
+1.212.848.7540  
jcrandall@shearman.com

Kenneth J. Laverriere  
New York  
+1.212.848.8172  
klaverriere@shearman.com

Doreen E. Lilienfeld  
New York  
+1.212.848.7171  
dlilienfeld@shearman.com

Linda E. Rappaport  
New York  
+1.212.848.7004  
lrappaport@shearman.com