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July 27, 2007

Delaware Chancery Court Addresses the Cancellation Value of Employee Stock Options in Mergers

When a corporation is acquired in an all-cash merger, it is generally anticipated that the target company's employee and officer stock options will be cancelled, with the holders receiving the excess, if any, of the per-share consideration paid in the merger over the per-share exercise price of their options. Under that formula, option holders will receive nothing if their options are "out-of-the-money" or "underwater" – that is, if the exercise price is equal to or higher than the merger consideration. The expectation that stock options can be treated in this manner in a merger is derived from standard provisions in stock option plans which permit the acquired company's board or compensation committee to "adjust" options to deal with routine capital events and mergers. However, in a decision filed on July 20, the Delaware Court of Chancery, following a 4-day, 14-witness trial, served notice that the ability to cancel out-of-the-money employee stock options without consideration depends entirely on the provisions of the governing stock option plan, and that less-than-clear language in such plans will not be interpreted against the interests of option holders. While the Chancery Court's holding is based on its interpretation of specific language in the plan at issue, the opinion provides rare guidance on when underwater options may be cancelled, and awards damages to all option holders (including in-the-money holders), based on the "economic value" of the options determined by the Black-Scholes options pricing method. *Lillis* v. *AT&T Corp.,* No. 717-N (Del. Ch. July 20, 2007) (Lamb, V.C.).

The Plaintiffs in *Lillis* were former officers and directors of MediaOne Group, Inc. ("MediaOne") who held employee stock options in AT&T Wireless Services, Inc. ("Wireless") as a result of the acquisition of MediaOne in 2000 by AT&T Corporation ("AT&T") and the subsequent spin-off of Wireless. The dispute arose in 2004, when Wireless was acquired by Cingular in a cash merger, in which the Wireless options held by former MediaOne employees were adjusted into the right to receive the cash merger price minus the strike price of the option, so that holders of out-of-the-money options received nothing, while in-the-money options were redeemed for only their "intrinsic value" – i.e., the difference between per-share the strike price and the per-share merger price.

Although there was little evidence that anyone involved in the Wireless-Cingular merger paid any attention to the 1994 Media One options plan ("the 1994 Plan"), which was in effect when AT&T acquired MediaOne, the plaintiffs brought this case relying on language in that 1994 Plan. The key language provided that, in the event of a merger, the terms of the options "*shall be appropriately adjusted* . . . provided that each Participant's *economic position* with respect to the Award shall not, as a result of such adjustment, be worse than it had been immediately prior to such event." (Emphasis added.)

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The court made clear at the outset that whether a corporation can cancel employee stock options must be determined by the contract under which the options were issued – here, the 1994 Plan. Vice Chancellor Lamb readily acknowledged that, “as a general rule,” adjustment provisions in stock option plans are interpreted to “permit the adjustment of options into the right to receive the difference between the merger consideration and the exercise price of the options,” and accordingly, “underwater options are cancelled for no consideration.” But according to the Vice Chancellor, this was not the usual case. Rather, the Court found the above-quoted language in the 1994 Plan to be an unusual “mandatory adjustment provision” that *required* the Wireless options to be adjusted so as to “preserve the options’ economic position.”

In determining the meaning of “economic position, “ the Court noted that the 1994 Plan did not define the term, that neither party could find another agreement containing such a provision, and that there was no evidence that it had any special trade meaning. The court thus held the term to be “ambiguous” and relied upon extrinsic evidence to determine its meaning, including the fact that the options at issue formed a significant part of the plaintiffs’ total compensation when they were MediaOne employees and the testimony of the plaintiffs themselves (including those who had drafted the 1994 Plan) as to their understanding of what would happen in a merger. Based on this and other evidence, the Court determined that the term “economic position” was meant to encompass the “true economic value” of the options, not just their intrinsic value.

Finally, in determining what measure of damages would restore plaintiffs to the “economic position” their options enjoyed immediately prior to the merger, the court used the Black-Scholes option pricing model, noting that Black-Scholes had been used to cash out options held by Wireless directors, including the chairman of Wireless’ compensation committee, who had agreed to cancel the out-of-the-money options of the MediaOne option holders for no consideration. Accepting the plaintiffs’ expert’s calculation under the Black-Scholes formula, Vice Chancellor Lamb determined that the total economic value of plaintiffs’ options (both in-the-money and underwater) at the time of the merger was $16.5 million, deducted the $5.19 million paid to plaintiffs for the intrinsic value of their in-the-money options, and awarded damages of $11,306,986.

* * *

Although the disputed provision in the 1994 Media One plan was unusual, it is not unusual for employee stock option plans to contain adjustment provisions which are perhaps ambiguous or incomplete. In light of *Lillis*, drafters of employee stock option plans and of merger agreements should recognize that the precise words used in a plan can have substantial consequences. If it is the intention of the plan drafters that holders of employee options will receive only intrinsic value in a merger – and, therefore, holders of underwater options will receive nothing – that intent should be spelled out clearly in the plan. Likewise, if it is intended that the amount payable should be left for negotiation of the merger agreement, and/or that the acquired company’s board or compensation committee will decide on an *ad hoc* basis what option holders will receive, that, too, should be made clear in the plan itself. But *Lillis* teaches that, to the extent that a plan can reasonably be read to *require* an adjustment of options and to *guarantee* option holders something more than intrinsic value, there is a significant risk of protracted litigation, and of courts, sympathetic to employees who received options as part of their compensation, making significant awards based on a Black-Scholes or other “true economic value” measure of damages.

Meanwhile, the parties to merger negotiations will have to take existing option plans as they find them – ambiguities and all. *Lillis* underscores the need to review carefully all of the plan documents governing outstanding awards, which might include not only the current stock option plans of the companies involved in the merger, but also the old plans of companies previously acquired by the merger parties (or, as in the case of Wireless, the former parents of spun-off companies). Forewarned by *Lillis*, the parties to a merger can price the risk of having to compensate option holders for the lost "economic value" of cancelled options, and negotiate which side should bear that risk.

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This memorandum is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its contents. Questions concerning the issues addressed in this memorandum should be addressed to the following lawyers at the Firm:

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