

MERGERS & ACQUISITIONS | BY JONATHAN K. LAYNE AND ARI B. LANIN

Cashing out company stock options in M&A transactions

In July 2007, the Delaware Court of Chancery rendered its decision in *Lillis v. AT&T Corp.*, and with it, provided the M&A community several valuable insights into the significance of option plan provisions in the context of an acquisition transaction. In *Lillis*, the Court faced the issue of whether parties to an acquisition agreement may cash out company stock options notwithstanding the existence of an ‘anti-destruction’ provision in the underlying option plan requiring those options to be ‘appropriately adjusted’ so as not to decrease their holders’ economic position. The Court ultimately answered this question in the negative.

Background

The case drew from a set of facts dating back to 1994, when MediaOne Group, Inc., a broadband telecommunications company, adopted an option plan containing an ‘anti-destruction’ provision. This provision required the following treatment of options in the event of certain transformative transactions: “the number or kinds of shares ... subject to an [option] and the per share price or value thereof shall be appropriately adjusted ... at the time of such event, provided that each Participant’s economic position with respect to the [option] shall not, as a result of such adjustment, be worse than it had been immediately prior to such event.”

In 2000, the significance of the provision was first considered in the context of an M&A transaction when AT&T Corp. acquired MediaOne. The treatment of the options awarded under the 1994 plan was heavily negotiated, with AT&T requesting that the options be cashed out, and any underwater options be cancelled. MediaOne refused, and in turn

demanded that the options be adjusted into AT&T options that would remain subject to the 1994 plan. Ultimately, AT&T consented to MediaOne’s demand, and agreed not only to take those actions necessary to assume the MediaOne options, but that no further changes would occur to the 1994 plan without the approval of the optionees.

In April 2001, AT&T delivered a letter to former MediaOne optionees announcing that AT&T’s wireless business unit would be split off, and that AT&T options would be adjusted into options to acquire both AT&T stock and AT&T Wireless stock. In June 2001, both AT&T and AT&T Wireless delivered another letter to the former MediaOne optionees indicating that AT&T Wireless had adopted a new plan for all adjusted stock option grants, and that the new plan would not change the terms and conditions of the underlying options. After the completion of the AT&T Wireless split-off, AT&T options (including the former MediaOne options) were converted into AT&T options and Wireless options pursuant to a formula that preserved the options’ intrinsic value, remaining exercise time period and other basic characteristics. The new AT&T Wireless plan, however, unlike the 1994 MediaOne plan, did not include an anti-destruction provision protecting the optionees’ ‘economic position’ in the event of an adjustment. Instead, the new plan contained far more pro-company language, as it provided for “such adjustment and other substitutions [of options]... as the Committee, in its sole discretion, deems equitable or appropriate”, in the case of a merger or similar transaction.

In 2004, AT&T Wireless entered into an agreement to merge with Cingular, a private LLC jointly owned by SBC Communications, Inc. and BellSouth Corporation, in exchange for consideration of \$15 per share of AT&T Wireless common stock. The merger agreement provided that all AT&T Wireless options would be exchanged for their intrinsic value – thus, all options with an exercise price below \$15 would be cashed out for the ‘spread’, and all options with an exercise price above \$15 would be cancelled without consideration. As a result, a group of former Media-one optionees brought suit, ultimately against both AT&T and AT&T Wireless, alleging, among other things, that the anti-destruction provision included in the 1994 plan had been violated because the optionees’ ‘economic position’ had deteriorated in contravention of that clause. (Shortly after Cingular’s acquisition of AT&T Wireless, SBC acquired the original AT&T Corp. and changed the name of the surviving company to AT&T, Inc. Cingular became wholly-owned by the new AT&T, Inc. in 2006 when AT&T, Inc. acquired BellSouth.)

The ruling

In framing its decision, the Chancery Court noted option plans and agreements are no less than contracts that must be construed in accordance with established rules of contract interpretation. Despite the Court’s finding that the key term in the 1994 plan’s anti-destruction pro- ▶▶

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vision, 'economic position', was ambiguous, it ultimately concluded, after a careful review of the prior relationship of the parties, their previous treatment of the options (including the negotiations that had taken place in the MediaOne acquisition) and other extrinsic evidence, that the term 'economic position' meant 'full economic value', that 'full economic value' was not limited to solely the intrinsic value of the options (the value of the underlying security net of the option exercise price), and that the terms of the Cingular / AT&T Wireless merger violated the 1994 plan by not preserving the 'full economic value' of the MediaOne options.

The Court also determined that AT&T (rather than AT&T Wireless or Cingular) was liable under the 1994 plan, as the plaintiffs never agreed to an assignment of AT&T's performance obligations or to a novation releasing AT&T from its duties under the 1994 plan. As such, from and after the time the Cingular / AT&T Wireless merger occurred, AT&T remained liable to the optionees and was obligated to adjust the MediaOne options in accordance with the anti-destruction provision included in the 1994 plan. In assessing the magnitude of the resulting liability, the Court used a Black-Scholes valuation methodology to determine the full value of all the MediaOne options – both the out-of-the-money options that had been cancelled as well as the in-the-money options that had been exchanged for their intrinsic value. As a result, the Court ruled that the plaintiffs were entitled to \$16.5m for the total value of their options, and AT&T Corp. found itself with a liability that was \$11.3m higher than the \$5.2m that had been paid to the optionees by Cingular.

Lessons

Although the *Lillis* decision is subject to appeal, M&A practitioners and parties to acquisitions should consider several lessons that can be derived from the Chancery Court's opinion.

The 'general rule'. Buyers will find some degree of comfort in the Court's explicit recitation of the 'general rule' of construction with respect to options and option plans in the context of M&A transactions. Simply stated, because the value of an option is tied to that of the underlying security, if the value of that security is converted into the right to receive a fixed amount of cash, the value of the option will also be measured by reference to that amount of cash.

Look several steps ahead. Notwithstanding the existence of the 'gen-

eral rule', companies should be mindful when crafting their option plans. Not leaving sufficient discretion to the board of directors and management when awarding options or other derivative securities can lead to significant issues down the road. Potential buyers are likely to be displeased when asked to cover a meaningful and unexpected expense in order to cash out target company options for an amount in excess of their intrinsic value.

Equity compensation plans should be carefully reviewed. Buyers and sellers should carefully review operative option plan provisions altering the general rule in favour of optionees. A failure to do so could lead both parties into unwanted litigation, and depending upon the nature of the transaction and terms of the related acquisition agreement, can also leave one party with an unexpected liability. As should be noted from the chain of events in the *Lillis* case, reviewing historical option plans of target companies that had themselves been acquirers in the past is imperative.

Certainty of closing. If a risk of optionee litigation does exist, buyers and sellers should carefully assess that risk in the context of closing conditions (including the structure of the material adverse effect condition, if any) and overall certainty of closing, and consider to whom that risk should be allocated.

The significance of indemnification. Though in the *Lillis* case the Chancery Court ultimately concluded that the responsibility to remunerate the former MediaOne optionees rested with AT&T Corp. (rather than the ultimate buyer, SBC), in most instances, the buyer is not likely to get off so easy. Without the benefit of a well-drafted employee benefits indemnification provision or a transaction structured to leave appropriate employee benefits liabilities with the target or its shareholders, as the case may be, a buyer can find itself left with some or all of this liability. The significance of carefully crafted indemnification provisions becomes even greater in the context of split-off transactions, where indemnities will dictate what liabilities are left behind and what liabilities are retained. ■

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