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MODIFYING OPTIONS AFTER EXERCISE: GOOD FAITH REQUIRED

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A privately held company recently learned that the company's broad authority under its LTIP to modify or even cancel outstanding stock options had its limits. The result was that the company's former CFO received $5.4 million more upon exercising options than the company argued was owed. The case, involving Coty Inc., the fragrance and beauty company, was *Fishoff v. Coty Inc.*, 2011 U.S. App. LEXIS 4068 (2d Cir. 2011).

Coty had issued to its chief financial officer 200,000 options, with various exercise prices, over a period of three years or so. After serving as CFO for about six and a half years, the company severed the executive's employment contract. Though the court decision did not indicate whether there was a connection, the CFO's termination occurred just 10 days or so after he gave notice that he was exercising all of his 200,000 options. Disagreements about the option exercise arose almost instantaneously.

The options were cash-settled. That is, upon a valid exercise, the participant was to receive cash, not stock. In determining the amount of that cash payment, fair market value was to be "determined" periodically by the company's board, "using" a nationally recognized investment bank or other comparable valuation expert selected by the board.

Options could be exercised only on the last day of a month. An executive could not, though, exercise on the last day of the month prior to the month in which a valuation date fell. The plan did not seem to specify the valuation dates, but the company apparently had a practice of setting valuation dates in March and September of each year. The CFO gave notice of exercise as of the end of November 2008. The board had determined that as of a couple of months earlier, in September 2008, the company stock's fair market value was $58 per share. Based on this valuation, the CFO would have been entitled to cash in excess of $7.6 million.

Within a few days of the CFO's notice of exercise, the board convened a meeting to alter the terms of the LTIP. It is easy to understand why the board wanted to change those terms. Specifically, between the date of the September 2008 valuation and the time of the CFO's exercise, the stock market dropped precipitously. The board was presumably concerned not only about what it considered to be a stock valuation that no longer reflected the company's value, but also the possibility of a "run on the bank" by optionholders seeking to take advantage of a stale valuation.

The board's actions put at jeopardy the CFO's $7.6 million payment in several ways. First, the board voided all option exercise notices tendered in

December 2008 that were intended to constitute an exercise on November 30, 2008. This was an issue because November 30, 2008, the last day of November, fell on a Sunday. The CFO argued that because November 30 fell on a Sunday he could provide an exercise notice on the following Monday, December 1, 2008, that would be treated as an exercise on November 30, 2008.

The second action the board took was to decide that there would be four valuation dates each year instead of two. Remember, the plan did not specify the number of valuation dates, but instead authorized the board to periodically determine fair market value. Third, the board redefined the permissible exercise dates so that optionees could only exercise options four times a year, on the 15th business day after each valuation, rather than on the last day of any month (other than the month preceding a valuation date). Fourth, the board decided that the next valuation date would be January 31, 2009. Coupled with the new permissible dates for exercising, this meant anyone wanting to exercise options would have to wait until February 2009 to do so.

Consistent with the board's action, Coty informed the CFO that his option exercise had been voided because it was not "submitted prior to the last day of the month." Two days after delivering this news, Coty notified the CFO that his employment was being terminated.

About a month later, the now former CFO forwarded to Coty's board a complaint drafted by legal counsel. Shortly after receiving the complaint, the board convened another meeting, which resulted in the company developing a plan under which it would agree to honor the former CFO's November option exercise, but would not pay based on the $58 per share valuation normally applicable to one exercising in November. Instead, the board would authorize a special valuation limited exclusively to the CFO's shares. Everyone else who exercised options in November would receive an amount based on $58 per share, but the CFO would receive a different amount.

The company, in furtherance of this plan, engaged a new bank to conduct a valuation to set the CFO's share valuation as of November 30, 2008. In February 2009, about two and a half months after the CFO's attempted exercise, the board notified the CFO that the bank had determined the dollar value of his options, based on a share value of $31. Under this valuation, the CFO would have received a total cash payment of $2.2 million, or $5.4 million less than the $7.6 million he would have gotten had he been treated like other optionees who exercised options in November.

The court rejected the board's attempts to modify the CFO's option rights in this way. Although the terms of the LTIP seemed to give the board very broad authority to modify or even cancel outstanding awards and provided that there was no obligation to treat optionholders in a uniform fashion, and even though the board was to determine fair market value ("using" an investment bank or valuation expert selected by the board), the court concluded that the modifications Coty's board attempted to make violated the implied covenant of good faith and fair dealing implied in all contracts under New York law.

Before getting to this conclusion, though, the court was required to consider whether the CFO's filing of his notice of intent to exercise on Monday, December 1, was effective as an exercise on Sunday, November 30, 2008. The court cited the New York statutes in holding that the December 1 exercise was effectively a November 30 exercise. That is because New York law provides that where a contract requires the performance of a condition on a Sunday, unless the contract expressly or impliedly indicates a different intent, that condition may be performed on the next succeeding business day. Applying this rule to the current dispute, the court said the option was a contract, and said it required the performance of a condition when it required the CFO to give notice of exercise.

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Because the LTIP and option award did not expressly or impliedly indicate otherwise, a Monday, December 1 notice of exercise was effective as a Sunday, November 30 exercise.

The court then proceeded to explain that the covenant of good faith and fair dealing implied in all contracts "embraces a pledge that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract." Further, "where the contract contemplates the exercise of discretion, this . . . includes a promise not to act arbitrarily or irrationally in exercising that discretion." This means the board was required to exercise its discretion "reasonably and with proper motive, . . . not . . . arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties."

Coty did not argue that its decision to cut its share price by almost 50 percent in order to reduce the value of the former CFO's options was consistent with the implied duty of good faith and fair dealing. The court said that was a good thing because it would be "difficult to conceive of a set of facts under which Coty's seemingly arbitrary post hoc valuation, which was applied *only* to [the former CFO] and only *after* he exercised his options, would not be a clear violation of the duty of good faith and fair dealing." Instead, Coty argued that the implied duty of good faith and fair dealing was of no consequence because the LTIP expressly provided the company's board with an unrestricted discretionary right to modify or cancel the options. The court disagreed, saying that although the company had a considerable amount of discretion, the LTIP was silent as to the company's discretion to alter the share value after an optionee had validly exercised his options. To the contrary, the court thought the plan implied that the company would have no such right since the plan provided that upon any valid exercise the participant "shall" be entitled to receive a payment in cash equal to a certain amount.

"[W]hen interpreting an LTIP or an award thereunder, there is danger in treating individuals inconsistently, and more generally there is hazard in changing the rules (to an executive's detriment) after the time many would consider it fair to do so."

Lesson. One might conclude that the lesson of *Fishoff* is that LTIPs should include express discretion to change the rules even after exercise. But the difficulty of saying that aloud without blushing suggests that it's probably the wrong lesson. Instead, the lesson is probably that when interpreting an LTIP or an award thereunder, there is danger in treating individuals inconsistently, and more generally there is hazard in changing the rules (to an executive's detriment) after the time many would consider it fair to do so. But this does not necessarily mean a private company's LTIP cannot be written so as to provide at least some protection to the company against sharp drops in the value of the company's stock. One strategy might be to provide that for cash-settled options (or other cash payments based on share value), an average value will be used in well-defined circumstances, with payment delayed until a later valuation to be included in that average can be performed. To avoid a repeat of the result in *Fishoff*, though, the trigger for this special process should be specified, such as by reference to a particular change in a generally accessible index or some change in a company-specific performance metric. To be sure, providing for settlement on a basis that tinkers with the determination of fair market value could raise issues under Section 409A, such as whether non-discounted "options" would continue to enjoy the option exception, but with careful design it is possible those concerns could be addressed. For equity-based compensation other than options, one would want to be cognizant of the possibility that any delay in payment would result in the loss of short-term deferral treatment or an impermissibly long delay in payment under the 409A rules.

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