

KELLY, HANNAFORD & BATTLES P.A.

ANTHONY R. BATTLES
JULE M. HANNAFORD IV
A. DAVID KELLY
THEODORE K. RICE
SONJA LEMMER MARTENS
HOLLY A. FISTLER

MARK D. MEYER
OF COUNSEL

ATTORNEYS AT LAW
900 BAKER BUILDING
706 SECOND AVENUE SOUTH
MINNEAPOLIS, MINNESOTA 55402
TELEPHONE (612) 341-0881
FACSIMILE (612) 341-1041
KHBLAW.COM

WRITER'S DIRECT DIAL:
612/341-0935
JHannaford@KHBlaw.com

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Re: Net Exercise of Stock Options

Dear Clients and Other Friends:

Introduction. Until recently, stock options not exercised with cash or shares that have been held for at least six months were subject to variable accounting. It was the same for stock appreciation rights. This variable accounting treatment required periodic charges to compensation expense as a company's stock changed in value. Now, Financial Accounting Standard 123(R) provides relief from variable accounting for stock options with a net exercise provision and for stock settled stock appreciation rights (SSAR's). These awards now receive the same accounting treatment as an option where the exercise price is paid in cash.

In addition, the use of net exercise provisions or SSAR's is also permissible under IRC Section 409A, governing deferred compensation. Final regulations under Section 409A allow both public and private companies to utilize net exercise provisions provided that the equity awards are issued at fair market value and do not contain deferral features other than the option period itself.

What are They? Stock options with net exercise provisions are essentially rights to receive the value associated with the appreciation, if any, of the underlying shares after the date the stock option is granted. Economically, options with a net exercise provision provide the same compensation value as a stock option settled in cash. To generate funds for a cash exercise, optionees often use a broker to sell a portion of the stock in the open market to cover the cost of exercise. By contrast, with a net exercise, an optionee is not required to make a cash payment for the exercise price. Instead, the optionee simply receives the number of shares with a fair market value equal to the difference between the exercise price and the market price on the date of exercise. There are a number of advantages to net exercise options vs. cash settlement options. These include the following:

- Net exercises result in fewer shares issued and sold into the market.
- Net exercises result in less dilution because fewer shares are ultimately issued upon exercise.
- Optionees do not need to raise the cash to pay the exercise price.

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- For public companies, a reduced number of shares in the open market may mitigate the need for a repurchase program. This may be a consideration at a time when many public companies are suspending their repurchase programs.
- Since net exercises may use fewer shares, the life span of an option plan may be extended.
- Executives and other key employees are not required to sell shares in order to exercise stock options, thus lessening securities law compliance issues.

To Do List: To implement net exercise provisions, plan sponsors will want to review their option plans, draft plan amendment language allowing for net exercises, make certain that the plan can be amended by the Board or a committee of the Board, consider listing issues and update Form S-8 prospectuses covering the plan. The question of shareholder approval should be considered as well; although in most cases we do not think it would be required.

Conclusion: Because of the positive changes provided by new accounting standards, net exercises of stock options are an attractive and practical benefit. Net exercises are administratively less burdensome for the sponsor and a cost-free additional benefit for participants. Before implementing any net exercise provisions, companies should consider the tax, securities law, accounting and plan amendment issues that may be implicated by a new net exercise provision.

Please contact us with any questions you may have about this subject.

Sincerely,

Jule M. Hannaford IV

JMH/bz/jks