

Dealing with Stock Options and Free Shares when Launching a Tender Offer on a French Company

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Acquisitions of French companies raise a number of employment law issues, including issues related to employee share compensation plan, information and consultation of employee representatives, management transition and treatment of employee personal data. Dealing with these issues is important, especially when employees are key to the success of the business.

When the target is a public company acquired through a tender offer, bidders need to carefully consider employees' incentive schemes as they may have a significant impact on the outcome of the tender offer itself. As bidders generally seek to control at least 95% of the target for tax integration purposes and in order to be allowed to squeeze out the minority shareholders, French tender offers are often subject to a minimum tender condition threshold generally computed on a fully diluted basis. In a friendly deal, it is therefore both the target's and the bidder's interest that stock options and free shares be tendered.

Most French listed companies have stock option and free share plans in place, benefiting not only top executives but also more and more often other executives as well as rank-and-file employees. At the time a change of control is considered, the number of shares or options granted pursuant to such compensation plans can represent a significant portion of a company's capital on a fully diluted basis. Considering that stock options and free shares are subject, under French law, to restrictive vesting and lock-up periods during which the underlying shares cannot be assigned, share compensation plans must be dealt with carefully in the context of a public tender offer in order to ensure that the bidder owns in the end more than the required number of target shares to meet the condition, on a fully diluted basis.

Dealing with such stock options and free shares requires a prior review of the moving legal framework applicable to French stock option and free share schemes, in order to identify and distinguish between several groups of holders and treat each of these groups in a way which will allow the bidder to fulfill its objectives.



French stock option and free share schemes: a moving legal framework

Whereas share compensation is usually considered as wages and therefore subject to employers and employees' social contributions and income tax, favorable tax and social contribution regimes have been attached to stock options and free shares, to encourage the development of employee shareholding.

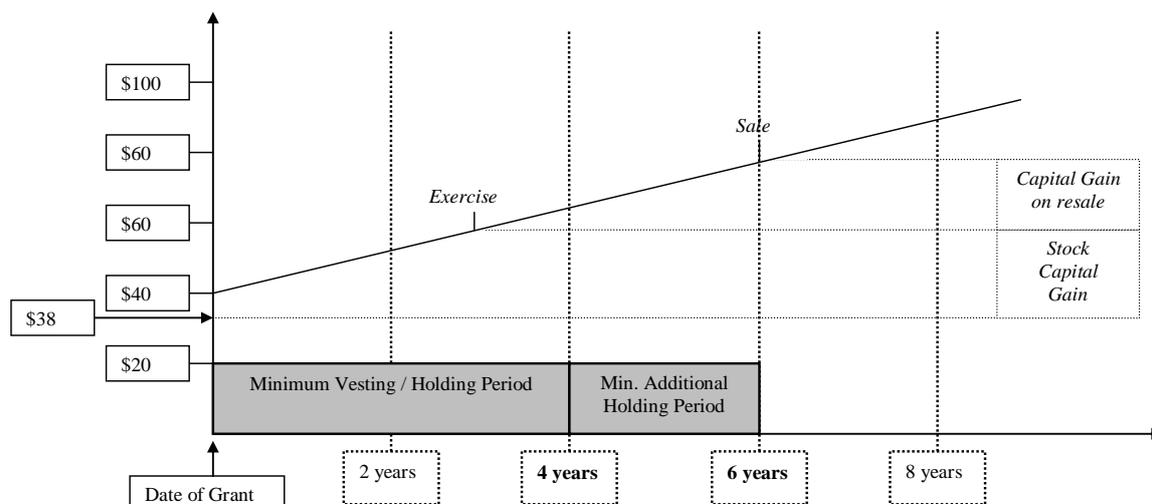
Since their initial implementation in 1970 (stock options) and 2005 (free shares), the favorable tax and social contribution regimes have been frequently revised and amended. In the same way that

the Sarbanes-Oxley Act of 2002 addressed issues raised by the proliferation of stock options granted to and exercised by top corporate executives, numerous French laws have been enacted over the past few years¹ with the aim of increasing social and tax contributions attached to stock option and free share schemes, tightening conditions of grant to executives, and encouraging global grants to all employees.

Under French law, eligible beneficiaries of stock options and free shares include not only all employees and officers of the company granting options, but also employees and officers of a company of which at least 10% of the share capital is held directly or indirectly by the company granting the options. In addition, beneficiaries of incentive stocks of an eligible listed company also include employees and officers of a company (i) which holds, directly or indirectly, at least 10% of the company that grants the option, or (ii) 50% of the share capital of which is held, directly or indirectly, by a company itself holding, directly or indirectly, at least 50% of the share capital of the company granting the options. As a result, beneficiaries of stock options or free shares of French companies often include employees of foreign affiliates who are non French tax residents. Foreign beneficiaries are subject, in addition to the main provisions attached to stock option and free share schemes by French law that are detailed below, to specific local tax and social security regulations which should also be considered in the context of a public tender offer in France.

Stock Options Vesting and Lock-up Periods

- Stock-options granted to employees and officers cannot be assigned.
- The period during which stock options granted can be exercised is determined by the shareholders' meeting and is usually up to ten years.
- The benefit of a favorable tax and social regime, which applies only to French tax residents and/or persons subject to the French social security regime, is conditioned upon the shares issued or delivered upon the exercise of the options not being assigned during a four-year period from the grant of the options. In this respect, the stock option plans usually require that the beneficiary may not transfer all or part of the stock received under the stock option plans during a period that must not exceed three years from the date of exercise of the option.
- An even more favorable tax treatment of the stock capital gain may apply whenever the shares underlying the options are held for an additional two years (*i.e.*, a total of six years).



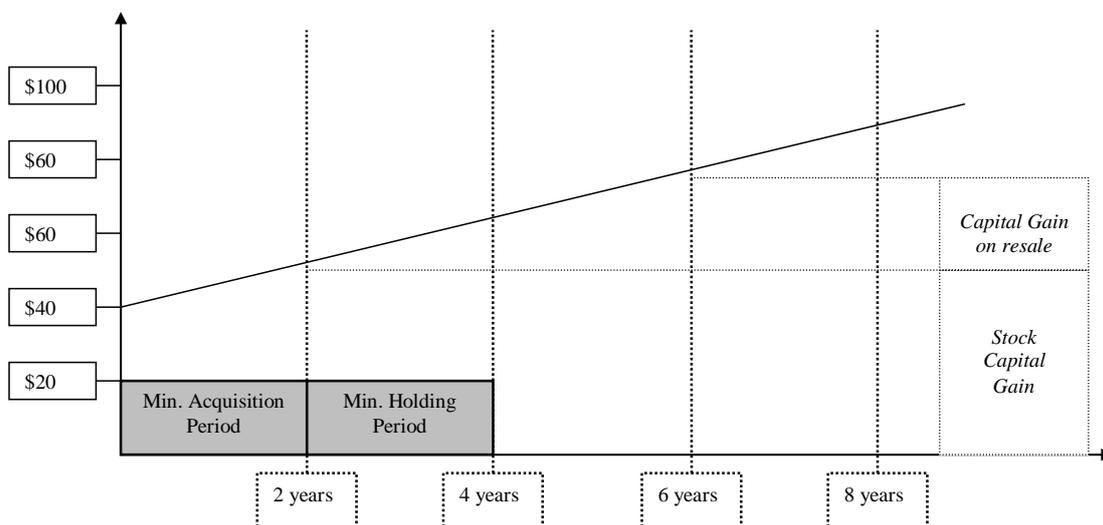
French law does not prohibit a beneficiary from exercising his/her vested stock options and tendering its shares during the lock-up period. The opening of a public tender offer does not,

however, automatically accelerate the vesting of stock options. As a consequence, the loss of the applicable tax and social contribution favorable regime which would result from the exercise and sale of stock options before the end of the above-mentioned four-year lock-up period makes it unattractive for the beneficiary to tender his/her underlying shares. In addition, where the completion of a public tender offer is subject to the achievement of a specific threshold – usually the tender of 2/3 of the shares of the target company on a fully diluted basis – stock option holders will likely not take the risk to exercise their options and tender underlying shares as they would lose the applicable tax and social contribution favorable regime with no certainty as to the realisation of the public tender offer. Under such circumstances, stock option holders would either keep their vested stock options or exercise them and sell the underlying shares on the public market.

Depending on the number of stock options granted and the value of the underlying shares, the bidding and/or target companies may consider to indemnify beneficiaries for the loss of the applicable tax and social contribution favorable regime to incentivize them to exercise their options and tender their shares.

Free Share Acquisition and Lock-up Periods

- The grant of free shares becomes definitive at the end of a vesting period of at least two years. The beneficiary receives such shares only at the end of such a vesting period.
- The vested free shares are thereafter subject to a minimum two-year lock-up period.
- With regard to the duration of the lock-up period, French law allows the shareholders' meeting to waive the minimum two-year lock-up period if the acquisition period is extended to four years. The benefit of a favorable tax regime, which applies only to French tax residents and/or persons subject to French social security regime, is however subject to the non assignment of the free shares during at least two years after the acquisition period.



As opposed to stock option vesting and lock-up periods which are set up for tax and social contribution purposes, free shares acquisition and lock-up periods are required by French corporate law, so that the parties cannot overrule such requirements. Even the implementation of a mandatory squeeze out may not ensure that the bidding company will own 100% of the target company in the end if free shares have been granted to employees or officers.

Negative Windows and Specific Lock-up Conditions Applicable to Officers

In a company whose shares are admitted to trading on a regulated market, free shares may not be sold, even when the lock-up period is over, during the period of ten trading days that precede or follow the date on which the financial statements are published. Insider trading regulations also prohibit beneficiaries of free shares or stock options to assign underlying shares during the period between the date on which the company's management has knowledge of information (such as the knowledge of a contemplated tender offer) which, were it to be published, could have a significant impact on the price of the company's securities, and the date being ten trading days after such information is published.

In addition, some officers and directors of French companies² are required, pursuant to article L. 225-185 of the French commercial code to hold a portion – determined by the board – of their outstanding stock options or underlying shares until the termination of their mandate as officer.

Identifying and distinguishing groups of stock option and free share holders

In the context of a tender offer, an accurate understanding of stock option and free shares outstanding in light of the above-mentioned applicable legal framework is necessary in order to identify the different groups of stock options and free share holders and set the most appropriate threshold conditions and provide an adequate treatment of their stock options and/or free shares.

Groups of Stock Option Holders	Groups of Free Share Holders
- holders of vested in the money stock options	- holders of free shares subject to the acquisition period
- holders of vested out of the money stock options	- holders of free shares subject to the lock-up period
- holders of unvested in the money stock options	
- holders of unvested out of the money stock options	
- stock options held by officers and subject to specific lock-up requirements	

Finding adequate treatment of outstanding stock options and free shares

In order to optimize the result of the tender offer, various options addressing specific constraints applicable to each identified groups of stock options and free share holders can be implemented.

The standard approach to address most of these constraints is to enter into so-called liquidity agreements with stock option and free share holders in order to ensure that shares underlying outstanding stock options and free shares be assigned to the bidding company at the end of any applicable lock-up period. While stock option and free share holders may, under this approach, continue to benefit from the applicable tax and social contribution favorable regime, underlying shares will not be tendered to the offer. As a consequence, the bidder may not be in a position to achieve the threshold condition based on a percentage of the fully diluted capital and voting rights which may have been set forth as a condition to the completion of the tender offer.

Depending on the outcome of the review of stock option and free share grants, the target company and/or the bidding company may therefore have to consider alternative and immediate effect options:

- amending the terms and conditions of stock option and/or free share plans, subject to the mandatory legal provisions detailed above, i.e., accelerating the vesting of non-exercisable stock options or free shares, or anticipating the expiration of stock options. The purpose of these amendments is to allow stock option and free shares holders to tender a maximum of underlying shares to the offer. Such amendments should, however, be handled carefully in order to ensure that the holders of stock options and free shares are still in a position to benefit from the applicable favorable tax and social contribution regimes. Making these amendments fully enforceable would also require prior formal approval of each stock option and free share holder, except in specific circumstances where it can be demonstrated that the amendments have no adverse effect for the holders;
- entering into waiving agreements with each holder of unvested stock options (whether in or out of the money), holder of vested stock options out of the money and holder of unvested free shares, pursuant to which such holders would waive all their rights in relation with such grants in consideration for the payment of a compensation, subject to the success of the public tender offer after taking into account the cancellation of such instruments. Such waiving agreements tend to ensure to the bidders that no stock options survive the tender offer, as vested stock options in the money should be exercised and tendered by holders – if the tender offer is attractive – and all other stock options, i.e., unvested and out of the money stock options, would be cancelled. The same goal could be achieved with respect to free shares only during the vesting period. However, according to French case law, such compensation paid to individuals subject to the French social security regime and French tax residents should be treated as wages and therefore be subject to social contributions and income tax. The favorable tax and social contribution regime applicable to such stock options and free shares would therefore no longer be applicable;
- exchanging, only in the context of a public exchange offer, shares of the target company resulting from the exercise of stock options and target company free shares with shares of the bidding company. While this alternative approach proves to be efficient, it can only be implemented in the context of a public exchange offer. In this respect, the shares of the bidding company granted to holders in lieu of shares resulting from the exercise of stock options and free shares must be registered in pure registered form, with a legend indicating their unavailability, during the remaining lock-up period, in order to ensure that the holder continuously benefits from the favorable tax and social contribution regime;
- implementing a mix of the above-mentioned options, which is likely to be the case if different groups of stock option and free share holders have been identified.

To implement these choices, the competent corporate body, i.e., the board of the target company or the target company's shareholders meeting, must adopt whatever resolution is needed. In most cases, however, depending on the resolutions initially adopted by the target company's extraordinary shareholders meeting and delegation of powers granted to the board of the target company, the latter shall have sufficient authority to implement the options listed above, without having to convene an extraordinary shareholders meeting.

In addition, all treatment options require each holder's approval in order to be fully enforceable, except in case of acceleration of the vesting of options or where it can be demonstrated that amendments to the terms and conditions of stock option or free share plans have no adverse effect for the holders.

As a consequence, massive grants of stock options and free shares by a public company can be considered as poison pills in the context of a hostile tender offer, as it will force the bidder to identify and finance treatment options which may prove to be costly.

Therefore, it is important to anticipate these issues as much as possible by conducting a review of stock option and free share grants and structuring the tender offer efficiently so that it will be attractive for employees benefiting from stock incentives as this will maximize chances for success.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Paris lawyers:

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¹ Including notably laws enacted on Dec. 30, 2006, Dec. 19, 2007, Dec. 3, 2008 and Dec. 20, 2010, and recently commented by the French Tax Authorities in its literature dated April 9, 2008, Jan. 5, 2009 and Jan. 24, 2011, and the Social Security Authorities in its position paper dated April 8, 2008.

² « président du conseil d'administration, directeur général, directeurs généraux délégués, membres du directoire ou gérant d'une société par actions »