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COVID-19: Considerations in Stock Option Repricing

By James E. Gregory and Darren Goodman

In the past weeks, many companies, both public and private, have seen their stock prices and values decline because of the economic disruption caused by COVID-19.

As a result, outstanding stock options may no longer provide adequate incentives, as their exercise prices may be well above the current fair market value for the company's common stock (i.e., the options are "underwater"). In addition, for those companies that have a limited number of shares remaining available for issuance under their equity incentive plans, these underwater stock options may impair companies' ability to grant the equity awards needed to properly incentivize employees. Finally, underwater stock options may result in accounting charges for awards that do not provide any of the intended value to the optionholders.

We have seen interest from many clients seeking to rectify this situation. One of the strategies available to many employers is the "repricing" of the stock options to lower their exercise price per share to an amount equal to current fair market value. This alert discusses key considerations for potential stock option repricings. For a discussion of other strategies to address underwater equity awards and other executive compensation topics impacted by COVID-19, see "COVID-19: Focus on Executive Compensation."

Structure

Stock option repricings can take a variety of forms. The most straightforward form of repricing is a lowering of the exercise price of outstanding options to the current market price, without any change to the other terms and conditions of the options. A company could, however, condition the reduced exercise price on amended terms, such as an extension of the vesting schedule. A company could also lower the exercise price to a price that is higher than the current market price, to require optionholders to stretch to receive value.

Optionholder consent will typically be required for any adverse change in terms, although, as described below, optionholder consent may be needed in any event with respect to options intended to be "incentive stock options" (ISOs) under Section 422 of the Internal Revenue Code of 1986, as amended (the "Code")).

Alternatively, a repricing can be implemented by canceling the outstanding underwater options in exchange for new at-the-money options (or another form of equity award). The exchange could be one for one (e.g., for each option surrendered, one replacement option would be granted), or it could be based on a ratio other than one for one (if, for example, options are exchanged for full-value awards, such as restricted stock or restricted stock units). If a company cancels the outstanding options, it should review any individual grant limits in its equity incentive plan to ensure that any regrants, together with other grants, do not exceed those limits. It should also review the terms of its equity incentive plan to ensure that shares subject to canceled options return to the pool of shares available for awards under the plan.

Options can also be canceled in exchange for cash, but given the liquidity concerns many companies face in light of COVID-19, cancellation in exchange for cash may be less feasible.

Shareholder Approval Requirements

For a public company, the NYSE and NASDAQ listing rules require shareholder approval of repricings (other than a buyout for cash), unless repricings are specifically authorized under the company's equity incentive plan. Public companies should be aware that Institutional

Shareholder Services (ISS) and Glass Lewis have expressed opposition to stock option repricings, and they may vote against or withhold support from members of the compensation committee and potentially the full board if the company has recently repriced options. ISS has advised that it will continue to apply its case-by-case approach for analyzing stock option repricings during the COVID-19 pandemic, while Glass Lewis has said to "[e]xpect a marked increase in shareholder concerns on repricing" and other matters related to equity compensation.

For private companies, the approval process is more straightforward. Shareholder approval of a repricing is generally not required for private companies, although private companies should have counsel review their equity incentive plans to confirm shareholder approval is not required. Further, private companies should review agreements with investors, if any, to confirm the proper approvals are obtained.

Communication to Optionholders

For public companies, a repricing will generally constitute a tender offer (assuming optionholder consent to the repricing is required). That requires compliance with tender offer rules, including the preparation of a publicly filed disclosure document regarding the repricing, as well as disclosure of certain other documents prepared in connection with the repricing.

Those public disclosure requirements are not applicable to private companies. However, if the options being repriced are ISOs, or if the repricing is conditioned on an amendment to stock option terms, consent from optionholders will still be required.

Consent from ISO holders is typically required since lowering the exercise price of outstanding ISOs is treated as a modification of the ISOs, resulting in a new "date of grant" (and in order to receive the ISO tax benefits, among other things, the shares received on exercise of an ISO must be held for at least two years from the date of grant and one year from the date of exercise).

When seeking consent from ISO holders, the ISO holders should be given 29 days (or less) to consider whether to accept the repricing. If the offer were outstanding for 30 days or more, ISOs would be treated as modified and have a new date of grant, even for ISO holders who decline the repricing.

For nonqualified stock options (NSOs), lowering the exercise price typically does not result in an adverse tax consequence. Accordingly, consent from NSO holders is not normally required unless other changes to the terms of the NSOs are sought as part of the repricing.

Additional Considerations

Section 409A of the Code

Stock options are exempt from the requirements of Section 409A of the Code if, among other things, the exercise price per share can never be less than the fair market value per share on the date of grant. A repricing should generally result in a new date of grant for this purpose, so a reduction in exercise price alone should not result in an issue under Section 409A. However, a series of repricings could suggest that stock options had a "floating" exercise price on the date of grant, potentially resulting in a loss of the exemption from Section 409A.

Overseas Participants

If non-United States optionholders are eligible to participate in a repricing, care should be taken to ensure compliance with local law. The effects of a repricing vary by country, but among other things, companies may need to consider the tax, securities, and labor law implications of a repricing.

$100,000 Limit for Incentive Stock Options

Under Treasury Regulations, to the extent the aggregate fair value of stock underlying ISOs that becomes exercisable for the first time by any individual during any calendar year exceeds $100,000 (measured by fair market value per share on the date of grant), only the first $100,000 is treated as ISOs, and the remainder is treated as NSOs.

Note that, for this purpose, (i) an option (or portion thereof) is disregarded if it is modified and thereafter ceases to be an ISO or is canceled prior to the calendar year during which it would have otherwise become exercisable for the first time, but (ii) if the option is modified or canceled at any other time, it is treated as outstanding according to its original terms until the end of the calendar year during which it would otherwise have become exercisable for the first time.

Rule 701

Grants of stock options by private companies are typically exempt from SEC registration requirements under Rule 701 of the Securities Act of 1933, as amended. Rule 701 contains limits on the amount of securities that may be issued in reliance on it, and it also requires certain financial and other disclosures if the amount of securities sold in reliance on Rule 701 during any consecutive 12-month period exceeds $10 million. If there is a repricing, a recalculation is required under Rule 701, which could cause Rule 701's limits to be exceeded (requiring that the grants be made under an alternative exemption) and/or trigger heightened disclosure requirements.

Accounting Treatment

A summary of the accounting treatment of stock option repricing is beyond the scope of this client alert, but companies should be mindful that a repricing may have accounting consequences and should consult their accountants as part of the repricing process.

If you have any questions regarding this client alert, please contact one of the attorneys in our Employee Benefits and Executive Compensation Practice.

To see our prior alerts and other material related to the pandemic, please visit the Coronavirus/ COVID-19: Facts, Insights & Resources page of our website by clicking here.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

JAMES E. GREGORY
Partner
T: **212.419.5857**
jgregory@lowenstein.com

DARREN GOODMAN
Partner
T: **212.419.5865**
dgoodman@lowenstein.com