Private Companies: Time to Consider Repricing Underwater Stock Options?

Given recent market trends, many private companies have seen valuations decline significantly, resulting in an increasing number of service providers holding "underwater" or "out of the money" stock options. As a result, companies may be considering repricing their stock options to help retain and appropriately incentivize employees and other service providers by reducing the exercise price of stock options that are above the current fair market value of the underlying stock.

This article answers frequently asked questions from private companies that are contemplating a stock option repricing.

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1. How are stock options repriced?

For private companies, stock options are almost always repriced simply by the board of directors amending the stock option to reduce the exercise price of the applicable stock options without generally changing other terms. Public companies may use different structures (e.g., a reduction in the overall number of stock options in exchange for the reduced exercise price or a conversion of the old stock options into a different type of equity award).[1]

2. Who can participate in a stock option repricing?

Private companies typically provide that all current service providers with stock options that have an exercise price above a specified price participate in the repricing. Some companies, however, choose to only reprice stock options held by a certain group of service providers (e.g., employees below the C-suite). Companies should be careful of discrimination or human relations issues if all current service providers will not be eligible to participate in the option repricing. Companies should also be mindful of the considerations around repricing stock options held by officers and directors (see Q&A point 14 below).

Former service providers are often excluded from the repricing because of potential corporate waste concerns and difficulties with securities exemptions. Further, one purpose for a repricing is to incentivize current service providers to build the company's value and former service providers are not able to contribute in a similar manner to the future growth of the company.

For the avoidance of doubt, a stock option that has already been exercised cannot be repriced since such stock option technically no longer exists but has rather been converted to a share.

3. What are the vesting and exercise terms of the repriced stock options?

A company must decide on the vesting schedule of the repriced stock option. The simplest and most common approach with regard to vesting is to maintain an identical vesting schedule so that the only change to the stock option is a lower exercise price. Sometimes, additional vesting terms or an exercise "blackout" period is imposed on the repriced stock option, but that can make the repricing more complicated (see point nine). Note that any such change would generally require the consent of the optionee, whereas simply reducing the exercise price may often be done without such consent (subject to the terms of the underlying equity plan and award agreement).

4. How should the stock option repricing be communicated to the optionees?

The simplest and most common approach is to provide a one-page notice that informs the optionees about the repricing and the lower exercise price that now applies to their stock option(s). Some companies, however, may want to amend and restate each optionee's stock option agreement to reflect the new exercise price and to establish new grant and expiration dates, if desired (since a repriced stock option is effectively the cancelation of the old stock option and grant of a new stock option). Again, the company should always consider

[1] The purpose of these various structures is generally to lessen the potential windfall effect to optionees. To be clear, the purpose of stock option repricings is generally to assist in retention of personnel when the stock options do not appear to hold value, but this must be weighed against the fact that simply reducing the exercise price of stock options without lessening the stock option count directly cuts into the capital investments made by investors. For example, if the exercise price is reduced from \$10 to \$5, an investor that bought stock at \$10 per share with a 10% stock option pool previously would have shared with optionees 10% of the upside of the company. Following the repricing, the same investor would forfeit 10% of their investment between \$5 and \$10, assuming the company does recover to \$10 (thereafter the economics are the same).

whether consent is necessary, particularly if the repricing may result in a recharacterization of incentive stock options into nonqualified stock options or if additional vesting or exercise terms are being applied.

5. Should the grant and expiration dates on the optionee's paperwork and the company's capitalization table be updated based on the date of the stock option repricing?

Because a repriced stock option is a "new grant" for tax and accounting purposes, companies must consider whether the repriced stock option should also include a newly calculated expiration date (e.g., for most options, an expiration date of 10 years from the repricing [the new "grant date"] rather than 10 years from the original grant). Whatever choice is made should be clearly communicated in the board action to adopt the repricing and in any communications with optionees to avoid later confusion. Note that such choice will generally impact the accounting expense of the stock option.

6. Are there any special considerations for repricing stock options held by optionees that are based outside of the United States?

Companies should discuss any stock option repricing with local counsel and tax advisors before effectuating such a repricing for optionees outside of the United States.

7. Is shareholder approval required?

Private companies are typically not required to obtain stockholder approval of a stock option repricing unless they are contractually obligated to do so (e.g., pursuant to an investor rights agreement, a credit agreement or an equity plan). These documents, and all relevant governing documents, should be reviewed prior to commencing a repricing to confirm any third-party consent requirements.

8. Do securities laws impact a stock option repricing?

Most private companies rely on Rule 701 of the Securities Act of 1933, as amended, to issue stock options to service providers. Repriced stock options are generally considered a "new" sale of securities that must qualify under Rule 701 as of the time of the repricing. While Rule 701 allows for sales to current service providers, it may not be relied upon when issuing awards to former service providers (i.e., such former service providers would generally not be eligible to participate in the repricing unless a separate securities exemption applies).

In addition, the value of the stock options being repriced should be included in the calculation of the amount of securities sold within a 12-month period for purposes of Rule 701 volume and disclosure limits.[2] For this purpose, if the original grant was made in the 12-month period preceding the repricing, the U.S. Securities and Exchange Commission (SEC) does not require the stock option to be "double-counted" and actually allows the lower repriced value to be used in lieu of the presumably higher value of the original grant. The Rule 701 calculations should be analyzed before the company's board of directors approves a repricing so that the company can prepare for any additional disclosure requirements that may be triggered under Rule 701.

9. Does a private company need to comply with the SEC's tender offer rules?

Another factor for private companies to consider when deciding whether to reprice stock options is compliance with tender

[2] Applicable state securities laws (i.e., "blue sky" rules) should be reviewed as well.

offer rules promulgated by the SEC. SEC tender offer rules are generally implicated when a securityholder is required to make an investment decision with respect to the purchase, modification or exchange of that security. A basic stock option repricing in which the stock option is simply amended to reduce the exercise price arguably does not involve any investment decision, so it is unlikely to implicate SEC tender offer rules. Moreover, a basic stock option repricing typically is done unilaterally by the company, so no optionee consent should be required (assuming that the repricing is solely in the optionee's favor).

On the other hand, if the repricing is contingent on the optionee agreeing to an adverse effect (e.g., imposing additional vesting on the stock option or blacking out an exercise period), then there is a strong argument that the optionee is making an investment decision and SEC tender offer rules may be implicated. In addition, if the company's equity plan specifically requires optionee consent to a repricing, then SEC tender offer rules could similarly be implicated.

The SEC may consider a repricing of stock options that requires the consent of optionees to be a self-tender offer by the issuer of the stock options. For private companies, compliance with SEC tender offer rules basically requires that the offer to amend stock options must remain open for at least 20 business days and the impacted optionees must be provided with information necessary to enable them to make an informed investment decision (e.g., information about the proposed amendment and information about the company).

In the case of incentive stock options (ISOs), care should also be taken to ensure that any offer to amend does not remain open longer than 29 calendar days (as discussed below). It is unclear whether seeking consent or an acknowledgement from a holder of ISOs triggers an investment decision and the tender offer rules; however, we believe the better view is that a change in tax treatment in and of itself would likely not give rise to a tender offer concern.

10. Are there any accounting consequences?

Companies should consider potential accounting consequences of stock option repricings. Most private company stock option repricings will result in an incremental accounting charge under accounting rules (e.g., FASB ASC Topic 718). The incremental charge for repriced stock options is generally fixed at the time of repricing and typically equals the increase of the fair value, if any, of the repriced stock options over the original stock options. If the vesting of the repriced stock option is extended, then the company's rate of accrual may need to be adjusted, since any stock option expense is typically accrued over the vesting period. Companies that are seeking to go public in the near term may have heightened concerns with accounting consequences of a stock option repricing.

11. How does a stock option repricing impact ISOs?

Companies should also factor in potential tax consequences when considering a stock option repricing. To qualify for ISO treatment (and thus favorable tax treatment), the maximum fair market value of stock with respect to which ISOs may first become exercisable in any calendar year is $100,000. In applying this limitation, the underlying stock is valued when the stock option is granted and stock options are taken into account in the order in which they are granted. For tax purposes, a stock option repricing is deemed to be a cancelation of the underwater stock option and a regrant of the repriced stock option. Thus, when an ISO is repriced, the

$100,000 limitation must be recalculated for the year of the repricing, including with respect to stock options that became exercisable and counted against the $100,000 limit in a prior year. In addition, any stock options scheduled to become or that previously became exercisable in the calendar year of the repricing would (i) continue to count against the $100,000 limit for that year (based on the previous, higher exercise price), and (ii) be counted again as a new ISO for the year of the repricing. Accordingly, the number of stock options that can receive ISO treatment may be reduced as a result of the repricing and deemed nonqualified stock options (NSOs).[3]

A stock option repricing restarts the holding period requirement to qualify for ISO treatment. ISOs have to be held for two years from grant and one year from exercise in order to be eligible for favorable tax treatment. Repricing an ISO will restart the clock on the two years from grant requirement. Companies should provide notice to any holders of repriced ISOs to inform them of the new holding period and the potential for loss of ISO treatment due to the $100,000 limitation, as discussed above.

The length of time that a repricing offer is open can also result in negative tax consequences. If a repricing offer is open for more than 29 days with respect to stock options intended to qualify for ISO treatment, those ISOs are considered newly granted on the date the offer was made, whether or not the optionee accepts the offer. The consequence of the new grant date is that the $100,000 limitation must be remeasured and the holding period discussed above is restarted.

12. What are the Section 409A considerations?

Any repriced stock options must have an exercise price of no less than fair market value on the date of the repricing (i.e., ideally based on a new valuation report procured consistent with Section 409A of the Internal Revenue Code) in order to avoid subjecting the optionee to potential Section 409A penalties. Certain practitioners have argued that engaging in successive repricings of the same stock option could raise issues under Section 409A as well as accounting rules due to the fact that it may be argued that the original stock option had an adjustable exercise price that did not meet the Section 409A stock rights exemption on the date of the grant. We would recommend companies avoid the appearance of serial repricings in an attempt to capture the lowest exercise price but rather reprice only upon a material change to the value of the underlying stock, particularly if the stock price drop is largely understood and/or there is a reasonable expectation that fair market value has reached its lowest point. If subsequent, material changes nevertheless occur, an additional repricing may be considered, however, such repricing would require further analysis of the underlying facts and circumstances.

[3] While an optionee may lose favorable ISO tax treatment in connection with a stock option repricing, it is important to remember that in instances where the value of the exercise price reduction is material, the additional value received by the optionee from the repricing will outweigh any potential lost tax benefits of ISOs. Again, consider the example of a reduction of the exercise price from $10 to $5. If an ISO is not repriced and is rather exercised at $10 and later sold in accordance with the applicable ISO rules for $20, the post-tax value of the $10 of appreciation may approach $8 (assuming 20% long-term capital gains tax rate). If the same stock option is repriced to $5 (now a 'new' NSO) and is never exercised but rather cashed out at $20, the post-tax gain to the optionee on the $15 of appreciation would be over $9 (assuming a 39% ordinary income tax rate). In this example, the underlying stock price would have to exceed $26 before the old ISO (without a repricing) would start to outperform the new NSO (with a repriced exercise price of $5). Note, that with this example, this effect can be eliminated as long as the NSO is exercised (at which point the NSO stock would start to qualify for long term tax rates on appreciation) at any point prior to the stock being worth $26. Additionally, in many instances, holders of ISOs do not exercise their stock option and actually qualify for ISO treatment, in which case the repriced stock option will always be more valuable.

13. Can a stock option repricing impact overtime pay?

Subject to compliance with Section 7(e)(8) of the Fair Labor Standards Act (FLSA), any income that a non-exempt employee earns from the exercise of stock options is excluded from the employee's regular rate of pay for purposes of determining overtime pay. One of the conditions of Section 7(e)(8) of the FLSA is that the stock option cannot be exercisable for at least six months after grant, with limited exceptions for death, disability, retirement or a change in control. Therefore, a company should consider the potential overtime pay obligations if it plans to grant a repriced stock option to a non-exempt employee without a vesting condition of at least six months. What complicates the assessment is the absence of guidance in Section 7(e)(8) regulations, opinion letters or published caselaw addressing how overtime pay would be determined under Section 7(e)(8) if the vesting period is less than six months.

14. Will the stock option repricing be an interested party transaction?

Companies should consider whether the holders of repriced stock options will be held by "interested parties" (i.e., board members or officers) under Section 144 of the Delaware General Corporation Law (DGCL). If any of the repriced stock options will be held by "interested parties," the company's board of directors should consider such stock option repricing an interested party transaction and take steps to obtain additional corporate approval if appropriate.

As is evident above, stock option repricings can be complicated and should be discussed further with the company's tax, accounting, and legal advisors. Goodwin serves as legal counsel to many private companies, and we regularly partner with our clients to address challenges, including the impact of volatile markets on executive compensation.

Contact Us

If you would like to discuss any of the topics covered by this article, please reach out to Monica Patel, Malhar Naik, or any other member of Goodwin's ERISA + Executive Compensation practice.

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