COVID-19: STOCK OPTION REPRICING CONSIDERATIONS DURING THE PANDEMIC

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U.S. Benefits, ESOPs, and Executive Compensation Alert

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INTRODUCTION

Companies — public and private — have suffered steep declines in value in the wake of the COVID-19 pandemic. The declines have caused many employee stock options to become "underwater"— in some cases, significantly so. As a result, companies are forced to take accounting charges and deplete equity plan reserves for underwater stock options that no longer incentivize or retain employees. As in the Great Recession, companies are encouraged to consider mitigating these undesirable consequences through stock option repricings.

Stock option repricings take many forms and entail many issues and considerations, including:

- Shareholder approval requirements under exchange listing rules;
- Guidelines from institutional investors and proxy advisory firms;
- Incremental accounting charges under Accounting Standard Certification (ASC) Topic 718;
- Self-tender offer rules under the Securities Exchange Act of 1934, as amended (the "Exchange Act");
- Registration and exemption rules under the Securities Act of 1933, as amended (the "Securities Act");
- Tax implications under the Internal Revenue Code of 1986, as amended (the "Code"); and
- Analogous state laws.

This client alert briefly highlights some of these issues and considerations. Companies are encouraged to contact us with questions or for more guidance.

SHAREHOLDER APPROVAL REQUIREMENTS UNDER EXCHANGE LISTING RULES

Both the NYSE and NASDAQ generally require listed companies to obtain shareholder approval of stock option repricings, unless the relevant equity plan specifically permits a stock option repricing without shareholder approval. As explained below, even where the relevant equity plan specifically permits a stock option repricing, a company that is concerned with the recommendations of proxy advisory firms will nevertheless generally put the stock option repricing to a vote of its shareholders.

INSTITUTIONAL SHAREHOLDERS AND PROXY ADVISORY FIRMS

Many institutional investors and proxy advisory firms, including Institutional Shareholder Services (ISS), have established stock option repricing guidelines that are taken into account when the advisory firms recommend a vote for director election, say-on-pay and stock option repricing proposals.

As noted above, even if a company's equity plan specifically permits a stock option repricing without shareholder approval (so that the company does not need to obtain shareholder approval under the relevant exchange listing rules), ISS has indicated that a stock option repricing (including an underwater stock option buyout for cash) without shareholder approval will likely result in an adverse recommendation for the company's say-on-pay proposal and, in certain circumstances, for the election of the members of the company's compensation committee.

To the extent that a stock option repricing is put to a vote of a company's shareholders, ISS will make a recommendation on the proposal on a case-by-case basis. In this regard, ISS will consider whether: the company's stock price is so volatile that the repriced options are likely to be back “in-the-money” over the near term; the stock option repricing entails an incremental accounting charge; the stock option repricing occurs at least one year out from any precipitous drop in the company's stock price; the term of the repriced stock options will remain the same; the new exercise price of the repriced stock options will be set at fair market value or a premium to fair market value; and the company's executive officers and directors will be excluded from the stock option repricing.

Of significant importance to the COVID-19 pandemic, ISS believes that repricing underwater stock options after a recent precipitous drop in a company's stock price demonstrates “poor timing and warrants additional scrutiny.” Further, ISS has indicated that repriced stock options should have been granted “far enough back (two to three years) so as not to suggest that repricings are being done to take advantage of short-term downward price movements.”

On 8 April 2020, ISS issued new guidance in light of the COVID-19 pandemic, reiterating that:

- A company that reprices stock options without shareholder approval will likely receive an adverse vote recommendation for the company's say-on-pay proposal (and, in certain circumstances, for the election of the members of the company's compensation committee);
- ISS will generally recommend opposing any repricing that occurs within one year of a precipitous drop in a company's stock price; and
- ISS's existing approach to stock option repricings (as described above) continue to be “appropriate” even during the COVID-19 pandemic.

ACCOUNTING CHARGES UNDER ASC TOPIC 718

Under ASC Topic 718, a stock option repricing will generally require a company to take an incremental compensation expense to the extent that the repriced stock options have higher fair values than the original (underwater) stock options. “One-for-one” stock option repricings, a form of stock option repricing where the exercise price of underwater stock options are decreased and the other terms and conditions of the stock options (including the number of covered shares) remain the same, will generally entail an incremental compensation expense.

As a result, shareholders, institutional investors, and proxy advisory firms overwhelmingly prefer stock option repricings that are structured as “value-for-value” or “value neutral” repricings. In these types of repricings, the underwater stock option grants are exchanged for new stock option grants with both a lower exercise price and fewer covered shares (or for a new type of grant, such as a restricted stock unit grant). Consequently, the ASC Topic 718 fair values of the new stock option or other equity grants will generally be the same as (or very close to) the ASC Topic 718 fair values of the original (underwater) stock option grants, minimizing both the incremental compensation expense and the dilution to a company's shareholders.

TENDER OFFER RULES UNDER THE EXCHANGE ACT

In agreeing to exchange an underwater stock option for a repriced stock option covering fewer shares, the relevant optionee is typically required to make an investment decision. As a result, a stock option repricing may be considered a “self-tender offer” for purposes of the Exchange Act. Where a public company's stock option repricing is considered a self-tender offer, the company will be required to file a Schedule TO with the Securities and Exchange Commission (SEC) and the offer will have to remain open for at least 20 business days. Moreover, the company will generally have to file with the SEC all written communications related to the offer and any documentation filed with the SEC will generally be subject to SEC review and comment. Where a private company's stock option repricing is considered a self-tender offer, the company will be relieved from filings with the SEC, but will otherwise have to follow analogous rules.

REGISTRATION AND EXEMPTION UNDER THE SECURITIES ACT

For private companies, both the original (underwater) stock options and the repriced stock options will count towards the “hard cap” and “soft cap” limits under Rule 701 of the Securities Act (Rule 701). The hard cap limit under Rule 701 imposes a limit on the number of equity awards that a company may grant in reliance on Rule 701 in any consecutive 12-month period — in certain cases, a stock option repricing will cause the company to exceed the limit, so that the company will be required to find another exemption from the registration requirements under the Securities Act. Because the most common exemption from registration under state securities laws for equity awards is predicated on exemption under Rule 701 on the federal level, the company will also be required to find another exemption from relevant state securities laws. The soft cap limit under Rule 701 requires a company that grants equity awards exceeding US$10 million (pursuant to valuation rules contained in Rule 701) in any consecutive 12-month period to provide sensitive disclosure (including current financial and risk disclosure) to its equity award holders — in certain cases, a stock option repricing will cause the company to exceed this limit as well, so that the company will be required to provide that sensitive disclosure to its equity award holders. Public companies will need to consider whether their existing short-form registration statements on Form S-8 will cover the repriced stock options.

TAX TREATMENT

A stock option repricing of an incentive stock option (an “ISO”) generally will restart the ISO's two-year grant-date holding period and generally will require retesting the US$100,000 limit on the number of shares that may become exercisable in a calendar year under the ISO. In addition, under the ISO rules, a stock option repricing offer that remains open for more than 30 calendar days will generally disqualify the ISO and convert it to a nonqualified stock option. Under both the ISO rules and those under Section 409A of the Code (Section 409A), a repriced stock option will generally be treated as a new grant on the date of the repricing, requiring the repriced option to meet the ISO (if an ISO) and Section 409A rules as of that date. Public companies should note that a repricing of stock options that are otherwise exempt from the deduction limit under Section 162(m) of the Code (as arrangements that are grandfathered from the repeal of that exemption under the Tax Cuts and Jobs Act) will cause those stock options to lose that exemption.

CONCLUSION

As illustrated above, stock option repricings entail many issues and considerations. However, in many instances, stock option repricings can be structured to benefit companies, employees, and shareholders. Companies are encouraged to contact us with questions or for more guidance.

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