Michael Best

August 04, 2020

The Dilemma of Underwater Stocks and Option Repricing as a Solution – Summer 2020 Considerations

COVID-19 continues to spread rapidly and market volatility has followed suit. While certain companies experienced a quick recovery, others continue to feel the impact as stock price value fluctuates. What is clear is that some companies' stock options are now underwater (i.e., "out of the money"), meaning that the current value is below the purchase price (also referred to as the "exercise price" or "strike price") of the option. Many employers grant options as part of a total compensation package to incentivize hard work by the option holder and in turn increase the value of the company. The underwater position of stock options may trigger repricing considerations - lowering the strike price of an option after it is granted to current market value - as a viable tool to simultaneously account for the new market price and reengage and incentivize option-holders.

As employers begin to vet a repricing strategy, various forms of repricing may be on the table, such as Option-for-Option Exchange, Option-for-Equity Exchange, Cash Exchange/Buyout, and basic Option Repricing. The underlying corporate governance documents, plan documents, and other considerations may color the favorability of each of those alternatives. A deep dive into the "options" with respect to the underwater "options" may be warranted. A few initial thoughts:

- A basic starting point is whether the plan allows for repricings; if it does not, consider whether the plan can be amended to allow them now (and what approvals are required to add the features).

- Assuming repricings are allowed under the plan (and governing award agreement), consider whether the option holder needs to agree to the repricing. Whether option repricing is done unilaterally or with option holder consent elicits specific consequences. For example, repricing can require consent or create

Related Practices

Corporate
COVID-19 Resource Center
Employee Benefits & Executive Compensation
Labor & Employment Relations

new contractual terms, especially if options were changed through an amendment or cancellation of an existing award.

- Keep in mind, even though an option one-for-one exchange creates a new exchange at a lower price, this does not guarantee the newly granted options will not become underwater too. With the COVID-19 still meaningfully impacting the day-to-day of many businesses (and other items on the horizon, such as the upcoming flu season, return to school challenges and Congress's struggle to pass a fourth stimulus package (CARES Act 2.0)), it is unclear what the coming months will mean for company valuations.

- Generally, option repricing does not change how/when an option will be included on income taxes; however, it can implicate accounting considerations such as the Accounting Standard Certification Topic 718 if the new award is worth more than the canceled award.

Public Company-Specific Concerns

Being traded on an established securities exchange yields special repricing considerations for public companies. For example:

- A repricing strategy for public companies traded on the New York Stock Exchange (NYSE) and NASDAQ, should vet shareholder approval requirements, investor/proxy firm consequences, and other cost/benefit considerations.

- For example, companies should also consider the impact of stock option repricing on proxy advisors' voting recommendations. Institutional Shareholder Services and Glass Lewis have expressed opposition to stock option repricing, particularly if shareholder approval is not obtained, and they may recommend voting against or withholding support from members of the compensation committee and potentially the full board.

- Depending on the scope of the repricing, it could be considered a "self-tender offer" (a special regulated investment decision) that requires a public company filing under Rule 13e-4. Whether the repricing is accomplished unilaterally or with option holder consent will influence this requirement.

- There is not necessarily a "one size fits all" for a repricing strategy. For example, two repricing programs may be established for executives versus non-executives.

Private Companies

Of course, private companies do not benefit from being able to look to an established securities market on which the stock readily traded to understand the current value. Instead, for a private company stock that is not readily tradable on an established market, value must be determined in some other manner like a safe harbor valuation approach. One such approach is use of an independent appraiser that meets certain requirements. The absence of a safe harbor valuation method creates a risk that the value used for the repricing is too low, resulting in very negative tax consequences for the option holders.

While a company may "know" that its stock value has decreased since issuing options, and want to reprice, that begs the question of how it will set the new price. For example, whether to engage in a new independent appraisal now (mid-year) or later in the year to align with a "normal" appraisal timeline may

be something to vet based upon the status of the business, receipts, projections and other considerations (e.g., status of supply chain concerns).

The Bottom Line

Decisions regarding the type of repricing/option exchange program to implement, the timeline and process to implement the same, and the program's effectiveness are all very fact specific. When determining the structure of a repricing, considerations include liquidity (e.g., in a cash exchange/buyout), accounting, and protection against future volatility (particularly as we potentially move into a recession environment). Careful collaboration with counsel and accounting experts is advisable.

This article was co-authored by Michael Best Summer Associate Lauren Nelson.

Related People

Carrie Byrnes
Partner
cebyrnes@michaelbest.com
T 312.596.5838

Joshua Erekson
Partner
jberekson@michaelbest.com
T 801.833.0505

Galen Mason
Partner
gmason@michaelbest.com
T 312.596.5814

Martin Tierney
Partner
mptierney@michaelbest.com
T 414.223.2533