Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 15
Stock Option Repricings: What Do Tech Companies Need to Know, What Different Forms Do They Take, and How Can Repricings Contribute to a Motivated Workforce?

By Megan Monson, Darren Goodman, Taryn Cannataro
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Taryn Cannataro: Welcome to the latest edition of Just Compensation. I'm Taryn Cannataro an Associate in Lowenstein's Executive Compensation & Employee Benefits group. And I will turn it over to my colleagues to introduce themselves.

Darren Goodman: I'm Darren Goodman. I'm a Partner in the firm's Employee Benefits & Executive Compensation group.

Megan Monson: And I'm Megan Monson, also a Partner in our Employee Benefits & Executive Compensation group.

Taryn Cannataro: Today, we will be discussing a topic that has been coming up frequently in response to recent economic changes, stock option repricing. When the value of a company declines, as we've been seeing lately due to current economic climate, particularly with respect to tech companies, outstanding stock options may no longer provide adequate incentives for employees as the options exercise price may be above the current fair market value of the company's stock. This would mean employees would be paying more to exercise the options and the options aren't currently worth, meaning the options are underwater. One of the strategies companies use to rectify this situation is to reprice the stock options. Today, we will provide you with a brief overview of what stock option repricing is and the key considerations for potential stock option repricing, in particular, for companies in the tech space. Let's jump right in, what is a repricing?

Megan Monson: So in general, option repricings can take a variety of forms. However, the most common and straightforward approach that we see is to lower the exercise price of the option to the current fair market value of the company's shares without changing any other terms, a company can make other changes such as conditioning, the reduced exercise price on amended terms. We sometimes see companies extend the vesting schedule in consideration for lowering the exercise price, but normally just simply reducing the exercise price is all that most companies do and occasionally including the condition that a release of claim is signed in connection with that lowered exercise price.

Darren Goodman: In addition to implementing a repricing by lowering the exercise price of an outstanding option, as Megan said, it can be implemented by canceling outstanding options and granting new options at the new fair market value or granting another form of equity award in lieu of the option such as restricted stock or restricted stock units. If you were canceling and granting new options, I would expect it to be a one for one exchange, i.e. for each option surrendered you'd get one replacement option, but if it was an option for a different type of equity award, I would expect it to be a ratio different than 1:1 because if it's restricted stock or restricted stock units, they're more valuable on a share by share basis because neither restricted stock nor restricted stock units have a purchase price. If a company is canceling options, it should review their equity plan to make sure that the shares subject to those options return to the pool of shares available for issuance under the plan, because they need to make sure that they don't exceed the overall number of shares available for issuance.

Megan Monson: Another alternative for companies would be to cancel options in exchange for cash. But by definition, since we're talking about companies whose value has declined, this may be less attractive and feasible for them. So for many tech companies, they're in a position where they want to conserve cash. So this might not really be a viable alternative.

Taryn Cannataro: Why would a company consider a stock option repricing? Are there any potential downsides to doing so?

Darren Goodman: The repricing is intended to restore the incentive value to the stock options and also to promote retention. If an employee knows that [inaudible 00:04:11] water, it just doesn't have the same incentive to drive value that an option that is in the money would have. And from a retention perspective, options are normally only exercisable for 90 days if somebody quits that's an incentive in most cases to stick around but if the employee knows that their options are under water, they might not view it as a big loss to leave and forfeit those options. In terms of downsides, investors could frown upon it because they could have bought in at a higher price and they don't get the benefit of a repricing. That said, we typically see investors on board with repricings because it's in everyone's best interest to have a properly motivated workforce. Another downside is that there is some legal work and administrative work involved in preparing for and implementing the repricing. But at the end of the day, when companies stock options are underwater, I see them proceeding with repricing. I don't see the amount of work deterring people from proceeding.

Taryn Cannataro: What is involved in a repricing?

Megan Monson: So as Darren alluded to, there is some legal and administrative work involved in the repricing. At the threshold level, the board or compensation committee, whomever is the plan administrator, would need to approve the repricing and the considerations and documentation involved in the repricing is going to depend upon whether the options being repriced are incentive, stock options or non-qualified stock options. With respect to incentive stock options in general, to receive the tax benefits of the ISO, the ISO holder must exercise and hold the shares for two years from the date of grant and one year from the date of exercise. Lowering the exercise price of that option will be treated as a new grant, therefore, restarting the clock on the requirement for the shares to be held for two years from the date of grant.

In addition with ISOs, there's the limit of $100,000 worth of ISOs that can become exercisable each year. Due to how the quirky ISO rules work, the repricing can also cause ISOs to exceed that limit and become non-qualified stock options. In our experience, employees would rather have the benefit of the lower exercise price, even if it causes ISOs to become non-qualified stock options. But these are considerations that need to be thought through when dealing with the repricing. In particular, in addition to the board and compensation committee approval, because of the adverse consequences to ISO holders as a result of the potential change to either non-qualified stock options or being treated as a new grant, companies are normally going to require written notice to each ISO holder seeking their consent, that they're agreeing to the lower exercise price.

Megan Monson: When seeking consent from ISO holders, the ISO holders must be given 29 days or less to consider whether or not to accept the repricing. If the offer were outstanding for 30 days or more, the ISOs would be treated automatically as modified and have a new date of grant and potentially convert ISOs to non-qualified stock options even for ISO holders who ultimately decline the repricing. Something else to be aware of is that to avoid a tax issue, the repricing can only lower the exercise price to fair market value as of the date that the repricing actually becomes effective. In practice, this means if the fair market value may change, for example, the company expects to receive a term sheet for an investment, it's important to consult with council on the timing of the repricing and the period being given to the ISO holders to consider whether to accept it.

While we've been focusing on tech companies so far throughout our discussion, our listeners should know that if company is public, shareholder approval of a repricing may be required. So it's important not only to check the equity incentive plan, but any applicable listing rules as well.

Darren Goodman: I agree with everything that Megan said, I'd add that it can be difficult to determine if the a hundred thousand dollars limit on ISOs that Megan mentioned is exceeded. But if a company uses Carta, Carta has a repricing tool, that'll do the math. So Megan's discussion was focused on ISOs. For NSOs, for a private company, it's much simpler. Whether vested or unvested, the company can reprice the existing exercise price by a board consent approving the new price and delivering written notice to each option holder that their exercise price has been lowered. Option holder consent is not required for an NSO holder if the only change is to lower the exercise price. If a company were conditioning the repricing on signing a release of claims or making a change in the terms of the options, then consent would be required of course. In that case, the NSO holders would get a notice just like ISO holders seeking their consent to the repricing and to the other changes or the release of claims that are being proposed.

Taryn Cannataro: Are there any other considerations regarding our repricing that our listeners should be aware of?

Darren Goodman: There can be a variety of considerations. There are a lot of unique situations that can arise. Just a couple of things to be mindful of. The first one is that our repricing can have accounting consequences. So companies should be sure to talk to their accountants before implementing the repricing. Another item to be aware of is that there can be additional legal complexities if a company amends the exercise price for former employees. Normally it's not a huge issue because as I mentioned, there's only a 90 day window typically to exercise post termination. So often you don't have former employees holding options, but if you do, you need to be aware of it and you need to talk to council as to how to handle them. In general, I'd say even when there are former employees, many companies exclude them from participating in the repricing because the purpose of the repricing is to restore the incentive value to the options. If someone's a former employee by definition, they're not working for you anymore so there's nothing to incentivize.

Megan Monson: Those are good points Darren. Another point to keep in mind is that if there are any non-US option holders, local laws on repricing can vary. So for companies with non-US option holders, we would typically coordinate with local council to ensure compliance with local laws. Some companies may also in practice decide to limit repricing to only US option holders to avoid that additional level of complexity and analysis involved.

Taryn Cannataro: As we've heard today, given the current state of the economy stock option repricing may be a valuable tool in incentivizing employees. This episode is intended to give you a high level overview of stock option repricing, why companies utilize them and key procedural considerations, but was by no means a comprehensive discussion of all considerations. And in addition, individual circumstances may vary. If you're planning to or thinking about implementing or repricing, we encourage you to consult with executive compensation council. Thank you very much for joining us today. We look forward to having you back for our next episode of Just Compensation.

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