COVID-19: Addressing Underwater Options and Stock Appreciation Rights

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The coronavirus (COVID-19) pandemic and the ensuing market uncertainty, as well as recently enacted legislation, have upended the compensation and benefit programs of many companies. This is the third memorandum in a series of client memoranda that we are preparing regarding how companies may wish to consider addressing their programs in this context.[1]

The recent market volatility means that many companies have seen a precipitous drop in their stock prices, which has in turn reduced the value of outstanding equity awards, jeopardizing the effectiveness of such awards to reward and retain employees (at least in the near-term). In particular, some companies may find that the exercise price of their outstanding options and stock appreciations rights (SARs) substantially exceeds the company's current stock price (for purposes of this memorandum, we refer to such options and SARs collectively as "underwater options"). This memorandum sets forth a number of considerations for companies that may find themselves in this position and provides some guidance as to possible approaches to be taken regarding underwater options so that companies can continue to incentivize and retain employees amid the ongoing market volatility, while also taking into account reaction from their shareholders and the proxy advisory firms.[2]

1. What are the main concerns associated with underwater options?

Underwater options present a number of issues for both the optionholders and the company, including that they:

- cease to provide the intended incentive and retentive benefits;
- may be an inefficient use of the company's equity reserves, particularly if they count against the share limits of the relevant equity plans and limit the number of new awards that can be granted; and
- may result in an unnecessary accounting expense, given that they may not provide any value to the employees or the company.

2. What are the strategies for addressing underwater options?

There are four main strategies to consider: (i) taking a "wait and see" approach, (ii) providing additional cash compensation, (iii) providing additional equity compensation or (iv) restructuring the underwater options.

- **Wait and see**. While somewhat passive (as it means maintaining the status quo), there are some reasons why this approach may be prudent for some companies, including the following:

[1] Please see our previously published client memoranda: **COVID-19: Considerations for Companies That Have Not Yet Established Their 2020 Incentive Compensation Programs** and **COVID-19: Considerations for Companies That Have Already Established Their 2020 Incentive Compensation Programs.**

[2] While this memorandum was written with public companies in mind, many of the principles, and in particular the outline of the four main strategies for addressing underwater options, apply to both public and private companies alike.

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- While it may be painful for optionholders to have underwater options, the stock price is hurtful to shareholders generally, and it may seem like a windfall for optionholders to have a chance to "reset" when shareholders have no such opportunity.
- Despite current market uncertainty, a company's stock price may rebound over the remaining term of the underwater option, in which case there would be no reason to take an aggressive action before the company has a better picture of its long-term trajectory and the trajectory of the market as a whole.
- Similarly, actions taken to address underwater options may signal to the market that management does not believe that the company's stock price will rebound to its previous level (or to any level where the option may have value), which could serve to further depress the company's stock price. This may be a lesser concern, however, given current market circumstances.

The concern with taking *no* action is that employees may come to feel discontent and will look elsewhere for other employment opportunities. Even in a volatile economy, valuable employees can find other opportunities and may look to do so if they do not feel that they are being adequately incentivized.

- **Additional cash compensation**. Rather than adjusting or replacing underwater options (which approaches are described below), a company can also elect to provide employees with additional cash compensation, whether in the form of increased salary, cash-based incentives, lump-sum retention awards or something similar. A cash-based award could provide immediate retentive value to employees. However, it may not be feasible if the company does not have sufficient cash flow, or as may be the case in this market, if the company is trying to preserve cash or to deploy available cash toward other purposes, such as keeping its workforce employed or maintaining their supply chain. Further, if a cash payment is provided in lieu of an adjustment to or exchange of underwater options, employees will not have the opportunity to participate in any increase in the company's stock price to the same extent as an option adjustment or exchange for another equity-based award (of course, this means there would not be a downward risk either). Providing additional cash compensation does not address a company's concerns relating to underwater options being an inefficient use of the company's equity reserves and to the unnecessary accounting expense.
- **Additional equity compensation**. Similar to providing additional cash compensation, this strategy may provide near-term retentive value while allowing employees to keep their outstanding awards. Assuming that there is sufficient share capacity under the company's equity plans to cover additional equity grants, this can be appealing to employees because such equity has the potential for meaningful upside if the stock price goes up. However, shareholders may view this approach negatively, since it could result in a windfall to employees, especially if the company's stock price rebounds to pre-COVID-19 levels. Providing additional equity compensation also does not address a company's concerns relating to the potential unnecessary accounting expense and may exacerbate the inefficient use of the company's equity reserves.
- **Restructuring underwater options.** This strategy is comprised of two main approaches (collectively, "option restructuring programs"):
  - *Option repricing*. The existing award is amended by the company (typically unilaterally, although contractual consent rights should be reviewed) to reduce the exercise price to a price at or above the company's stock price on the date of the repricing. The amendment may also include additional vesting and forfeiture conditions, but these types of changes will usually require optionholder consent. We would note that solely amending the performance criteria of performance-based options does not constitute a repricing.
  - *Option exchanges*. The optionholder consents to a cancellation of his or her existing option in exchange for a new equity award (whether in the form of options or a different type of equity award, such as restricted stock or restricted stock units (RSUs)).

Alternatively, the option can be exchanged for cash (often referred to as an "option buyout"). These alternatives are discussed in further detail below.

Option Restructuring Programs

The remainder of this memorandum will focus on this fourth strategy of restructuring underwater options, as well as the associated design, shareholder approval, securities law and disclosure, tax and accounting considerations.

3. What are the design considerations for option restructuring programs?

When putting together an option restructuring program, there are a number of threshold design considerations that must be addressed, including the following.

- *Type of exchange*. As discussed above, underwater options can be exchanged for new options, a different type of equity award or cash.
  - *Options-for-options*. Option-for-option exchanges are the most common approach, because they are easiest to explain to employees. The major drawback to an option-for-option exchange is the risk remains that the newly granted options could also wind up underwater if the company's stock price continues to decline.
  - *Options-for-other security.* Underwater options can also be exchanged for a different type of equity award, typically restricted stock or RSUs. Because restricted stock and RSUs are full-value awards, they will always retain some value (unless the company goes into bankruptcy). However, they generally do not give employees flexibility with respect to the timing of settlement and taxation in the way that options do (though there is some flexibility to defer the settlement of RSUs, subject to the restrictions of Section 409A of the Internal Revenue Code).[3]
  - *Options-for-cash*. Option buyouts are attractive to employees because they ensure a certain level of payout, even if the company imposes additional vesting and forfeiture conditions, and can also be attractive to companies, since they can often be executed without optionholder consent (depending on the contractual terms of the option). However, they preclude the employees' participation in the future appreciation of the company and may not be a realistic option for cash-strapped companies. The value of the options would be determined by a valuation method such as Black-Scholes or binomial.
- *Exchange ratio*. Another threshold question is whether the exchange ratio should be one-for-one or value-for-value.
  - *One-for-one*. In a one-for-one exchange, each underwater option is cancelled in exchange for one new option, just at the lower exercise price. This approach is easy to communicate to employees, and, while it can look and feel more like a repricing than an actual exchange, it does give companies the opportunity to provide new contractual terms. The one-for-one approach is not typically used when the option is being exchanged for another type of equity award, but it is available to the extent that it makes sense.
  - *Value-for-value*. In a value-for-value exchange, each underwater option is cancelled in exchange for a new award (whether an option or other form of equity award) of equal

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[3] The issue of providing flexibility with respect to the timing of settlement and taxation may be more of an issue for private companies due to the lack of a liquid market for shares.

value based on a valuation methodology such as Black-Scholes or binomial. This usually results in a fewer number of options being issued.

- *Changes to contractual terms of the option.* Whether the underwater option is simply being repriced through an amendment or is actually being exchanged through the cancellation of the existing award and the granting of a new equity award, new contractual terms can be introduced, such as changes in the timing of exercise and the inclusion of additional vesting requirements or forfeiture conditions. Note that these changes will require optionholder consent.
- *Scope of participation (i.e., whether to include executive officers and directors).* As discussed in more detail below, both ISS and Glass Lewis do not support option repricings or exchange programs that include executive officers and directors. Thus, where shareholder approval for an option repricing or exchange program is necessary (as is typically the case for the vast majority of public companies), companies may want to consider excluding their executive officers and directors altogether from any option repricing or exchange program, or at a minimum, consider whether two similar but separate programs should be established – one to cover the executive officers and directors, and the other to cover employees generally.
- *Options that are about to expire.* Options that are about to expire present a particularly complicated set of considerations. While it may be highly unlikely that a company's stock price will rebound to pre-COVID-19 levels during the remaining life of the option, repricing at the current fair market value may still give little-to-no value to the optionholder (assuming the remaining option term is not extended). Likewise, granting a new type of equity award that is subject to additional vesting and forfeiture conditions may not be desirable since the options have likely been fully vested for quite some time. In these circumstances, companies may wish to consider whether a cash buyout, or alternatively, granting new awards that have vesting and forfeiture conditions but retain the potential for upside, may be best suited for their needs.

4. What are the Shareholder Approval Requirements for Option Restructuring Programs?

While the vast majority of public company equity plans require, as a matter of contract, shareholder approval for any option repricing or exchange program, such plans are also subject to the relevant NYSE and NASDAQ shareholder approval requirements. These approval requirements are discussed below, along with what is necessary for obtaining such approval based on the ISS and Glass Lewis guidelines.

- *NYSE and NASDAQ Rules.* Based on the NYSE and NASDAQ listing rules, shareholder approval is required for any type of option "repricing" unless explicitly permitted by the equity plan itself (thus if a plan is silent on repricing, it will be viewed as a prohibiting repricing). "Repricing" is defined broadly to include any straight repricings, exchanges for other securities and any other action treated as a repricing under GAAP. Note, however, that neither the NYSE nor NASDAQ listing rules require shareholder approval for a cash buyout of underwater options.
- *ISS and Glass Lewis Guidelines.* In order to facilitate support of institutional shareholders, and in many cases, shareholders generally, companies considering any type of option repricing or exchange program should be cognizant of the applicable ISS and Glass Lewis guidelines with respect to such programs.
  - Both ISS and Glass Lewis will:
    - recommend against an equity plan that permits option repricing or exchanges without shareholder approval;
    - recommend votes against (or withheld from) the members of the compensation committee, and potentially the entire board, if the company conducts a repricing or option exchange without shareholder approval;
    - require companies to clearly articulate why the company is seeking a repricing or option exchange; and

        - consider each repricing or option exchange proposal on a case-by-case basis based on the factors described below.

    - On a proposal seeking shareholder approval of an option repricing or exchange, ISS will evaluate the purpose on a case-by-case basis taking into consideration the following:[4]
        - historical trading patterns – the company's stock price has historically been so volatile that options are likely to be back "in-the-money" in the near-term;
        - rationale for repricing or exchange – the company's stock price decline was beyond management's control;
        - if it is a value-for-value exchange;
        - whether surrendered options will be added back to the plan reserve (and if they are, ISS will review the company's total cost of equity plans and three-year average burn rate);
        - timing – whether repricing occurred at least one year out from any precipitous drop in the company's stock price;
        - option vesting – whether the new options vest immediately or if there is a blackout period;
        - term of the option – the term should remain the same as that of the replaced option;
        - exercise price – the exercise price should be set at or above current fair market value, and the surrendered option's exercise price should be above the 52-week high for the company's stock price;
        - whether the grant dates are far enough back (two to three years) so as not to suggest that the repricing is being done to take advantage of the short-term market decline; and
        - whether executive officers and directors are excluded.
    - On a proposal seeking shareholder approval of an option repricing or exchange, Glass Lewis takes the view that such programs are only acceptable if macroeconomic or industry trends (rather than specific company issues) cause the company's stock price to decline dramatically and repricing is necessary to motivate and retain employees. In such a circumstance, Glass Lewis will recommend supporting a repricing proposal if the following conditions are met:
        - officers and directors cannot participate in the program;
        - the stock decline mirrors the market or industry price decline in terms of timing and approximates the decline in magnitude;
        - the exchange value is value-neutral or value-creative to shareholders using very conservative assumptions; and
        - management and the board make a cogent case for needing to motivate and retain existing employees, such as being in a competitive employment market.

[4] On April 8, 2020, ISS issued COVID-19 Guidance, which, among other things, reiterated that repricing actions without shareholder approval will still be subject to scrutiny and that proposals seeking shareholder approval/ratification of repricing actions at 2020 meetings will be considered on a case-by-case basis according to the existing ISS policy guidelines described in this memorandum. For a more detailed overview of the ISS Guidance, please see **this blog post** published on the Davis Polk Corporate Governance blog.

5. What are the securities law and disclosure considerations for option restructuring programs?

For public companies, option restructuring programs will also trigger certain securities law and disclosure requirements, which must be taken into consideration.

- *Tender offer requirements*. Because option exchange programs require an investment decision on behalf of the optionholder, they are generally considered to be "tender offers" within the meaning of the Securities Exchange Act of 1934 (the "Exchange Act"), and are subject to the tender offer requirements of Rule 13e-4 (this is *not* the case with respect to a unilateral repricing or a cancellation and regrant that does not require optionholder consent and thus does not constitute an investment decision). Based on an **SEC exemptive order**, there is some limited relief from the standard tender offer requirements of Rule 13e-4 based on the "all holders" and "best price" rules for awards granted under employee benefit plans, but companies will still need to comply with certain requirements, including:
  - Filing a Schedule TO with the SEC.
    - The Schedule TO is comprised of an "offer to exchange," a letter of transmittal and other ancillary documents.
    - The "offer to exchange" document provides information regarding the terms of the offer, the type of securities being offered, the business and stock price performance of the company, the officers and directors of the company (including the extent to which such individuals are participating in the offer) and the procedure for tendering underwater options. The offer to exchange must be distributed to all eligible employees either by mail or electronically.
    - The letter of transmittal is what participants will use to tender their options.
    - Any communications regarding the tender offer must also be filed on Schedule TO-C.
  - The tender offer must be left open for at least 20 business days.[5]
  - The tender offer will be subject to SEC review and comment, and the SEC may require supplemental materials to clarify the company's disclosure and/or amendments to the Schedule TO. While the supplemental material is typically only provided to the SEC itself, in some instances the SEC may require that a company provide supplemental materials to the participants to clarify the original disclosure.
- *Disclosure.* As noted above, shareholder approval is required for any option repricing or exchange program, except, depending on the terms of the plan, in the case of a cash buyout. As such, the material terms of the program must be included in the next proxy statement (if, however, shareholder approval is needed before the next annual meeting then a special shareholder meeting must be called).

  Additionally, if named executive officers are participating in the option repricing or exchange program, then the material terms of the program must be described in in the company's Compensation Discussion and Analysis section of the proxy statement for the year in which the repricing or exchange occurs, and the incremental value of the modified award will need to be disclosed in the "Summary Compensation Table" and the "Grants of Plan-Based Awards" table for the named executive officers and the "Director Compensation Table" for the directors.

[5] Private companies must comply with Rule 14e of the Exchange Act with respect to tender offers, which prohibits certain practices in connection with the offer, and requires the offer to remain open for at least 20 business days and that the consideration for the tendered securities be paid promptly.

Companies may also need to file an 8-K when named executive officers are participants in the program.

- *Section 16 filings*. Forms 4s will need to be filed on behalf of any executive officers and directors who participate in the option exchange program, disclosing both the cancelled awards and the new grant.
- *Share capacity (Form S-8).* Before implementing any option exchange program, a company will need to confirm that it has sufficient shares available under its existing Form S-8, and if more shares need to be registered, that the company will register additional shares prior to the offering.

6. What are the tax law considerations for option restructuring programs?

When considering the implementation of any option repricing or exchange program, companies will need to evaluate the tax implications of doing so. As a general matter, neither the exchange of an option for another option or other equity award that was not otherwise a currently taxable award nor the cancellation or repricing of an option, would be an income tax event under U.S. federal tax law, but a cash buyout would be immediately taxable (unless the payment was subject to additional vesting or forfeiture conditions). Below are a few other specific tax considerations that may come into play when adjusting or exchanging an option.

- *Incentive Stock Options (ISOs)*. The Internal Revenue Code permits the grant of ISOs, which are subject to preferential tax treatment. However, in an option exchange program, the options are considered cancelled, and any new replacement options must meet all of the requirements relating to ISOs under the Internal Revenue Code, including a restart on the mandatory holding periods. Likewise, if an offer under an option exchange program remains open for more than 30 days, the ISOs may be considered to have been “modified” at the time of the offer, and if the optionholder chooses not to participate, the ISOs will lose their preferential tax treatment. It is also important to note that, even if ISOs are cancelled, any cancelled ISOs that would have otherwise become exercisable within a year of the cancellation will still count toward the applicable $100,000 per-year limit under the Internal Revenue Code.
- *Section 409A*. Section 409A of the Internal Revenue Code places restrictions on the ability of employees and employers to defer compensation and to determine when income may be realized and taxed. Options are exempt from these requirements when they are structured in accordance with the parameters set forth in Section 409A. However when an option is modified, such as in connection with an exchange program or repricing, the option must have a new exercise price that is at or above the fair market value at the time of the modification in order to remain exempt under Section 409A. It is also important to note that multiple price adjustments could cause the option to be characterized as having a floating exercise price, which could put the option at risk for losing its Section 409A exemption and exposing optionholders who are U.S. taxpayers to a 20% additional tax.
- *Section 457A*. Section 457A of the Internal Revenue Code places restrictions on foreign entities with respect to service providers who are U.S. taxpayers that are similar to the restrictions placed on U.S. entities under Section 409A, and thus even non-U.S. entities should avoid multiple price adjustments that may make it seem as though the exercise price is floating, as doing so could expose optionholders who are U.S. taxpayers to a 20% additional tax.
- *Section 162(m)*. In instances where the underwater options were intended to comply with tax deduction limitation of Section 162(m) of the Internal Revenue Code and have not been amended since the passage of the Tax Cuts and Jobs Act of 2017 (*i.e.*, the awards are considered “grandfathered”), an option repricing or exchange would constitute a material modification to the original option award, causing such awards to lose their grandfather status and resulting in a loss of the compensation deduction to the company (to the extent that the executive’s annual compensation exceeds $1 million).

7. What are the accounting considerations for option restructuring programs?

As a general rule, under Accounting Standard Certification Topic 718, an option repricing or exchange would be considered a modification of the award, and thus if the replacement awards are worth more than the cancelled awards, an incremental compensation expense will generally need to be recorded. Companies should consult with their accountants when considering any option repricing or exchange program.

In Conclusion

Companies that have found themselves with underwater options due to the market volatility associated with the COVID-19 crisis will want to consider all available strategies for addressing the loss of efficacy of the awards, both to the employees and to the company itself. Where the decline in a company's stock price is not a result of management's performance, but due to the market conditions themselves, implementing some type of option repricing or exchange program may make sense. However, given the current unpredictability of the market, companies will want to consider whether such adjustments at this early stage could result in an unintended windfall to optionholders, if and when, the market rebounds, or to the contrary, if such adjustments will be futile if a company's stock price continues to decline. In any event, companies will want to consider utilizing all the tools and resources reasonably available to them to retain and motivate their most valuable employees who will be critical as the company navigates these uncharted waters, while also balancing the reaction from its shareholders and the proxy advisory firms.

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