LATHAM & WATKINS LLP

Paying the Premium: An Alternate Approach to Repricing Underwater Options

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Introduction

Can we keep our heads (and options) above water? As we enter the middle of the first quarter of 2024, many management teams and boards are still asking themselves this question. Volatility in equity markets has, for many employers, resulted in their employees holding stock options with exercise prices significantly above the current market price of their stock (often referred to as "underwater" or "out of the money" options), making the option a less effective (or ineffective) means of retaining and incentivizing those employees.

In the current uncertain economic landscape, stock option repricing and exchange programs have once again resurfaced as commonly explored alternatives to alleviate the competitive compensation and retention headwinds faced by companies with a significant number of underwater options. However, the inherent complexities and potential limitations of these programs often create roadblocks or require commercial compromises that impair the program's effectiveness in achieving the desired incentive and retention goals.

Companies grappling with these issues may want to consider a novel approach to addressing underwater options that delays the availability of the repricing unless and until certain new exercise conditions are satisfied (e.g., continued employment through a later date) — the delay is accomplished by requiring the employee option holders to pay a premium when exercising their otherwise repriced options if the additional conditions are not satisfied.

Traditional Stock Option Repricings and Exchanges

Common alternatives to address underwater options include:

- **Traditional Option Repricing.** In a traditional option repricing, the plan administrator unilaterally amends an underwater option to reduce the exercise price to the current fair market value of the shares underlying the option. This approach generally does not require employee consent or implicate US tender offer rules (discussed further below), but repricing without imposing additional vesting on the repriced option may not create strong retention incentives, and the repriced option may fall out of the money again if the company's stock price declines after repricing.

- **Option Exchange.** In an option exchange, underwater options are canceled and exchanged for new options, other equity-based awards, or cash. Exchanges are often done on a "value for value" basis, meaning that employees are offered the opportunity to exchange underwater options for new awards with equivalent accounting value to the surrendered options. Option exchanges typically implicate US tender offer rules because they involve an investment decision by the option holder as to whether to relinquish existing options and accept the new award.

  - *Option for option:* In an option for option exchange, underwater options are exchanged for new options with new vesting terms and an exercise price that is at least equal to the fair market value of the underlying shares on the grant date — if the exchange is a "value for value" exchange, the number of new options will be less than the number of relinquished options. As with an option repricing, the newly exchanged options may fall out of the money again if the company's stock price declines after repricing.

  - *Option for other equity award:* In some option exchanges, options are exchanged for another type of equity award, such as restricted stock or restricted stock units. The new award will retain some value even with continued stock price decline, alleviating the risk of new awards falling out of the money and thus losing retention value. As with option for option exchanges, if the exchange is a "value for value" exchange, the new award will cover fewer shares.

Tender Offer Considerations

An option exchange program typically requires option holder consent and constitutes a tender offer under applicable US securities rules because option holders are required to make an investment decision when electing whether to participate in the exchange. An option repricing can also trigger the tender offer requirements where option holder consent is required, such as if the repricing is tied to the imposition of additional or extended vesting conditions on the repriced options. However, in certain limited circumstances, an option exchange program may not constitute a tender offer if participation is limited to a very small group of individuals (e.g., a management group of less than 10).

When conducting a tender offer, companies with a class of securities registered under the Securities Exchange Act of 1934 must comply with the tender offer requirements of Rule 13e-4A, which requires that the company file a Schedule TO with the SEC at the beginning of the tender offer, disclose the essential features of the offer to all eligible employees, leave the offer open for at least 20 business days, and file with the SEC all employee communications regarding the offer. Additionally, since tender offers are subject to SEC review, companies may need to file an amended Schedule TO, which may require the extension of the original offer period.

Companies often shy away from option exchange programs due to the administrative challenges and associated expense, leaving these companies with limited alternatives to address underwater options beyond a straight repricing, which isn't always practical or effective.

The "Premium" Approach

With management teams and boards feeling restricted by the traditional repricing and exchange methods summarized above, an alternate approach to option repricing is available through which repriced options remain subject to a higher exercise price (or a "premium" exercise price) applicable to exercises occurring prior to the expiration of a specified vesting or retention period (the "premium period"), which may be longer than the original vesting period and/or contain other new vesting conditions.

As with a traditional option repricing, under this approach the exercise price of an underwater option is reduced to the fair market value of the company's stock on the effective date of the repricing (thus locking in the availability of the repricing-date fair market value). However, if the option holder exercises the repriced option or terminates service, in either case, prior to the expiration of the premium period, the option holder does not benefit from the repricing and must instead pay the premium exercise price per share (i.e., an amount up to the original exercise price) upon exercise.

This approach effectively imposes a new vesting schedule on the repriced option, but typically can be implemented by the plan administrator unilaterally since it conveys only a benefit (i.e., the reduced exercise price after the satisfaction of the premium period) and has no material adverse impact on the option as it currently exists. In addition, since the premium approach offers no investment decision to option holders, it should not implicate the tender offer rules.

The premium exercise price for the option is determined by the plan administrator and may equal the original exercise price of the option or may be a lesser amount based on another formula (but in no event less than the new exercise price of the repriced option based on the repricing-date fair market value of the underlying shares), such as a multiple of the fair market value of the company's stock on the repricing date.

Likewise, the length and terms of the premium period are also determined by the plan administrator. The premium period may be structured as a typical new option vesting schedule, such that a portion (e.g., 25%) of the repriced option benefits from the lower exercise price for exercises occurring on or after the first anniversary of the repricing, and the remainder of the repriced option benefits from the lower exercise price on a pro-rata basis for exercises occurring over the following 36 months. Alternatively, the premium period may expire in full upon the occurrence of a fixed future date or event, such as the first anniversary of the repricing date, the option holder's involuntary termination, or a change in control of the company (or the first to occur among these or other events).

For example, assume an employee holds a vested option with an exercise price equal to $20 per share when the employer's underlying stock is trading at $5 per share. Using the "premium" approach, the plan administrator could unilaterally amend the option to reduce the exercise price to $5 per share, subject to the condition that if the employee exercises the option or terminates employment prior to the first anniversary of the effective date of the repricing (the "premium period" in this example), the employee must pay a "premium" exercise price of $20 per share to exercise the option. Following the first anniversary of the effective date of the repricing, the employee would only be required to pay $5 per share to exercise the option, provided the employee remains employed through the premium period. Because the employee is never required to pay more than the original exercise price to exercise the option, there is no adverse impact on the employee, supporting the plan administrator's ability to act unilaterally.

ISO Considerations Under the "Premium" Approach

For options intended to qualify as incentive stock options under US tax laws (ISOs), the "premium" approach will have a similar impact on the ISO status of repriced options to that of a traditional option repricing program, meaning that the repricing will be treated as the grant of a new option and the grant date for determining the ISO holding period will be the effective date of the repricing. To the extent any shares acquired upon exercise of an ISO are sold or otherwise disposed of prior to the second anniversary of the effective date of the repricing (or prior to the first anniversary of the exercise date), such sale or other disposition will be treated as a "disqualifying disposition" giving rise to tax at ordinary income rates.

In addition, because the effective date of the repricing is treated as a new grant date, the annual $100,000 limit applicable to ISO exercises will be reapplied to any repriced ISOs (calculated using the new exercise price, not the premium price), which may result in some of those ISOs converting to non-qualified stock options. Companies will want to consider whether any of the ISO changes require consent to reprice (including under the "premium" approach) ISOs, though many equity plans will allow changes to ISOs without consent.

Accounting Considerations Under the "Premium" Approach

As is the case with any repricing or option exchange, accounting considerations are a significant factor in structuring a repricing using the "premium" approach. Under Financial Accounting Standards Board Accounting Standards Codification Topic 718 (Topic 718), a repricing or option exchange will result in a "modification" and the company will potentially be required to take an accounting charge for the incremental value, if any, of the new or repriced awards over the canceled or repriced awards. Companies will want to carefully consider and discuss with their financial and accounting advisors the accounting impact of any repricing or option exchange program prior to proceeding.

Exchange Considerations Under the "Premium" Approach

All stock option repricing and exchange programs, including the "premium" approach, must be designed to comply with applicable exchange listing rules, securities and tax laws, and the equity plan under which the options were granted.

Conclusion

Unlike traditional repricing and exchange programs, the "premium" approach — which only gives the option holder the benefit of the repriced option for exercises occurring following expiration of the premium period — offers certain key advantages. Management teams and boards have increased flexibility to tailor a repricing program to the company's specific needs while restoring the retention and incentive features of an underwater option without, in most cases, implicating US tender offer rules or incurring significant stock dilution or cash expenditures resulting from additional equity grants or cash awards.

Appendix: Flow Chart

Underwater options: Repricings, option exchanges, and the "premium" approach for public companies

1. Strategies: Key terms

Repricing. The company unilaterally amends an option to reduce the exercise price to current FMV. Generally does not implicate tender offer rules or require employee consent. Repricings can entail significant compensation charges and potential disclosure obligations for executive officers and directors.

Option exchanges. Options are canceled and exchanged for new options, other awards, or cash. Can result in return of shares to equity plan reserve for future issuances and reduce share overhang. Generally implicates tender offer rules (see below) and requires employee consent.

Option-for-option. Options are exchanged for new options with current FMV exercise price but may become out of the money again.

Option-for-other-award, i.e., restricted stock or RSUs. Retains some value even with continued stock price depreciation; exchange ratio will result in less dilution for shareholders than option-for-option exchanges.

Option-for-cash. Protects employees from future stock depreciation and generally does not require shareholder approval, but considerable liquidity is necessary and often lacking. Not a commonly used alternative.

The "Premium" approach. Similar to a repricing, the company unilaterally amends an option to reduce the exercise price to current FMV. However, the repriced options are subject to a higher exercise price (or a "premium" exercise price) for exercises occurring prior to the expiration of a specified vesting schedule or retention period.

2. Procedural considerations

Does the equity plan specifically permit the desired repricing or exchange without shareholder approval?

No → Shareholder approval is required under NYSE/Nasdaq rules. The company must disclose material terms of the repricing or exchange in the proxy statement. Preliminary proxy statement is required. The company must also file Form 8-K under Item 5.07 ("Submission of Matters to a Vote of Security Holders").

Yes → Shareholder approval is not required but may be advisable. ISS considers a non-shareholder approved repricing/option exchange to be a "problematic pay practice." If shareholder vote is not sought, ISS will recommend AGAINST the election of board and compensation committee members, say-on-pay, and new or amended equity plans for up to three years.

If shareholder approval is sought, Glass Lewis and ISS will recommend FOR or AGAINST the proposal case-by-case, based on multiple factors. If proxy advisory firms oppose the proposal, a friendly shareholder base is usually needed for it to prevail.

Factors weighing in favor of ISS support:

- Shareholder approval was not required but sought regardless
- Directors and officers excluded
- Extended vesting schedules, where applicable
- Forfeited shares not returned to share reserve
- Share price decline beyond management control

Factors weighing against ISS support:

- Share price might increase in the near future
- Exercise price of the eligible options is below the 52-week high for the share price
- Approval is sought less than one year after a significant share depreciation
- Amendment would cause incremental accounting charges

Are executive officers and directors included?

Yes →

- Additional disclosures are required in the "Compensation Discussion and Analysis" section of the company's proxy statement for the following year.
- Summary Compensation Table and Director Compensation Table must disclose the incremental value of the modified award.
- New equity awards must be included in "Grants of Plan-Based Awards Table."
- All participating directors and officers must file Form 4s with the SEC.
- Form 8-K may need to be filed under Item 5.02(e) if named executive officers participate.

No →

After considering the factors above, is the company pursuing an option exchange or is participant consent required?

No → In a straight repricing (including the "premium" approach), the company can proceed with Board or applicable Committee approval and amendment of applicable options.

Yes → A public tender offer is required (unless offer is to a small number of persons).

Does the exchange meet all of the following criteria?

- Company is eligible to use registration statement on Form S-8
- The program is conducted for compensatory purposes
- Company discloses essential features of the offer, including adverse effects on option holders

Yes → The exchange qualifies under the SEC's exemptive order to Rule 13e-4 of the Securities Exchange Act of 1934.

Provided that all other filing, disclosure, and dissemination requirements of Rule 13e-4 are followed, the company may:

- exclude certain employees and tranches from the exchange (all-holders rule does not apply); and
- modify the consideration offered to certain employees (best-price rule does not apply).

No → The exchange must fully comply with Rule 13e-4, including the all-holders and best-price rules.

In case of any repricing or option exchange, additional issues to consider:

- Accounting charges (ASC Topic 718)
- Re-assessing ISO requirements for modified or new option grants
- Differing obligations in domestic and foreign jurisdictions
- Administration of public tender offers can be challenging
- Committee approval must meet Section 16 qualifications
- Implications under Rule 10b5-1 trading plans if modified options are covered

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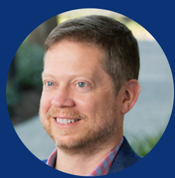

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