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Repricing Options: What Every Private Company Needs to Know

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Stock options are typically a critical component of a private company's ability to recruit, incentivize and retain key talent. Particularly for early-stage companies, rewarding equity packages can help make up for the gap between the cash compensation a startup can offer against the more significant cash compensation their larger competitors can afford to pay. However, when stock options have exercise prices that are higher than the fair market value of the underlying stock (i.e., when the options are "underwater") they lose most, if not all, of their incentive and retentive value. And where there is a competitive market for talent, the lack of effective equity incentives may make the departure of key employees more likely. As a result, a company may determine that a repricing of underwater options is necessary to retain executives and other employees who are instrumental in the company's future success.

While the term "repricing" can cover a variety of structures, private companies usually opt for a simple options-for-options approach in which the exercise price of underwater options is reduced to an exercise price equal to the then-current fair market value of the underlying stock. While there are other repricing structures—options-for-restricted stock, options-for-restricted stock units, or event option-for-cash—in this alert, we focus solely on the options-for-options structure because it is the least administratively complicated, avoids undesirable tax consequences and preserves cash. Even so, there are number of business and legal considerations that a private company must balance as it evaluates whether and how to implement a repricing, including the (often surprising) consideration that the consent of option holders may be required, as discussed below.

Repricing Structure Considerations

Terms of the Repricing. For many private companies, a repricing can be as simple as reducing the exercise price of all outstanding underwater options held by current service providers to the current fair market value of the underlying stock but leaving the other terms and conditions of those options unchanged. Such a simple approach may be the beginning and end of what they seek to accomplish. Indeed, private companies generally demand little or no "giveback" from participants in exchange for the reduction in their option exercise price: they do not require that option holders participating in the repricing receive a reduced number of options or have a portion of their vested options made subject to vesting again. However, in some cases additional changes to the repriced options may be necessary or appropriate to achieve the goals of incenting and retaining employees via the repricing. Specifically, a company may wish to consider one or some combination of the following terms:

- *Repricing Threshold*: Should all underwater options be repriced or should the company choose a threshold above the current fair market value of the underlying stock in identifying which options may be repriced? While private companies generally allow options having an exercise price that is in excess of the then-current fair market value to be repriced, choosing a higher threshold could limit the number of options being repriced and avoid repricing options that are only modestly underwater.
- *Number of Participating Options*: Depending on the number of options outstanding, the company may wish to limit the size of the repricing. If so, in addition to (or in lieu of) setting a repricing threshold that is higher than the then-current fair market value of the underlying stock, the company could consider either setting a limit on how many underwater options each eligible participant may reprice in total or setting an exchange ratio (for example, providing that every 3 underwater options may be exchanged for 1 repriced option). Setting such an exchange ratio would also generally have the effect of returning shares to the equity plan that could be made available for new awards.
- *Repriced Option Exercise Price*: The new exercise price of the repriced options must be at least equal to fair market value of the company's stock at the time of repricing to comply with Section 409A of the Internal Revenue Code ("Section 409A"). While companies generally set the new exercise price to exactly fair market value, a company could choose to set the new exercise price higher instead.
- *Vesting Schedule*: Typically, existing vesting schedules are carried over to the repriced options without change; however, the company may wish to reset vesting schedules in whole or in part so that the repriced options provided greater retention.
- *Expiration Date of Repriced Options*: Repriced options typically have the same expiration date as the original underwater option. The company may instead provide each repriced option with a new 10-year term in connection with the repricing.
- *Tax Characterization of Repriced Options*: Repriced options will generally retain their character as incentive stock options ("ISOs"), subject to the rules regarding ISOs (described below), or as nonstatutory stock options ("NSOs"); however, the company could structure the repricing so that the repriced options are either ISOs (to the extent allowed under the Internal Revenue Code) or NSOs, even if the original option had a different tax character.

The more extensive the changes to the terms of the repriced options, the more likely it is that option holder consent will be required to effect the repricing. But even a repricing that only reduces the exercise price of the underwater options may require option holder consent if the underwater options are ISOs or the form of award agreement requires it.

The extent of the changes to the terms of the repriced options will generally determine whether option holder consent to the repricing is required. But even a repricing that only reduces the exercise price of underwater options may require option holder consent.

<u>*Eligible Participants*</u>

Within the United States. The company must determine who is eligible to participate in the repricing and can be as selective or broad as best accomplishes the goals of the repricing, absent any constraints imposed by the company's stock incentive plans or award documents. Typically, companies allow all current service providers (employees, consultants and directors) to participate, though it is permissible to offer the repricing to a small group of key employees. Former service providers who still have time left in which to exercise vested options are generally excluded from repricings both because the company no longer needs to incentivize or retain them and because their inclusion raises securities laws concerns.

Outside the United States. An option repricing for employees who are tax residents outside the United States may be subject to local securities, tax and other legal requirements that differ from those in the United States. Compliance with these requirements—and providing descriptions of the securities and tax consequences in all applicable jurisdictions to the relevant eligible participants—can become burdensome. Unless the company is willing to incur the expense of complying with all local law requirements, foreign employees will need to be excluded from any repricing. If the company does wish to include foreign employees, it will be necessary to consult with foreign counsel in any applicable jurisdictions. While some jurisdictions may be quite straightforward and similar in approach to the U.S., others may require compliance with complicated administrative regimes or present adverse tax consequences.

Tax, Securities Laws, and Accounting Considerations

<u>*Tax Considerations*</u>. A repricing by itself generally does not result in taxable income to option holders or a tax deduction to the company, but it does present several potential tax issues that may be determinative of whether option holder consent to the repricing is required:

ISO Rules	*The Waiting Period.* Under U.S. federal tax law, in order to get the benefit of preferential ISO tax treatment, an option holder must sell stock received upon exercise of an ISO on a date that is more than two years after the ISO was granted and more than one year after it was exercised. The amendment of an ISO to reduce its exercise price—even where the reduction of the exercise price is the only modification to the option—is treated as the grant of a new

	option for U.S. tax purposes. As a result, the two-year waiting period described above will start over when the repricing occurs. *The $100,000 Limitation*. The aggregate fair market value of all ISOs granted to an employee that become "first exercisable" in any calendar year cannot exceed $100,000 (with fair market value for this purpose being the fair market value of the company's stock on the date of grant of the options). If an option is repriced, the $100,000 rule requires that both (i) any portion of the original option that is or would become "first exercisable" in the year of the repricing, as well as (ii) any portion of the repriced option that is or becomes "first exercisable" in the year of the repricing, be applied against the $100,000 limit for that year. Generally, this means that the portion of the original option that vests (or would have vested) in the year of repricing, using the fair market value on the date the original option was granted, is applied against the $100,000 limitation first and then the portion of the repriced option that is vested at the time of the repricing or that may become vested in the year of the repricing, at the fair market value at the time of the repricing, is applied against the $100,000 limitation. The effect of this recalculation of the $100,000 limitation for the repriced ISOs could result in all or a portion of an option that previously qualified as an ISO becoming an NSO, and, as a result, require an option holder affected by this rule to have to consent to the repricing. *Modification*. Offering the holder of an ISO the opportunity to participate in a repricing may constitute a "modification" of the outstanding ISO, even if the employee does not elect to participate in the repricing. The "modification" issue for ISOs can be avoided if the repricing offer is open for less than 30 calendar days.
Section 409A	Section 409A imposes harsh tax consequences on the holders of options that have an exercise price below the fair market value of the underlying stock on the date of grant. As long as the exercise price of the repriced option is set at or above the fair market value of the underlying stock on the effective date of repricing, there should be no issue under Section 409A. The company should have a recent Section 409A valuation received from an independent valuation firm to assist in determining the exercise price for the repriced options, and as with any determination of fair market value, the company's board must take all additional factors into account as well (such as an anticipated upcoming investment or liquidity event that was not accounted for in the independent Section 409A valuation). Note that while repricings generally do not raise any adverse concerns under Section 409A, to the extent that a company has multiple repricings, the Section 409A rules may deem the company to have "floating" exercise prices that are not at least fair market value on the grant date, and thus cause the options to violate Section 409A, triggering significant adverse consequences for the company and the option holder. As a result, a company should carefully consider these risks if it has previously undertaken a repricing or expects the fair market value of the underlying stock to fall further such that another repricing may become necessary.

__Securities Law Compliance__. A private company must ensure that the grant of the repriced options, which is treated as the grant of new options for securities law purposes, in an option repricing is exempt from registration under the Securities Act of 1933. This is typically achieved pursuant to the exemption provided by Rule 701 (and sometimes supplemented by Section 4(a)(2), Regulation D and/or Regulation S). The company's Rule 701 analysis should be revisited prior to completing the repricing, as Rule 701 sets certain dollar-value and share number limitations on the amount of equity awards that can be granted in any 12-month period. Large-scale repricings can sometimes result in proposed repriced options exceeding the relevant limitations imposed by Rule 701. In these situations, companies may need to consider either cutting back the scope of the repricing or finding alternative exemptions that would cover some of the newly repriced options.

__Accounting Treatment__. While one appeal of an option repricing is that it rarely results in a cash impact on the company, it could result in a material non-cash impact on the company's financial statements. ASC Topic 718 requires all companies to estimate the fair value of a compensatory stock option at the grant date, using the Black-Scholes or another valuation method, and to recognize that value as compensation expense over the option vesting period. When an option is repriced, ASC Topic 718 requires the fair value of the modified or new options minus the current fair value of the surrendered options to be recorded as compensation expense over the remaining vesting period of the repriced options. As a result, the repricing could result in significant new compensation charges, in addition to the ongoing compensation charges associated with the cancelled options (which are not eliminated upon the repricing).

Repricing Consent Considerations

__Stockholder Consent__. Subject to review of the company's stock incentive plans and any applicable investor agreements, stockholder consent is typically not required for a private company to reprice stock options. Companies often consider expansions in their option pool in coordination with repricings, however, which typically will require a stockholder vote. If stockholder approval is needed or if restrictions or covenants in the company's investor agreements and corporate charter must be waived (for example, investor anti-dilution protections, rights of first refusal and/or mandatory employee vesting provisions), however, the company will usually get direct feedback on the proposed program from its principal stockholders, who often sit on or control the company's board. Even if stockholder consent is not required, private companies generally will consult with their principal stockholders when structuring an option repricing program.

__Participant Consent__. The terms of the company's stock incentive plans and forms of award agreement under those plans will generally dictate the circumstances in which the consent of an eligible participant to a repricing is required. For example, some plans or award agreements prohibit any amendment to options without the consent of the option holder. Other plans and agreements may permit amendment without the consent of the option holder, but only to the extent that the board of directors determines that the amendment will not have a material adverse effect on the option holder.

In virtually all cases where the vesting schedule or the number of shares subject to the option is changing or where the plan under which the repriced option is granted is changing, the consent of the participant will be required. By contrast, where the only change to an outstanding NSO is that the option exercise price is to be reduced, the consent of the participant is rarely required. In most circumstances where the repricing will cause some or all of a participant's ISOs to cease to be ISOs by application of the $100,000 ISO rule (described above), the consent of the participant will be required. More nuanced is whether the repricing's restarting of the ISO Waiting Period (described above), is an adverse consequence that results in the consent of the participant being required, because preferential ISO treatment may be more difficult to attain as a result of the repricing. Making this determination requires a careful reading of the plan and award agreements to confirm exactly what types of amendments require the consent of the option holders, as well as assessment by the board of directors as to the timeline to a liquidity event, the type of liquidity event, the likelihood of participants exercising options in advance of a liquidity event and other relevant factors.

Depending, then, on the terms of the repricing itself and those of the governing plan and award agreements, the company may ultimately determine that it needs to seek consent of all eligible participants or that it needs to seek consent only from certain eligible participants and can unilaterally reprice the options of other eligible participants. The determination of what consent, if any, will be required from eligible participants is critical to determining how the repricing will be effected.

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For example, the U.S. Securities and Exchange Commission ("SEC") takes the position that option repricings in which option holders may either elect to surrender underwater options for new securities containing different vesting or exercise terms or a reduced number of shares, or modify existing awards not only to reduce the exercise price but also to modify the vesting schedule or change other material terms (including where the repricing has the effect of changing the status of the option from an ISO to an NSO), are exchange offers which must be conducted in compliance with the tender offer rules (described below). However, where consent to the repricing is only required from a limited group of participants, the company may be able to conclude that compliance with certain of the formalities of the tender offer rules is not required.

The Repricing Process

Preliminary Matters. Prior to obtaining board approval of any option repricing, the company should consult with its human resources team, legal counsel and third-party valuation specialists to assess the scope of any repricing and any practical impediments that could limit the company's ability to complete a repricing. A valuation can take several weeks to complete, and an updated Rule 701 analysis can also require some lead time and iteration if there are complicated facts. Appropriate involvement from human resources or equity plan administrators can help consider any changes to awards that will create appropriate incentives and retention structures for the company's employees.

Board Approval. Regardless of any required participant consent, the company's board, or a duly authorized committee of the board, must approve the terms of any option repricing program. Any such approval must be made after the board (or the committee of the board) exercises its fiduciary duties of loyalty and care to the company and its stockholders by carefully considering the need for, and the costs of, the repricing in the context of the company's current situation and future outlook. In connection with that approval, the board will need to determine the company's fair market value in compliance with Section 409A as of the date it approves entry into the repricing to ensure that the exercise price of the repriced options is at least equal to fair market value. If the repricing is to be effected as a tender offer, the board will also need to determine the fair market value in compliance with Section 409A again upon the close of the tender offer period.

Documenting the Repricing. The next phase is delivering documentation to plan participants. The documents necessary to effect the repricing depend in large part on the extent to which participant consent is required, as described below:

Nature of Consent Required	**Documentation Requirements**	**Effective Time of Repricing**
Consent from more than a limited number of eligible participants is required	The company will have to comply with the SEC's tender offer rules for the repricing. The company must provide adequate disclosure to eligible participants regarding the nature of the repricing and provide an offering period that is open for at least 20 business days (but, to comply with the ISO regulations, less than 30 calendar days) to elect whether to participate in the repricing. In an option-for-option exchange, the tender offer documents are generally straightforward. But the more complicated the structure of the repricing, the more complex the documents will be.	The date of board approval of the then-current fair market value of the underlying stock following the expiration of the 20 business-day tender offer period.
Consent from only a limited number of eligible participants is required	The company will need to provide adequate disclosure to eligible participants, similar to the disclosure that would be required for a	The date on which the eligible participant consents to the repricing.

	tender offer. Those eligible participants must be given time in which to consent to the repricing, but that period of time should be short enough that the fair market value is unlikely to change over its course. Generally, three to five business days or so is an appropriate window in which to allow participants to decide whether to participate in the repricing.	
Consent from an eligible participant is not required	The board may unilaterally approve the repricing of options. In such case, the company will typically provide a letter to eligible participants notifying them that their options have been repriced and the rationale for and key terms of the repricing. Some companies also choose to include additional information (such as a set of FAQs) to anticipate participant questions.	The date on which the board approves the repricing (or such other date as may be specified in the board approval).

Post-Repricing Recordkeeping

The repricing documents described above may, for those participants whose options were unilaterally repriced or who elected to consent to the repricing, serve as amendments to outstanding option award agreements. However, the company's stock option records and ledgers (whether maintained by the company or by a third party on an electronic platform) should be updated to reflect the repricing and care should be taken to ensure that any new ISO/NSO splits are property reflected.

Conclusion

Unlike a public company repricing, undertaking a private company repricing can be a fairly straightforward endeavor. However, even in the private company context care must be taken to ensure that the repricing is effected at a time when the company believes the stock has "bottomed out", that the terms of the repricing will appropriately incentivize and retain the company's key service providers, and, most critically of all, that the extent of any required participant consent is identified and obtained in accordance with applicable law.

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