SPOTLIGHT ON **COVID-19**

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The Impact of COVID-19 on Stock Options: Whether to Reprice or Not

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Stock options are a common form of long-term incentive compensation, among public and private companies, that aligns the interests of employees and executives with those of shareholders. Due to the current downturn in global market conditions caused by COVID-19, many companies are now facing a situation where outstanding employee stock options are significantly underwater (i.e., stock options have an exercise price greater than the current market price). As a result, it's expected that stock option repricing will reemerge as a "hot topic" of discussion.

This paper summarizes key strategic, talent, and technical considerations for boards and cross-functional management teams as they evaluate strategies related to stock option repricing. It reflects a collaborative effort of subject-matter experts from Houlihan Lokey and Compensation Advisory Partners (CAP), a leading independent consulting firm specializing in executive and director compensation and related corporate governance matters.

What Is a Repricing and How Common Is it to 'Reprice' Stock Option Awards?

Just over half of public companies grant stock options as part of their annual long-term incentive program.[1] Stock options typically vest over three or four years, and generally have a 10-year term during which they can be exercised. In addition, nearly 20% of private companies grant stock options as part of their long-term incentive programs.[2] The prevalence is even higher among private equity-backed and VC-backed companies.

The New York Stock Exchange (NYSE) and Nasdaq define a stock option repricing as follows:

- Lowering of the strike price of an option after its granted;
- Canceling an option at a time when its strike price exceeds the fair market value of the underlying stock, in exchange for another option; and
- Any other action that is treated as a repricing under U.S. generally accepted accounting principles (GAAP).

Stock option repricing and exchange programs are a strategy that companies may evaluate when options are "out-of-the-money" or "underwater." When the stock price falls well below the exercise price, options may have limited incentive value as the employee does not receive any benefit if the stock price increases (at least until the stock price gets back to the exercise price). While stock options are long-term vehicles generally with 10-year terms, when the options are deep underwater (e.g., require 50% plus appreciation to get back to the exercise price) they may provide very little motivation to employees and are unlikely to have any incentive value. For example, if an employee has 10,000 options with an exercise price of $50.00 and the

1. *Source: 2019 CAP 120 Research Report and 2019 NASPP Domestic Stock Plan Design Survey.*
2. *Source: 2019 Incentive Pay Practices Survey – Privately Held Companies (CAP & WorldatWork).*

stock price is currently at $25.00, the employee might be much happier with 2,500 options with an exercise price of $25.00 than the 10,000 underwater options.

From a shareholder perspective, they may be against a stock option repricing in principle as it represents a misalignment with employees. The shareholders do not have the ability to get "repriced" in their shares. They are stuck with the lower equity values. Why should management be treated better than shareholders? The main rationale for a repricing or an exchange from a shareholder perspective is to restore the incentives for management to increase the stock price.

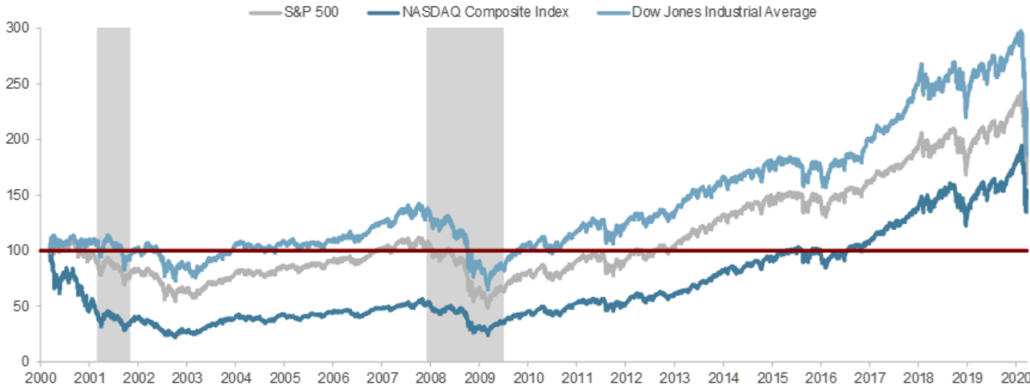
Stock option exchange and repricing programs saw a large spike during the last market decline in 2009 during the financial crisis (see the table on page 5 under Institutional Shareholder Viewpoint).[3]

STOCK PRICES AND STOCK OPTION REPRICING

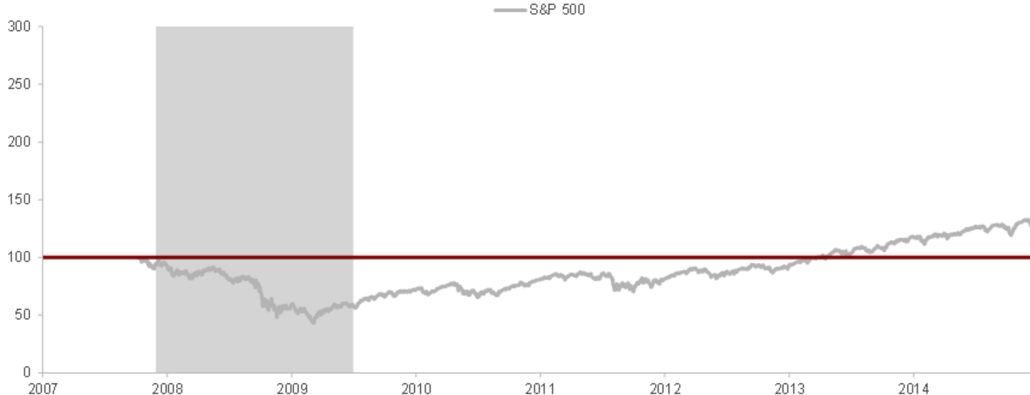
When evaluating whether a stock option repricing or exchange is right for your company, it is worth considering the recovery period of stocks during the last two market downturns during the dot-com bubble crash and the financial crisis of 2008–2009. The average recovery period from the dot-com crash for the three major indices was more than nine years with the Nasdaq taking over 17 years to recover, while the average recovery period from the last market downturn of the financial crisis took more than five years—as can be seen in the S&P 500 index below.

If the current downturn follows a similar pattern, we could be looking at a period beyond 2025 before stocks fully recover. Given this, and considering the average option vesting periods and average terms of awards, many stock option programs may

Performance of S&P 500, DJIA, and Nasdaq Composite After the Dot-Com Recession



Financial Crisis S&P 500 Recovery



3. Source: ISS Governance Analytics. Reflects proposals that went to a shareholder vote and excludes those that were withdrawn.

remain underwater indefinitely. In addition, the fact that entering the current market decline resulted in approximately two-thirds[4] of S&P 500 companies that granted stock options during the past five years are in a situation where some or all of such stock options are underwater. On the other hand, companies should be thoughtful in reacting to the current sudden decline, as stocks could bounce back quicker than expected and stock options are intended to be a long-term incentive program.

There are also company-specific factors to consider. For example, the amount of annual equity awards granted in the form of stock options, how deep in the organization stock option grants are made, whether stock option awards are made annually or front-loaded, if all outstanding stock options underwater are approximately to the same degree, etc. In addition, would the company intend to restore value for all underwater stock options, or only those where the exercise price is significantly underwater (e.g., 50% above the market price).

Repricing Strategies

There are four primary strategies used for repricing or exchange of an out-of-the-money or underwater option:

Repricing or Exchange Strategy	Approach
One-for-One Exchange	The exercise price of underwater stock options is reduced by the company.
Value-for-Value Exchange	Underwater stock options are cancelled and replaced with new stock options that have an exercise price that is equal to or greater than the market price at the time of the new grant. The exchange ratio for the program is generally intended to be on a value-for-value basis (i.e., the total number of options granted is less than the original grant but typically the new grant is the same fair market value of the prior options at the time of the exchange). The new options would typically have additional vesting conditions.
Option for Other Equity Award Exchange	The underwater stock options are exchanged for a different type of stock-based award (e.g., restricted stock or RSUs) typically based on the fair market value of the options at the time of the exchange. Such award would typically have additional vesting conditions.
Cash Exchange (“Option Buyout”)	Underwater stock options are purchased by the company for cash, typically based on the fair market value of the options at the time of the exchange. The payment could be subject to vesting conditions.

Institutional Shareholder Viewpoint

For public companies, the NYSE and Nasdaq require shareholder approval prior to commencing a stock option repricing or exchange strategy unless it is permitted by a company’s shareholder approved equity plan, which would be highly unusual in today’s governance environment. The threshold level of support for such a proposal to be “approved” by shareholders is a majority of votes.

While option repricing strategies have seen increased skepticism in the past 20 years, 96% of those proposed by companies since 2001 have been approved by shareholders.[3]

This rule does not apply in the case of an option buyout strategy. If shareholder approval is required, there are proxy disclosure and shareholder meeting rules that must be followed, as well as best practices that should be considered.

Large institutional investors, even in today’s governance environment, can support these proposals. For example, in its

4. Source: Capital IQ.

Year	# of Proposals	ISS Recommendation		Vote Result		Average shareholder support
		For	Against	Pass	Fail	
2001	-	-	-	-	-	-
2002	-	-	-	-	-	-
2003	8	6	2	8	-	88.7%
2004	-	-	-	-	-	-
2005	3	3	-	3	-	76.3%
2006	4	3	1	4	-	82.6%
2007	1	1	-	1	-	88.1%
2008	6	2	4	6	-	79.0%
2009	38	21	17	35	3	71.6%
2010	9	7	2	9	-	85.6%
2011	1	-	1	1	-	57.7%
2012	6	2	4	6	-	85.6%
2013	-	-	-	-	-	-
2014	1	-	1	1	-	78.7%
2015	3	1	2	3	-	85.8%
2016	4	-	4	3	1	67.2%
2017	3	-	3	3	-	74.7%
2018	-	-	-	-	-	-
2019	2	-	2	2	-	73.4%
2020	3 Pending	-	-	-	-	-

publicly disclosed proxy voting guidelines,[5] BlackRock states: "We believe that there may be legitimate instances where underwater options create an overhang on a company's capital structure and a repricing or option exchange may be warranted."

BlackRock

"We will evaluate these instances on a case-by-case basis. BlackRock may support a request to reprice or exchange underwater options under the following circumstances:

- *The company has experienced significant stock price decline as a result of macroeconomic trends, not individual company performance.*
- *Directors and executive officers are excluded; the exchange is value neutral or value creative to shareholders; tax, accounting, and other technical considerations have been fully contemplated.*
- *There is clear evidence that absent repricing, the company will suffer serious employee incentive or retention and recruiting problems.*

BlackRock may also support a request to exchange underwater options in other circumstances, if we determine that the exchange is in the best interest of shareholders."

Shareholder outreach can impact vote results, and in our experience, institutional investors generally can be more flexible with the application of their compensation-related voting guidelines than proxy advisors who are less open to individual company or industry facts and circumstances. For example, directors and executive officers are oftentimes excluded from option repricing or exchange programs. However, not including them can run counter to many of the goals of such

5. *Source: BlackRock Investment Stewardship – Corporate governance and proxy voting guidelines for U.S. securities (January 2020).*

a program. An alternative to consider, and discuss with large investors, is having directors and executive officers participate, but on less favorable terms than others. High-performing, experienced talent is critical to success, especially in tough times, and companies should do what is best for their business, within reason.

The two most influential proxy advisors are Institutional Shareholder Services (ISS) and Glass Lewis. Their support, or lack thereof, can materially impact the results of compensation-related shareholder votes. For example, an "Against" vote recommendation from ISS for an annual Say-on-Pay vote will typically reduce shareholder support by approximately 20% to 30%, depending on shareholder base.

The proxy advisors have specific voting guidelines related to (broadly defined) option repricing or exchange programs and proposals. This can impact their voting recommendations for option repricing or exchange proposals, which they will support "on a case-by-case basis", as well as for Say-on-Pay and director elections. Public companies should review and understand related ISS and Glass Lewis voting guidelines when contemplating a stock option repricing or exchange program. Support from the proxy advisors is not necessary to receive majority shareholder support for a stock option repricing or exchange proposal, but a decision to act outside their guidelines should be deliberate and the implications should be considered and clearly understood.

Public companies should review and understand the proxy voting guidelines of their largest institutional investors when contemplating a stock option repricing or exchange program. Such guidelines should be an input (i.e., a reference point) for boards and senior management teams when determining the best course of action for their company. Involvement of a specialist with expertise in this area is strongly advised.

Valuation, Accounting, and Exchange Rule Considerations

In accordance with U.S. GAAP (and International Financial Reporting Standards [IFRS]), the grant date fair value of a stock option award is expensed over the vesting period and this continues even if the stock option award is underwater and has no value to the recipient.

Also as noted above, an option repricing is considered a modification of the relevant outstanding options under U.S. GAAP Accounting Standards Codification Topic 718.[6] As a result of a stock option repricing or exchange strategy, an evaluation must be made of the fair value before and fair value after the event. Any incremental fair value will lead to an additional compensation expense.

Any awards that have already vested could lead to an immediate expense being recognized for incremental fair value and for unvested awards the incremental fair value is expensed over the remaining vesting period. Involvement of valuation and accounting specialists with expertise in this area is strongly advised.

Finally, exchange offers are considered to be tender offers and thus subject to SEC tender offer rules, with certain exceptions. This is required where employees are being asked to give up rights to an option in exchange for something else; i.e., a company generally cannot force employees to accept the exchange. Upon commencement of a stock option exchange program, a company is required to file a Schedule TO with the SEC and leave the offer open for at least 20 business days. The Schedule TO must outline the terms of the stock option exchange program. Once a tender offer has commenced, it is subject to SEC review and comment.

Tax and Legal Considerations

Generally, under the repricing or exchange strategies discussed above, a one-for-one exchange or a value-for-value exchange is considered to be a non-taxable event under U.S. tax law. Holders of the awards are not required to recognize income for federal income tax purposes upon the cancellation of stock options or upon the grant of new options that are subject to future vesting. There are, however, nuanced considerations related to IRC Section 409A and IRC Section 162(m), as well as with incentive stock options (ISOs), if applicable.

6. ASC Topic 718 defines a modification as any change in a stock award's conditions; e.g., a modification used to "reprice" an option award could be to adjust the exercise price of an out-of-the-money option down to the current market price of the company.

Any stock option repricing or exchange program must be done in compliance with applicable securities, tax, employment and exchange control laws, which can vary in non-U.S. jurisdictions. Requirements should be reviewed, and it may be appropriate for award terms to vary across different impacted employee populations. Involvement of a specialist with expertise in these areas is strongly advised.

Advantages and Disadvantages of the Different Strategies

Key advantages and disadvantages of the four primary stock option repricing and exchange approaches are summarized below:

Consideration	One-for-One Exchange	Value-for-Value Exchange	Option for Other Equity Award	Option Buyout
Advantages				
No new award plan required	✓			✓
Protects holder against further declines		✓	✓	✓
Easier to explain to award holders	✓			✓
Preserves approved but unissued shares		✓		✓
Reduces share overhang		✓	✓	✓
Simplicity				✓
No shareholder approval				✓
Non-taxable event for employee	✓	✓		
Disadvantages				
Negatively perceived by market	✓	✓	✓	✓
No opportunity to benefit from future stock price appreciation				✓
Requires public tender offer		✓	✓	✓
Option may subsequently go underwater	✓	✓		
Requires shareholder approval	✓	✓	✓	
Criticism and complications when directors and officers are included	✓	✓	✓	✓
Requires new equity awards		✓		✓
Requires cash outlay				✓
Additional compensation expense	✓			

Conclusion

Looking ahead, in light of the historic COVID-19 pandemic, we expect many companies will be evaluating how to best manage outstanding employee stock options that are significantly underwater. Boards and management teams should consult with external professional advisors if contemplating any form of option exchange. There are many employee, shareholder, and technical issues that should be considered.

Houlihan Lokey and Compensation Advisory Partners

Houlihan Lokey and Compensation Advisory Partners have deep experience assisting clients through tough times, extreme market volatility and uncontrollable events significantly impacting their business. Please reach out to one the authors below for more information. Our teams at Houlihan Lokey—the Corporate Valuation Advisory Services and Accounting and Financial Reporting groups—and Compensation Advisory Partners are ready today to address questions or provide expert assistance related to stock option repricing or exchange programs.

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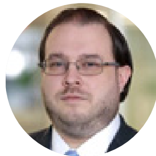

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