THE PROS AND CONS OF RE-PRICING OUT OF THE MONEY STOCK OPTIONS

Background

The compensation packages for many key service providers to private companies include options to acquire equity of the employer. Among the attractions of stock options are the fact that there is no current cash cost of issuing options, and they give the employee the potential to realize a significant economic return on the future sale of the employer or redemption of the underlying shares. For tax reasons, the exercise price of most employee options is equal to the fair market value of the underlying stock at the time the option is granted.

Unfortunately, for a variety of reasons, the valuation of many private companies has gone down in recent months, sometimes significantly, and may continue to do so, at least in the near term. As a result, the exercise price of options held by many service providers now exceeds the fair market value of the underlying stock that would be issued upon exercise of his or her option. This is often referred to as the option being "underwater" or "out of the money".

When this occurs, the holders of these out of the money options may feel that they are now under-compensated. In turn, this can result in a decline in employee morale and, in some cases, the loss of key service providers. Faced with these adverse consequences, employers often consider the pros and cons of reducing the exercise price of these options. This advisory touches on some of the pros and cons of repricing outstanding options that are underwater.

In general terms, there are two approaches to repricing outstanding options held by service providers. The easiest approach is simply to reduce the exercise price of the option, leaving all the other terms unchanged. The other approach is to modify other terms of the original option grant as a quid pro quo for reducing the exercise price.

Tax Considerations

While re-pricing of outstanding options is usually not a taxable event for US based service providers, there are other tax implications that should be considered.

IRC Section 409A. First, if the revised exercise price of the option equals or exceeds the fair market value of the underlying stock on the effective date of re-pricing, the re-pricing will not violate IRC section 409A. Section 409A is to be avoided when possible because it accelerates recognition of income and carries with it significant penalties.

Incentive Stock Options ("ISOs"). Some options granted to W-2 employees (independent contractors are not eligible) are granted as Incentive Stock Options. ISOs have material tax benefits if the holder meets certain requirements, including holding periods (two years from issuance of the option and one year from exercise). Re-pricing an ISO is treated as issuance of a new ISO, so the relevant holding periods restart. Also, the $100,000 annual limit on ISOs will have to be recalculated.

Governance Considerations

Any re-pricing of options will require the consent of the issuer's board of directors or managers, in the case of an LLC. A re-pricing which changes the exercise price and other terms of the option usually will require the consent of the option holder and may require the consent of the stockholders or members of the LLC, depending on the provisions of the option plan.

Securities Law Considerations

Re-pricing employee stock options may have implications under federal securities laws. These rules can be technical, may be complex and they require further professional guidance. Suffice it to say a simple reduction in the exercise price of the option usually does not trigger federal securities law issues, but revising other terms of a stock option may.

Some Practical Takeaways

For companies considering a re-pricing of outstanding options, it is important to keep in mind that the final decision must take into account the impact on the Company and all of the equity holders; not just the holders of options to be re-priced. This ultimately leads to the question of which options should be re-priced; i.e. all options that are out of the money or just certain options.

Re-pricing options may lead to employees and potential investors worrying that the company is having financial problems, which in turn may impact morale, retention of employees and any fund-raising efforts that are being planned.

Finally, re-pricing options may affect the company's financial reporting requirements. For that reason, analysis of the pros and cons of re-pricing out of the money options should include discussions with the Company's CPA and legal counsel.

If you have questions or would like further information about repricing employee stock options, please contact PLDO Partner William F. Miller at 508-420-7159 or email wmiller@pldolaw.com.

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