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Equity Incentive Considerations During COVID-19 Crisis

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Underwater Employee Stock Options

An unprecedented period of price volatility and general decline for many companies has left employee stock options with exercise prices below the current fair market value of the underlying stock.

It is possible to reprice, exchange, or supplement employee stock options with new awards. Each approach has differing levels of legal complexity, there are pros and cons for each approach, and it is important to plan and execute these steps so that they are effective and not done repeatedly (repricing or making new awards at a value that shortly after goes underwater defeats the purpose). While employee stock options are generally intended to serve as mid- to long- term incentives, projections for how the COVID-19 situation will affect business models and stock prices are very difficult if not impossible at this time, and the extreme volatility means that new awards made today could be substantially underwater tomorrow.

Now might be a good time to review the equity incentives for key employees including identifying the organization's key service providers, reviewing the equity incentives held by the key service providers (as well as the overall compensation package), and planning for what adjustments might be needed for price projections when possible. In previous downturns—2001-2002 and 2007-2008—there was a period of shock soon followed by a shopping period as cash rich acquirers realized their leverage and began to acquire talent and companies.

Performance Metrics for Incentive Bonus and Equity Award Vesting

The historic change in the economy and company performance has made many performance goals set as incentive vesting or payout measurements unattainable.

Companies can look to adjust goals to match attainable metrics where those metrics can be identified. In some cases, shifting from absolute or company specific metrics to metrics that are measured relative to an index or a peer group may allow improved goal setting. In other cases, it may simply make sense to communicate that the company is aware of the issue and looking to address it when the situation stabilizes.

Share Reserves

Companies with ESPPs and equity incentive plans may find that share reserves are used sooner than expected with the need for additional

grants or larger purchases at lower prices.

Projecting share use for equity plans at a range of new stock price estimates can help project whether share reserves are adequate for the time periods the reserves are expected to cover. If likely shortfalls are identified, company directors can plan for conserving share reserves or obtaining additional shares in equity plans which often involves shareholder approval.

Valuation Issues

Extreme changes to the business environment have greatly impacted company stock prices, and while public companies have a market price to use for establishing fair market value on the date of grant as required under Code Section 409A for employee stock options, private companies typically rely on a board determined fair market value or an independent valuation. In each case for a private company, the valuations must be updated when there is a material change to the business, and in periods of extreme volatility, it can be difficult to obtain a value that lasts for long enough to grant employee stock options.

In some cases, private companies can have independent valuations updated and make awards quickly enough to rely on the valuation, but in other cases, it might make sense to promise employees cash incentives based on a certain number of shares (phantom or synthetic awards) or other cash retention incentives as a surrogate for employee stock options.

We encourage you to visit Holland & Hart's Coronavirus Resource Site, a consolidated informational resource offering practical guidelines and proactive solutions to help companies protect their business interests and their workforce. The dynamic Resource Site is regularly refreshed with new topics and updates as the COVID-19 outbreak and the legal and regulatory responses continue to evolve. Sign up to receive updates and for upcoming webinars.

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