Down-Round Financings of Private Companies: Considerations for Outstanding Equity Compensation Awards

February 18, 2016

The recent market turmoil has forced VC firms and other private company investors to examine closely the real possibility of seeking financing at a lower valuation – what is often referred to as a "down round." More recently, the *New York Times* observed in January, "The unicorn[1] wars are coming, as the downturn in the market will force these onetime highfliers to seek money at valuations below their earlier billion-dollar-plus levels[.]"

While down-round financings impact all private company stakeholders, one demographic that can become particularly disaffected are employees – often, the one group of stakeholders that start-ups cannot afford to alienate because they are critical to the continuing operation and growth of the business. As the *New York Times* summarized it, "The down round is a 'lemon' signal to the market that the company's business plan is not working out. And one of the thorniest issues in dealing with down rounds is how a former unicorn keeps its employees after destroying the value of their shares."

When employees see the devaluation of their equity holdings in their employer, demoralization can set in, and it is often not long before they will become distracted at best and unretainable at worst. This is particularly true if employees hold stock options, which are typically viewed to be valuable only to the extent that the per share value of the company is higher than the exercise price of the options that they hold. Given that virtually all options are struck with an exercise price at least equal to the per share fair market value of the company at the time of grant, as soon as a down round occurs, employees' previously granted options will be underwater and will remain underwater until the company obtains a new valuation that is higher than the valuation at the time of grant.

While underwater options may not provide the intended benefits to employees, there may also be disadvantages to them from the company's perspective. Investors may view such options as creating an "overhang" on the company's capital structure, even though they are unlikely to be exercised unless the company's valuation increases. Underwater options still count against the company's equity compensation plan's share limits, thereby limiting the number of new equity awards that can be granted. And, a company must nevertheless account for options that are not providing value to employees.

For a company considering a down-round financing, there are four primary strategies[2] for dealing with underwater options:

- wait and see;
- pay additional cash or cancel underwater options for a cash payout;
- grant additional equity compensation awards; or

[1] A "unicorn" is a start-up company with a valuation greater than $1 billion.

[2] This memorandum is directed toward private companies, and public companies will have additional considerations when deciding whether to pursue the strategies presented, such as the shareholder approval requirements under the exchange listing standards and ISS/Glass Lewis proxy advisory considerations, as well as Section 16 reporting requirements and additional tender offer requirements under Rule 13e-4 of the Securities Exchange Act of 1934.

- reprice outstanding options or otherwise exchange them for new options or another type of equity compensation award.

Wait and see. This first strategy essentially means maintaining the status quo. While it may feel the most passive, there are a number of reasons why this approach may make sense – for example, valuations can turn around, so there may be no need to take precipitous action, and it may be more consistent with the view that employees should take their "lumps" with the money investors who themselves will be diluted by the down round. Further, actions to address underwater options may signal that management does not believe that the company's valuation will rise again to its previous level, which may have an impact on the reputation of the company with its multiple constituencies. The risk, of course, is that employees really will become discontented and, thinking that they have nothing to lose, prefer to take their chances somewhere else.

Cash solution. This strategy involves paying employees additional cash (*e.g.*, a salary increase, cash-based incentive compensation award, retention award, etc.), or canceling outstanding options for an immediate or deferred cash payment. While this can provide immediate value to employees, it may not be feasible for cash-strapped companies. Moreover, employees will forfeit the opportunity to participate in the growth of the company, they will be taxed on receipt of the cash (and will not be able to plan the time of taxation as they would with stock options) and, once the cash value is depleted, the company may find itself in the same position as it was before it started to distribute the cash. Furthermore, the cash payout will have almost no "going forward" retentive value, so new options or other equity compensation will likely need to be granted, as well.

Additional equity compensation awards. This strategy involves allowing employees to keep their outstanding equity awards and simply making additional grants (if the additional grants are in the form of options, they would typically have an exercise price at least equal to the per share value of the down-round financing). A threshold question is whether the company has the ability to grant additional options under its equity compensation plan (which may require approval from investors). If the company does have that headroom, this can be very good for the retention of employees because they will see their stake in the company increasing. For investors, however, this can be highly dilutive, and this may be viewed as a windfall to employees. It may also cause a dilution problem as the equity value rises and both the new and old grants are in-the-money.

Restructuring underwater options. This last strategy involves restructuring the underwater options, either by:

- reducing the exercise price to the company's new per share value (often called a "repricing"); or
- exchanging the options for new equity compensation awards – typically, options, but also possibly restricted stock or restricted stock units (RSUs).

Repricing. A repricing involves an across-the-board reduction of the exercise price of outstanding options to the company's new per share value, without any other changes (such as to vesting terms). It is relatively easy to implement and may not require the consent of option holders depending on contractual consent rights and tax consequences.

Option exchange: overview. An option exchange involves asking option holders to exchange their outstanding options for new options or other forms of equity compensation awards. It is generally effected through an exchange program and generally requires option holder consent.

O*ption exchange: options for options, or restricted stock and RSUs*. There are a number of design considerations in restructuring underwater options via an option exchange. One threshold consideration is the form of the back-end equity compensation award.

- *Option-for-option exchanges* are much more prevalent, as they are easily understandable by employees. In addition, so long as the company remains a private company, it is typically easier

for both the employer and the employee if the employee is able to control the timing of when the option will become taxable (*i.e.*, upon exercise). However, a future down-round financing or other external valuation event could result in the new round of options becoming underwater, and repricing options multiple times may not be feasible, as it may risk a tax and accounting characterization of the exercise price as being "floating."

- *Options-for-restricted stock or RSUs exchanges* are less common, but they do have two benefits: (1) they are almost always less dilutive to investors and (2) unless the company goes into bankruptcy, the new awards will always have some value for employees, in the sense that they will never be underwater. However, it is generally more difficult to control the timing of when the awards become taxable, and in fact the awards may become taxable at a time when the company's shares are still illiquid. This can make the satisfaction of any tax withholding obligations more difficult. In addition, while employees will be able to share in some upside as the company appreciates in value, it will be more limited than with options, where the upside tends to be more leveraged.

Option exchange: one-for-one exchange vs. value-for-value exchange. Another threshold design consideration is whether the exchange should be one-for-one or value-for-value:

- A *one-for-one exchange* involves the cancellation of the underwater option for a new option covering the same number of shares as the cancelled option, but with the new exercise price. If all other terms and conditions of the option are kept the same, it will look and feel like a repricing. However, companies can use this opportunity to change one or more of the contractual terms and conditions – such as extending the vesting schedule, shortening or extending the exercise period and so forth. One-for-one exchanges are easy for employees to understand and relatively easy to implement. However, these exchanges can be dilutive to investors.
- A *value-for-value exchange* involves the cancellation of the underwater option for a new option with the equivalent value, based on a Black-Scholes, binomial or other valuation methodology. This typically results in the new option grant covering a lesser number of shares than the cancelled option grant, as well as possible changes in other terms and conditions of the option. Value-for-value exchanges are less dilutive to investors, but they always require option holder consent, and there may be complications around communicating to employees how the exchange ratio was determined.

Option exchange: other design considerations. Other design considerations, some of which have been alluded to above, include:

- whether to change any contractual terms – such as changing the vesting terms; changing the period of exercisability; changing the consequences of a termination of employment, change in control or other event, etc.?
- whether to include or exclude executives and directors?
- how much dilution will the investors permit?
- when to take the desired action, especially if the spectre of a future down round is a real one?
- if the company were to go public, how will public company shareholders regard the pre-IPO option exchange?
- what are the tax, accounting and other technical considerations?

These considerations generally require a careful balancing of the twin goals of maximizing employee retention and incentivization on the one hand and managing investor concerns on the other.

Option exchange: tax considerations. Option exchanges generally do not result in adverse tax consequences. One risk, however, is if the company engages in multiple repricings or option exchanges

of the same option (which might occur if the company has multiple down rounds and the company tries to accommodate employees each time). If so, this may cause the option to be recharacterized as having a "floating" exercise price, in which case the option will be treated as non-complying non-qualified deferred compensation for purposes of the Internal Revenue Code. If an option is non-compliant, it will be subject to a 20% additional tax (*i.e.*, on top of ordinary income taxes) equal to the spread between the exercise price and the fair market value as the option vests (whether or not the option is exercised) and it is likely that a punitive interest rate will apply. In addition, for incentive stock options (ISOs), a repricing or exchange generally will restart the ISO holding period, and there may be limitations on how many new or repriced ISOs the employee can receive.

Option exchange: tender offer considerations. A unilateral repricing (with no other change in terms) that does not require the employee's consent will typically not trigger the SEC's tender offer rules because no consent will be sought. For all other types of option exchanges, unless the program is limited to a small group of senior executives, the program will generally need to comply with the tender offer rules under Section 14(e) of the Securities Exchange Act of 1934. These rules require private companies to comply with specified requirements, including holding open the tender offer for 20 business days and granting the back-end equity compensation award promptly after the closing of the offer. In addition, employees should be provided disclosure about the terms of the exchange and its potential consequences.

Option exchange: *Rule 701*. Compensatory equity awards, including stock options granted to employees, are often granted in reliance on an exemption from the federal securities laws that would otherwise require registration of the underlying shares with the SEC. A common exemption is Rule 701, which imposes caps on the value of securities that can be granted during any 12-month period. The SEC has made it clear that replacement equity compensation awards would count as "new" for purposes of determining whether the company is in compliance with the caps.

Option exchange: *accounting considerations*. The accounting considerations for any option restructuring also should be considered in advance, and it is important to consult with your accountants in the design of any option restructuring program.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Jeffrey P. Crandall	**212 450 4880**	**jeffrey.crandall@davispolk.com**
Alan F. Denenberg	**650 752 2004**	**alan.denenberg@davispolk.com**
Edmond T. FitzGerald	**212 450 4644**	**edmond.fitzgerald@davispolk.com**
Sophia Hudson	**212 450 4762**	**sophia.hudson@davispolk.com**
Kyoko Takahashi Lin	**212 450 4706**	**kyoko.lin@davispolk.com**
Jean M. McLoughlin	**212 450 4416**	**jean.mcloughlin@davispolk.com**
Byron B. Rooney	**212 450 4658**	**byron.rooney@davispolk.com**
Sarah K. Solum	**650 752 2011**	**sarah.solum@davispolk.com**
Cynthia Akard	**650 752 2045**	**cynthia.akard@davispolk.com**

© 2016 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's **privacy policy** for further details.