

Considerations for UK Companies to Take with Share Options and Other Compensation Arrangements in Light of the Coronavirus Pandemic

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As COVID-19 spreads throughout the United Kingdom and around the globe, companies are wondering what they can or should be doing to ensure the on-going effectiveness of their share-based compensation and other incentive plans.

We have listed the key steps we believe UK companies should implement or consider implementing in light of the COVID-19 pandemic, as well as additional considerations to keep in mind for the future.

- 1. Ensure that there is company discretion to determine whether corporate or individual performance targets are met.** Companies may need to rely on, or build in more, discretion within their newly implemented bonus plans or performance-based equity awards to give them flexibility to address the impact of COVID-19 on the company's business, the financial markets and the economy. When building flexibility into bonus plans and performance-based equity awards, companies should involve their accounting advisors in order to avoid inadvertently creating adverse accounting consequences in connection with such flexibility. Public companies will also need to consider the terms of their directors' remuneration policy before implementing any measures that impact directors.
- 2. Preserve company cash in connection with bonuses.** Consider whether the company has the flexibility to settle bonuses in equity rather than cash. Companies should, however, be cautious before imposing such changes unilaterally in the absence of existing discretion.
- 3. New grants of EMI options to UK employees: consider whether recent events have impacted the company's EMI valuation.** Private companies may have the ability to grant options at a lower exercise price if their equity value has been impacted by the COVID-19 pandemic. If a company desires to make use of a lower valuation, they should stop granting new share options until the company can obtain a new EMI valuation that takes into account the potential impact of the COVID-19 pandemic and market volatility on the company's valuation.
- 4. New grants of options to US employees: consider whether recent events have impacted the company's 409A valuation.** Private companies should keep in mind that until a new 409A valuation is obtained, options must be granted to US employees with an exercise price at least equal to the current 409A valuation in order to comply with the safe harbour under Section 409A of the US Internal Revenue Code. However, as with EMI options, companies should consider whether a new post-COVID-19 valuation may provide an opportunity to incentivise employees with lower-priced stock options, and if so, they should obtain a new 409A valuation taking COVID-19 into account.
- 5. Listed UK companies should consider using share price averages to determine the number of shares subject to incentive equity awards.** The impact of recent share price fluctuations and market volatility can be reduced by using a trailing average share price when determining the economic value of the number of shares subject to an equity incentive award.

6. **Preserve company cash in connection with equity award PAYE tax withholding obligations.** Consider discontinuing the use of net settlement or net exercise (i.e., the company delivering a net number of shares upon settlement or exercise) as a means of having participants satisfy applicable PAYE tax withholding obligations. Moving away from net settlement and net exercise of equity awards will improve the company's cash position.
7. **Keep track of vesting and changes in employment status.** If the current economic uncertainty results in redundancies, companies should ensure that records of vested and unvested equity awards at the point of employment cessation are current, accurate and accessible remotely, which will minimise the likelihood of future disputes. Similarly, any proposed extensions of exercise periods should be considered prior to the expiration of the underlying options (with care taken where such options are EMI – see further below).
8. **EMI-specific considerations.** It is also important to keep track of applicable provisions in option agreements and share plans that may be implicated when an option holder takes a leave of absence, is furloughed under the UK Government's Coronavirus Job Retention Scheme, transitions from full-time to part-time employment status or ceases employment entirely. An EMI disqualifying event occurs on any cessation of employment with potentially negative income tax consequences if exercise of the EMI option does not occur within 90 days thereof. An EMI disqualifying event will also occur if, at the end of the relevant UK tax year (which runs 6 April to 5 April), the UK option holder has not spent at least 25 hours a week or 75% of the option holder's working time with the group. Any advantageous amendment to a fundamental term of an EMI option, such as including extending the exercise period (as mentioned above) or adding an additional exercise event, may result in the loss of EMI tax favoured status.
9. **Consider cancelling existing "underwater" options in exchange for replacement options with an exercise price reflecting current market value.** Going forward, companies with options that are likely to be considerably underwater for a prolonged period may need to consider cancelling those options and replacing them with options with an exercise price reflecting the current (lower) market value of their shares. While such option cancellations and re-grants should address any lost retention and incentive value of the options, before implementation companies should make sure they are complying with the applicable option plan rules and consider the operation of specific tax laws and securities laws, and, if the company is public, the views of shareholders and advisory firms.

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