Top Ten Design Considerations When Drafting a Modern Equity Incentive Plan

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With the 2020 proxy season approaching, many public companies are readying new or amended equity plans for shareholder approval. These plans are a ubiquitous feature of public companies' compensation programs. They allow companies to grant various types of equity and equity-based awards to their non-employee directors, executives and other key employees. Although equity plans are broadly similar, companies still must make important design decisions. This article identifies the top ten design considerations when drafting a modern equity plan document.

1. Types of Awards. An equity plan should allow for the grant of every type of equity and equity-based award. This provides a company with the greatest flexibility in developing its equity compensation programs and avoids the possible necessity of seeking shareholder approval to add a new award type to the plan, should business circumstances or strategy change. In addition, often equity plans (generally referred to as omnibus plans) allow for the payment of cash awards tied to achievement of service and/or performance conditions.

2. Size of Share Pool (or Share Authorization). An equity plan should include a share pool that is large enough to ideally fund between three to four years of projected equity grants. This avoids the need to seek shareholder approval on a more frequent basis. A critical issue to consider in sizing a share pool is whether the share pool's potential dilutive effect on existing shareholders falls within industry practice and complies with large institutional shareholders' proxy voting policies, as well as those of proxy advisory firms such as Institutional Shareholder Services (ISS). ISS may recommend AGAINST an equity plan proposal if the equity plan would dilute existing shareholders by more than 20% in the case of S&P 500 companies and 25% in the case of Russell 3000 companies.

3. Share Recycling. An equity plan should address whether, and to what extent, shares that are not issued under a settled equity award return to the share pool to fund future grants. When shares of a settled award return to the share pool, this is called "liberal share recycling."[1] Depending on grant practices, liberal share recycling could potentially increase the duration of a share pool up to 1 to 2 years. However, ISS policy disfavors liberal share recycling provisions. Nonetheless, a company should carefully weigh the potential benefits of liberal share counting when designing an equity plan against ISS's contrary view.

4. Plan Administrator's Discretionary Authority to Accelerate Vesting. An equity plan should identify the circumstances under which the plan administrator (typically the Compensation Committee) may accelerate the vesting of outstanding equity awards. ISS policy favors discretionary vesting under limited circumstances (i.e., upon an equity holder's death or disability). Nonetheless, we recommend that the plan administrator have the authority to accelerate vesting for any reason at any time. This flexibility is particularly important when a company is negotiating a severance package and wishes to include vesting acceleration as part of the package.

[1] Under the broadest use of liberal share recycling, the following shares would return to the share pool and become available for future grants: (i) shares tendered (or withheld) to cover a company's withholding obligations; (ii) shares tendered (or withheld) to cover an option's exercise price; (iii) shares not issued in connection with a stock settlement of a stock appreciation right; and (iv) shares purchased on the open market with the proceeds from the exercise of an option.

5. Effect of CIC on Outstanding Awards. An equity plan should address the effect a CIC has on outstanding non-vested equity awards in the form of a default provision, which may be overridden by the terms of an award agreement. Typically, default CIC provisions provide for (i) immediate vesting of non-vested awards upon a termination without "cause" or termination for "good reason" that occurs within a specified period (usually 24 months) following a CIC or (ii) immediate vesting of non-vested awards upon a successor entities failure to assume or replace such awards at the time of the CIC. ISS favors equity plans that explicitly set forth the treatment of non-vested equity awards in connection with a CIC (even if such treatment may be overridden in an award agreement).

6. Clawback Provision. Companies should consider whether to include clawback provisions in their equity plans. The prevalence of clawback provisions in equity plans has increased significantly since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which includes a yet to be implemented mandatory recoupment requirement. Typically, equity plans incorporate, by reference, a company's existing or future clawback policy and subject outstanding awards to such policy.

7. Annual Limit on Non-employee Director Awards. Companies should consider whether to impose annual limits on equity awards made to non-employee directors, which has increased in prevalence due to a series of Delaware court cases reviewing shareholder claims of excessive director pay. To avoid or lessen the probability of such litigation, many large public companies impose annual limits on non-employee director equity grants. Typically, annual limits are expressed in dollar terms (rather than number of shares) to eliminate the effect of share price volatility on the annual maximum award size. To avoid bumping up against the annual limit, companies tend to set the limit at least equal to three times the value of annual equity grants (and, if applicable, cash compensation) paid to a non-employee director.

8. Dividends and Dividend Equivalents. An equity plan should address the treatment of dividends and dividend equivalents that accrue and are paid under outstanding equity awards. Due to ISS policy and changes in the governance environment, equity plans that allow for the payment of dividends/dividend equivalents on non-vested equity awards has declined sharply in prevalence. Instead, equity plans typically allow for dividends/dividend equivalents to accrue during the vesting period, and be paid solely to the extent the underlying shares vest, which is consistent with ISS policy and generally considered a best practice.

9. Minimum Vesting Requirement (MVR). Companies should consider whether to include a MVR provision in their equity plans, which has been increasing in prevalence due to ISS policy. ISS favors the inclusion of a one-year MVR in equity plans and allows for a 5% carve out of shares that may be excluded from the one-year MVR standard. For the most part, a one-year MVR should not prove problematic for the great majority of companies since equity awards are invariably subject to multi-year vesting.

10. Tax Withholding. Companies should consider whether to allow for share withholding at the maximum allowable statutory rate. Due to a change in the accounting standards, an equity plan may now withhold shares with a fair market value up to, but not exceeding, the maximum statutory withholding rate. We recommend equity plans allow, but not require, shares be withheld up to the maximum statutory withholding rate.