Drafting a Modern Equity Incentive Plan

By: Donald Kalfen, Meridian Compensation Partners, LLC
Nathan Williams, Meridian Compensation Partners, LLC

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 in drafting a modern plan document. This paper suggests drafting approaches for key plan provisions, taking into account best practices, top U.S. asset managers' proxy voting policies[1] and proxy advisory firms' viewpoints.[2]

- 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. To this end, an equity plan should allow for the grant of non-qualified stock options, incentive stock options, stock appreciation rights (SARs), restricted stock, restricted stock units, performance shares and performance share units. 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.

- Key Terms and Conditions of Awards. An equity plan should grant the plan administrator broad authority to determine the key terms and conditions of each award type. However, a threshold consideration is whether (and to what extent) key terms and conditions should be included in the equity plan document or incorporated within applicable award agreements. Market practices vary widely on this point. At a minimum, we recommend that the provisions discussed in this paper be included in an equity plan.

  Typically, an equity plan empowers the plan administrator to determine the following award terms and conditions, which generally are incorporated in the applicable award agreement:

  — For All Award Types: The number of shares subject to the award, vesting conditions or restrictions, vesting schedule, effect of certain terminations of employment on vested status of award (e.g., death, disability, retirement, termination without cause) and form and timing of payout/settlement.

  — For Options/SARs: Term of option/SAR (typically, the equity plan specifies the maximum term), exercise price (typically, the equity plan specifies that the exercise price may not be less than the company's share price on the date of grant), methods to pay exercise price (these methods are often set forth in both an equity plan and option/SAR award agreement) and effect of certain terminations of employment on duration of post-termination exercise period.

[1] For this article, "top U.S. asset managers" refers to BlackRock, Fidelity, Vanguard, State Street and JP Morgan, which collectively had assets under management of approximately $19.7 trillion as of March 2019 (statistic as of 2019).
[2] For this article, we focus on the proxy voting policies of the two major proxy advisory firms in the United States, Institutional Shareholder Services (ISS) and Glass Lewis.

— For Performance-based Awards: Performance measures and performance period.

- 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. Rather, ISS favors equity plans that subject dividends/dividend equivalents to the same vesting provisions as the underlying equity award. That is, dividends/dividend equivalents may accrue during an award's vesting period, and be paid solely to the extent underlying shares vest.

  Among the top U.S. asset managers, JP Morgan is the sole money manager whose proxy voting policy addresses this matter. Specifically, in its evaluation of an equity plan proposal, JP Morgan disfavors the payout of dividends/dividend equivalents on unvested equity awards.

- 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 its potential dilutive effect on existing shareholders. For this purpose, potential dilution typically is calculated using the following formula: (i) the sum of (a) the number of newly authorized shares, (b) the number of shares remaining available for grant under the existing equity plan (if transferred to the new plan) and (c) the number of shares subject to outstanding awards (this would include awards granted under a prior plan) divided by (ii) the number of common shares outstanding. Ideally, an equity plan's potential dilution falls well within industry and peer group practices.

  Proxy advisory firms' policies on dilution is another important consideration. ISS may recommend AGAINST an equity plan proposal solely due to "excessive" dilution. Under ISS proxy voting policy, excessive dilution occurs when an 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. Both Glass Lewis and ISS take into account an equity plan's potential dilution when evaluating the plan's "shareholder value transfer" under their respective proprietary costing models.

  Institutional shareholders also focus on the dilutive impact of an equity plan. However, the top U.S. asset managers' proxy voting policies do not address acceptable dilution levels, except for Vanguard. When total potential dilution exceeds 20%, Vanguard is likely to vote against an equity plan proposal.

- Share Counting. An equity plan should specify the manner in which shares subject to outstanding awards are counted against the share pool at the time of issuance or grant. Typically, the number of shares subject to an outstanding award reduces the share pool by the number of shares that are granted. However, share counting becomes more complex with respect to performance awards that provide for a range of potential payouts (e.g., threshold, target and maximum) based on achieved performance. To avoid any ambiguity with respect to share counting for performance awards, we recommend that the plan specify that the share pool be reduced by the maximum number of shares that could be paid under a performance award and that any shares that are subsequently forfeited should return to the share pool at the same rate.

  Some equity plans include an unusual share counting provision referred to as a fungible share ratio. A fungible share ratio provides that shares are counted against the plan's share pool based on the type of award being granted. For example, with a fungible share ratio of 2 to 1: (i) each “full-value” share (e.g., restricted stock units or performance shares) granted would count as 2.0 shares against the plan’s share pool and (ii) each stock option granted would count as a single share against the plan’s share pool. Generally, companies have included fungible share ratios in their equity plan solely for the purpose of maximizing and optimizing the size of their share pools that would be allowable under ISS policy.

- 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.” 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.

  However, liberal share recycling does ***not*** include shares that return to the share pool with respect to a ***non-settled*** award or an award that is settled in cash. This would include shares that return to the share pool due to: (i) the termination, expiration, cancellation or forfeiture of an equity award without the issuance of shares; (ii) the settlement of an equity award in cash or in-kind property in lieu of shares; or (iii) prior to the issuance of shares, the exchange of an equity award for an award that will not be settled in shares. Equity plans almost universally provide for the return of shares under the foregoing circumstances.

  The inclusion of liberal share recycling provisions will negatively impact ISS’s evaluation of an equity plan proposal. For this reason, we have seen a decline in the prevalence of liberal share recycling provisions.

  However, the top U.S. asset managers appear unconcerned about liberal share recycling provisions, as none of their proxy voting guidelines address such provisions.

  The benefit of a liberal share recycling provision is significant. Depending on the nature of a company’s grant practices, liberal share recycling could materially lengthen the life of a share pool (e.g., 1 to 2 years). Therefore, a company should carefully weigh the potential benefits of liberal share recycling when designing an equity plan against ISS’s contrary view.

- Minimum Vesting Requirement (MVR). Companies should consider whether to include a MVR provision in their equity plans. Historically, equity plans rarely have included a MVR. As a general matter, the inclusion of a MVR would have been (and remains) superfluous since the vast majority of equity awards were and continue to be subject to multi-year vesting periods. Nonetheless, ISS favors the inclusion of a one-year MVR in equity plans. For this reason alone, we have seen a steady increase in the prevalence of equity plans that include a one-year MVR.

  For the most part, a one-year MVR should not prove problematic for the great majority of companies. To ease the application of the minimum vesting standard, ISS allows a company to exclude up to 5% of an equity plan’s share pool from the one-year MVR standard. Ideally, this carve-out of shares will be sufficient to fund any fully vested grants, such as deferred vested stock grants made to non-employee directors. If that is not the case, then a company would need to examine the appropriateness of adopting a one-year MVR (or alternatively subject non-employee director grants to a one-year service-based vesting requirement).

Among the top U.S. asset managers, Fidelity is the sole asset manager whose proxy voting policy addresses minimum vesting standards. Fidelity requires an equity plan to impose a one-year minimum vesting period for performance-based awards and a three-year minimum vesting period for time-based awards. Fidelity's MVR has not been widely adopted among large public companies.

- Plan Administrator's Discretionary Authority to Accelerate Vesting. An equity plan should set forth the circumstances under which the plan administrator (typically the Compensation Committee) may accelerate the vesting of outstanding equity awards. Generally, we recommend that an equity plan grant broad discretionary authority to the plan administrator to accelerate vesting for any reason at any time (irrespective of the type of termination event). This flexibility is particularly important when a company is negotiating a severance package and wishes to include vesting acceleration as part of the package.

  ISS disfavors such broad discretionary vesting authority and believes that such discretion should be limited to when a participant dies or incurs a disability. For this reason, we have seen a slight increase in the prevalence of equity plans placing limits on a plan administrator's vesting authority.

- Definition of Change-in-Control (CIC). An equity plan should include a change-in-control definition that is comprehensive and appropriate for a company's given circumstances. At a minimum, a CIC definition should solely cover consummated events, such as the acquisition of a specified percentage of outstanding shares rather than a tender for outstanding shares. This is consistent with good governance and is favorably viewed by ISS. Generally, CIC definitions cover the following types of events:

  — Acquisition by a third party of at least a threshold percentage of a company's outstanding voting securities of common stock. Companies should periodically review the appropriateness of this threshold percentage. Generally, the threshold percentage should reflect the ownership level necessary for a third party to exercise effective control over the company. Typically, the threshold percentage for small cap and, to a lesser extent, mid cap companies tends to be at 50%, and for large cap companies tends to be at either 20% or 30%.

  — Consummation of certain corporate transactions. The most comprehensive definitions of "corporate transactions" would typically cover: (i) a dissolution or liquidation of the company; (ii) a sale of all or substantially all of the assets of the company; (iii) a merger or consolidation of the company with or into any other corporation, regardless of whether the company is the surviving corporation; and (iv) a statutory share exchange involving capital stock of the company. However, if pre-CIC shareholders of the company own a specified percentage of the voting securities of the surviving entity, generally the corporate transaction would not constitute a CIC. The most dominant post-CIC ownership percentages range from at least 50% to 60%.

  — Significant change in Board composition. Generally, a significant change in Board composition is defined to occur when more than one-half of the Board has been replaced by new directors who have not been approved by a majority of the Board members ("Incumbent Directors"). For this purpose, Incumbent Directors means those directors who were members of the Board on the effective date of the equity plan (and those directors who were subsequently approved by a majority of the Incumbent Directors). Occasionally, an equity plan will require a supermajority change (e.g., 75% of the Board) in Board composition that was not approved by Incumbent Directors to be treated as a CIC event.

- 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. As a default provision, the CIC provision may be overridden by the terms of award agreements approved by the plan administrator. Typically, new or modified equity plans include "double-trigger vesting" or a variant of double-trigger vesting to address the effect of a CIC.

  Under a double-trigger vesting provision, each outstanding non-vested equity award vests and is settled if a plan participant incurs a qualifying termination of employment (e.g., termination without cause or voluntary termination for "good reason") within a specified period following a CIC. The most dominant variant of double-trigger vesting is vesting due to "failure to assume/replace." Under this form of double-trigger vesting, outstanding non-vested equity awards immediately vest upon a CIC if a successor entity fails to assume or replace the awards at the time of a CIC. Otherwise, the awards are subject to traditional double-trigger vesting requirements.

  Regardless of the CIC vesting method employed by an equity plan, the treatment of performance-based awards raises unique issues regarding vesting determination and payout methodology. Many equity plans address these issues by providing that performance awards vest based on one of the following methods: (i) deemed level of performance (typically target); (ii) actual performance through date of CIC or termination of employment, as applicable; or (iii) the greater of deemed level of performance and actual performance. In addition, equity plans either provide that vested awards are paid in full or paid pro rata based on the portion of the performance period that has elapsed through the date of the CIC or termination of employment, as applicable.

  Some practitioners have suggested that equity plans should be silent on the treatment of performance-based equity awards in connection with a CIC. Instead, the treatment should be determined as part of the negotiations of the CIC transaction. We believe this approach does not sufficiently protect executive and employee interests.

  ISS requires that an equity plan's CIC vesting provisions specify the treatment of all award types upon a CIC and that the equity plan does not provide for single-trigger vesting or allow the committee discretion to accelerate awards upon a CIC. Importantly, ISS does not consider the actual treatment of awards upon a CIC pursuant to an award agreement. An equity plan can meet the ISS standard through "default" double-trigger vesting provisions in the plan document that can be overridden in an award agreement.

  Among the top U.S. asset managers, BlackRock and State Street have identified single-trigger vesting of equity upon a CIC as a negative factor that may result in a vote against an equity plan proposal.

- Annual Limit on Non-employee Director Awards. Companies should consider whether to impose annual limits on awards made to non-employee directors. The imposition of such limits is in response to a series of Delaware court cases reviewing shareholder claims of excessive director pay. To avoid or lessen the probability of such litigation, we recommend that companies strongly consider including an annual limit on equity awards made to non-employee directors (some equity plans also extend the limit to cover cash awards or total non-employee director compensation). The best approach is to express the limit in dollar terms (rather than number of shares) to eliminate the effect of share price volatility on the annual maximum award size. In addition, to avoid bumping up against the annual limit, we recommend that the limit be at least equal to three times the value of annual equity grants (and, if applicable, cash compensation) paid to a non-employee director.

- Section 162(m) Related Provisions. Since the enactment of the Tax Cuts and Jobs Act of 2017 (the "TCJA"), companies have wrestled with the question as to whether, and to what extent, provisions related to Code Section 162(m) should be included in a new equity plan or retained in an amended and restated equity plan.

  For plans that are being amended and restated, companies often retain 162(m) related provisions out of an abundance of caution to ensure the deductibility of awards that satisfy the 162(m) transition rules. These provisions include individual annual award limits for employee participants, a list of objective performance measures that may be used as a condition for awards to vest and a prohibition on the committee's exercise of positive discretion in determining the amount payable with respect to a performance award. Beyond tax considerations, companies should note that ISS considers a plan amendment or restatement that eliminates shareholder-friendly 162(m) related provisions as a negative plan change.

  Since the enactment of TCJA, practice is mixed among companies including and excluding 162(m) related provisions in newly adopted equity plans.

- Tax Withholdings. Companies should consider whether to allow for share withholding at the maximum allowable statutory rate. Prior to 2018, the value of shares withheld could not exceed the minimum statutory withholding obligations to avoid adverse accounting consequences. Due to a change in the applicable accounting standards, an equity plan may permit a company to withhold shares with a value up to, but not exceeding, the maximum statutory withholding rate without implicating adverse accounting treatment. We recommend equity plans allow, but not require, shares be withheld up to the maximum statutory withholding rate.

- 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 ("Dodd-Frank"), which includes a yet to be implemented mandatory recoupment requirement.[3] Typically, equity plans incorporate, by reference, a company's existing or future clawback policy and subject outstanding awards to such policy. Less prevalent, an equity plan's clawback provision includes the substantive elements of the provision (rather than incorporating by reference an external policy).

- Prohibition on Repricing. Equity plans should include a comprehensive provision that prohibits all direct and indirect forms of repricing of stock options and SARs, including cash buyouts of underwater awards, without shareholder approval. However, some equity plans' prohibition on repricing fall short of this standard. To be consistent with market practice, good governance and ISS policy, an equity plan should provide that, absent shareholder approval, no stock option or SAR may be: (i) amended to reduce the stock option's or SAR's exercise price; (ii) cancelled in exchange for the grant of any new stock option or SAR with a lower exercise price; (iii) cancelled in exchange for cash, other property or the grant of any new award at a time when the exercise price of the stock option or SAR is greater

[3] The Dodd-Frank mandatory recoupment requirement does not become effective until the Securities and Exchange Commission adopts final rules on the recoupment requirement and the national securities exchanges incorporate the final rules in their exchange listing requirements.

than the current fair market value of a share of company common stock; or (iv) involved in any other transaction that would be considered a form of repricing under applicable accounting rules and/or the applicable exchange listing requirements.

- Mandatory Adjustments of Outstanding Awards to Reflect Equity Restructurings. An equity plan should provide for the mandatory adjustment of outstanding awards to reflect the effect of an equity restructuring (e.g., stock dividend, stock split, reverse stock split, split up, spin-off). Typically, the plan administrator determines the appropriate adjustment to prevent unintended dilution or enlargement of participants' rights under the plan and applicable award agreements due to the equity restructuring. To avoid adverse accounting consequences, an equity plan must provide that the plan administrator is obligated to make such adjustment; however, the plan need not specify the manner in which the plan administrator makes the adjustment.

- Discretionary Adjustments to Outstanding Awards. In addition to the mandatory adjustments described above, an equity plan should authorize the plan administrator to make ***discretionary*** adjustments of outstanding equity awards under certain prescribed circumstances. Although such discretionary adjustments may result in an accounting charge, they may be appropriate to properly reflect the effect of an equity restructuring or to prevent unintended dilution or enlargement of participants' rights due to the occurrence of certain prescribed events. In the case of an equity restructuring, the plan administrator should have the discretionary authority to (i) modify an equity award's performance goals and performance period, or (ii) substitute other property of equivalent value for the common shares available under the equity plan or the common shares covered by outstanding equity awards, including arranging for the assumption, or replacement with new awards, of awards held by participants. In addition, the plan administrator should be authorized to make discretionary adjustments in outstanding equity awards to prevent unintended dilution or enlargement of participants' rights in the cases of certain prescribed circumstances (e.g., unusual or non-recurring events affecting a company's financial statements, changes in applicable laws or regulations and mergers, acquisitions and other significant corporate transactions).

  An equity plan should not grant the plan administrator unfettered discretion to reduce the payout under an otherwise earned equity award to zero. This may result in an equity award's "grant date" for accounting purposes to be delayed until the plan administrator determines the amount to be paid under the award.

- Protection of Participant Rights. An equity plan should include an anti-cutback provision that prohibits the plan administrator, Board and company from reducing a participant's rights under the equity plan and any applicable outstanding equity award without the participant's consent. However, anti-cutback provisions are often subject to certain exceptions, which would allow for the potential impairment of a participant's rights. These exceptions include a company's right to unilaterally amend an outstanding award to comply with changes in applicable law or exchange listing requirements.

In drafting a new equity plan, a public company should consider good governance practices, emerging market practices and the external standards of the top U.S. asset managers and proxy advisory firms. However, a modern equity plan's design should also reflect a company's specific interests, industry practices, compensation philosophy and anticipated equity grant practices. Ultimately, shareholders are likely to overwhelmingly support a well-designed modern equity plan whose provisions fall within market practice and whose potential dilution levels, and recent share usage rates, are consistent within industry norms.