Post #51: Time to Check Your Equity Incentive Plan Share Reserve

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With depressed energy stocks, more shares are now needed to maintain recent levels of employee equity awards. This increase in share use also means that equity incentive plan reserves will drain at a faster rate, and may run out sooner than expected.

Companies often ask for more shares when there is roughly enough left in the plan to cover one more year of normal cycle equity awards, in order to have a buffer if there are unexpected events or the proposal for a new or amended plan fails. In reality, very few of these proposals fail. Over each of the past five years, about 1% or fewer of new or amended equity incentive plan proposals have failed across Russell 3000 companies (there were no failures among energy companies during this period). But given the uncertainty in the energy industry, growing impatience for more consolidation and dramatic decline in market value over the past year, shareholders may be less supportive of more dilution.

In preparation for fourth quarter compensation committee meetings, companies should consider modeling the duration of the existing share reserve to project how many grant cycles remain in the plan and stress test the modeling at various stock prices. If there are only enough shares to get through one or perhaps two more grant cycles at current or lower stock prices, management should alert its Board of the upcoming need for more shares and develop a timeline of activities between now and the annual meeting in which the new or amended equity plan will be proposed. If modeling indicates there are sufficient shares to get through the next two to three years, even if prices drop further, then companies should continue to monitor share use but likely there is no urgent need to seek more shares in 2020.

Some companies may find themselves in a position with too few shares to fully cover the next award cycle that occurs before the annual meeting or have concerns about burn rate levels that are unsustainable. In these cases, companies may consider measures to reduce share use, which could include:

- Incorporating cash, either as cash-denominated awards or cash-settled units;
- Examining the mix of LTI vehicles, particularly if a company grants stock options which consume more shares than full value shares;
- Reviewing the participation depth, as extensive participation may exceed competitive norms and/or certain employees may not value receiving shares in a down industry; or,
- Reducing award levels to remain within the available share reserve or desired burn rate, which may be done by granting the same number of shares as the prior year, committing to a specific burn rate, using an artificial floor stock price to calculate awards, or simply reducing grant values from the prior year.

When determining the methods of share preservation to employ, companies should consider the pros and cons of each, particularly related to the internal and external communications (i.e., to participants and shareholders), accounting treatment and impact on the financials. Often it takes time for management teams and compensation committees to gain comfort with any of these approaches, so it helps to start talking about them now if it looks like there may be a need to consider share preservation tactics come grant date.

Incorporating a share pool duration projection into the annual process as a regular fourth quarter compensation committee agenda item will help companies proactively understand equity usage issues and consider potential mitigation strategies.