June 6, 2011

A Roadmap for Revising an Equity Compensation Plan

Now that proxy season is over, it is advisable to consider whether your current equity compensation plan will need to be amended or replaced and submitted for shareholder approval at next year's annual meeting. If the equity compensation plan will expire or will require additional shares, award types or changes to the eligible participants, now is the appropriate time to develop a strategy for successful implementation of a new or revised plan.

A Good Beginning Makes a Good Ending: Create a Timeline and a Team

Work backward from the date of the next annual shareholders' meeting, and create a timeline to track key deliverables. Beginning the process as early as 11 months before the next shareholders' meeting is advisable.

A detailed timeline, however, is only as effective as the team that will be working on the deliverables. It is important to assemble a team with representatives from Human Resources, Investor Relations and Legal. Also consider whether a compensation consultant, a proxy solicitor or outside counsel should participate in the process. Note that modeling assumptions can change significantly as plan details develop, and therefore be mindful of the point in the process where it is appropriate to include the Compensation Committee in the discussion.

Ensure that the team understands all exchange listing and shareholder approval requirements from the outset. For example, if the equity compensation plan is intended to qualify for a performance-based exception to Internal Revenue Code Section 162(m), only performance goals included in the shareholder-approved compensation plan can be used. Understanding this requirement may lead to drafting a more exhaustive list of possible performance goals.

Starting the process early with the right team in place will increase the likelihood of success. Understanding the requirements leads to informed drafting, which results in an equity compensation plan that is easier to sell to shareholders.

The Lay of the Land: Determine Who Your Investors Are and What They Want

The equity compensation plan needs to balance the company's equity granting practices with the current trends and governance standards. Given that standards vary among shareholders, it is important to understand the company's shareholder base from the outset of the process. For example, what influence do ISS or other advisory firms have on your own institutional shareholder vote?

Many institutional investors consider ISS recommendations, which means the company should be prepared for ISS's burn rate and dilution calculations. The "burn rate" is based on the company's use of equity compensation. ISS compares a company's three-year average burn rate to an industry-specific cap. "Dilution" considers the overall cost of the plan based on the amount of shareholder equity transferred from the company to its employees and directors. The company may want to consider conducting its own modeling before incurring the cost of an ISS-generated analysis.

Regardless of who your investors are, certain practices and provisions should be avoided or amended to correspond with current governance trends. For example, the company should not be able to reprice options without shareholder approval. You should also consider the alignment between CEO compensation and company performance based on the analysis ISS conducts of companies with low "total shareholder returns." Also, companies should understand that ISS is likely to vote against an equity compensation plan with a "liberal change in control definition," which in effect provides for accelerated vesting of awards even though an actual change in control may not occur.

Again, the drafting team should consider what is important to the company's investors. Many of the company's large institutional shareholders may have their own requirements for equity plans (e.g., burn rate, dilution, plan terms), so it is important to understand and consider those policies. Where appropriate, the Investor Relations team may seek feedback from shareholders regarding any concerns about compensation practices, run rate, dilution or past stock plans. Understanding how the company has been viewed can help the team draft the type of plan shareholders are willing to accept.

The Devil Is in the Details: Decide on Structure and Terms

Determine how many shares the company needs and how long the share reserve should last. Unlike in the past, shares available under equity compensation plans generally are no longer expected to last five or more years. The trend is to submit equity plans to shareholders every two or three years for the approval of more shares. The ultimate decision about the number of shares requested in the plan will need to satisfy the company's needs while ensuring that dilution levels and run rates do not alienate shareholders, resulting in a negative vote.

The company also will need to determine what type of share reserve structure best suits its needs. Under an omnibus or traditional share reserve structure, a grant of one award unit would reduce the number of shares available under the plan by one share, regardless of whether the award that was granted was a "full-value" award (e.g., restricted stock) or an option or stock appreciation right (SAR). While this approach is flexible and easier to administer, ISS will value every share available under the plan as a full-value award which is likely to make the plan too costly to gain ISS support.

Under a bifurcated or share limit share reserve structure, a company would limit the maximum number of shares that could be issued as full-value awards. Depending on the number of full-value shares reserved, this approach may help a plan pass muster with ISS. However, a company that fails to accurately estimate the needed number of full-value awards could deplete its reserve too quickly and be forced to seek shareholder approval for additional full-value awards or readjust its internal approach to equity compensation.

Under a flexible or fungible share reserve, full-value awards are counted against the total number of shares reserved under the plan at a higher multiple than options or SARs (e.g., each share of restricted stock under the plan may reduce the number of shares available under the plan by 2 shares or, alternatively, each option may reduce that number of shares available under the plan by 0.5 shares). Though more challenging to initially develop and to administer over time, this structure provides the flexibility of having unlimited access to the full range of equity awards within the overall share limitation.

If a company uses a flexible/fungible share reserve structure, it should consider prohibiting certain types of share recycling in the plan to avoid ISS valuing every share in the plan as a full-value award for purposes of its cost analysis. Many practitioners believe a prohibition against share recycling, or liberal share counting, means that any shares used to satisfy tax withholding requirements or tendered in payment of an option's or an SAR's exercise price cannot be returned to the share reserve. However, this interpretation may be too strong of a prohibition against the return of shares to an equity plan, as shares tendered to satisfy tax withholdings for full-value awards like restricted stock should be returnable to a flexible/fungible share reserve because reissuance of the shares as a new full-value award will not increase the overall cost of the plan. Meanwhile, options or SARs withheld for taxes or tendered in payment of the exercise price should not be returnable to a flexible/fungible share reserve (as reissuance of those shares as a new full-value award would increase the cost of the plan).

The ultimate goal is to make the equity compensation plan as permissive and flexible as possible. Though the company will need to present the plan to shareholders as additional shares are needed, if the plan is thoughtfully crafted, the substantive terms should not need to be revised.

It's Only the Seventh-Inning Stretch: Finish the Plan and Move On to the Proxy

Shareholders need a reason to vote in favor of the company's equity compensation plan. The team may have carefully drafted the plan, but now shareholders need to understand its merits. Use the proxy to convey the company's message. High dilution or a high burn rate cannot always be corrected in the short term - regardless of how thoughtfully an equity compensation plan was designed. A clear (and plain English) message explaining the issues and what the company is doing to rectify them may help the company overcome these types of obstacles.

Even after the proxy is filed, there is still more work to be done. Just as the team was involved in the details of drafting the actual equity compensation plan, the group should participate in creating the talking points used by Investor Relations and senior management when discussing the plan. Consider whether supplemental solicitation materials are necessary.