Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 40 – Equity Incentive Plan Considerations for Public Companies

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Jessica Kriegsfeld: Welcome to the latest episode of Just Compensation. My name is Jessica Kriegsfeld and I'm an associate in Lowenstein Sandler's executive compensation employment and benefits practice group. I'm joined today by two partners in my practice group, Andy Graw, chair of our group, and Megan Monson.

Andy Graw: Hi, this is Andy Graw. Nice to be here.

Megan Monson: Hi, I am Megan Monson. Pleasure to be here as well. Thank you all for joining us.

Jessica Kriegsfeld: Today's conversation will focus on equity incentive plan considerations for public companies. Equity incentive plans permit a company to grant one or more types of equity to executives, directors, employees, and consultants. This episode will discuss equity incentive plan features that are unique to public companies.

As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if you are a public or soon to be public company with or adopting an equity incentive plan. What are typical equity incentive plan design considerations for public companies?

Andy Graw: So Jessica, there's a lot of considerations. We'll touch on some of them in this podcast. Our usual starting point is to establish a plan, and we typically establish what we would refer to as an omnibus equity plan, meaning that it's a plan that is designed to provide a wide range of awards and try to minimize as much as possible the need to amend the plan later on to provide for additional kinds of awards.

So our typical omnibus equity plan provides for a range of awards including stock options, stock appreciation rights, restricted stock, restricted stock units, performance, awards of various nature, even cash-based awards. And that way, by providing for such a wide range of awards, we usually have a plan that is broad enough to encompass anything a client would want to do in the future.

In preparing a plan, we are mindful of this situation. If the plan is being adopted because a prior plan is expiring or running low on shares, we'd be careful to take into account terms of the existing plan in crafting the new plan. Often it's best to follow the terms of a prior plan so that there aren't disparate terms that apply to old and new grants, and that allows for consistency and administration over the course of time and with respect to awards that are granted under both the old plan or plans and the new plan.

On the other hand, if a new plan is being established in connection with an IPO or a SPAC transaction, there is reason not to be beholden to a prior plan, and we have a little bit more of a free rein to determine what the terms of the new plan will be.

Megan Monson: Probably one of the most important elements for a company to decide on with respect to its equity plan is the number of shares reserved for issuance. This is more important in the context of a public company because this is something that would require shareholder approval if you want to increase the pool. And so when you're thinking about the number of shares to reserve, there's a number of factors to think about.

First being, consider the level of dilution that would be acceptable to shareholders and for how many years the pool is expected to last before you want to reach out to shareholders to ask for an increase. This is going to vary based on where the company is in its life cycle, if it's mature or not. And to the extent there's already outstanding equity awards. If it's a company that has not yet but is planning to go public, they'll typically reserve up to 15% of the post IPO shares for grants of equity awards under a plan.

Also, companies that are going public often include an evergreen provision, and this is a mechanism built into the plan that allows the pool of reserved shares to automatically increase each year by a fixed percentage of outstanding shares. Mature companies don't typically include these types of provisions, for a number of reasons, amongst others that they're disfavored by shareholder advocacy groups like institutional shareholder services and Glass Lewis. And so mature companies are more beholden to these shareholder advocacy groups when they're determining what provisions to include in their plans.

Another kind of related point to think about in terms of the topic of shares is whether to include a share recycling provision. This would allow you to reuse shares that were once subject to grants, but that have become forfeited or expire or held back in payment of an exercise price or to cover tax withholding now become available under the plan again.

Share recycling is another provision that's disfavored by shareholder advocacy groups. And so while they tend to be utilized by newly public companies, or companies that are not on the radar of such groups, they're often again not utilized by mature, public companies.

Another important feature to think about is who's going to administer the plan and allowing for broad authority in what the administrator can do. Typically, for a public company, plans are administered by the board or a compensation committee designated by the board, and we would allow for flexibility in the plan for either. We also would suggest including language in plans that allow for delegation of authority to make grants to the extent it's permitted by state law. So if you're looking to utilize such delegation to allow for an officer or a group of officers to make awards, we would always suggest consulting with counsel on how to delegate it, if it's permitted by applicable state law, and how to carry out that grant authority.

It is also common and best practice to include a specific limit on the size of awards that can be granted to non-employee directors each year. There may be some variable between how much they can receive the first year of joining versus annual grants, and this limits typically expresses a number of dollars or share limits.

Andy Graw: And on that point, Megan, I guess that's always a source of an interesting conversation with clients about what's the right number to put into that particular place. And generally, we look at it as we want to include a number that is reasonable, but not something that the company is really in fear of hitting. So given that the plan will be in place for a number of years, companies should use a number for that particular blank that will allow them to make awards to directors without fear of being limited by this particular provision.

While the plan itself is drafted very broadly to allow for all kinds of situations and to allow for, as we said before, all different kinds of awards, what's equally important, if not more so, is the particular award or grant agreements that are used under the plan. Award agreements will have the particular terms for not only the number of shares granted, the exercise price if an option, but also vesting terms, terms for exercise, how the option will be allowed to be paid when it's exercised and similar provisions. So we typically will have very broad-based provisions in a plant and very narrow, very carefully crafted provisions for option and other award agreements that will govern the terms and conditions of each particular person's award.

Megan Monson: And I'll just add on that, the point that Andy made about the award agreements, that's not something that's specific to public companies. This is something that would apply to any equity incentive plan.

Andy Graw: That's right. Although it's worth making the point also, Megan, that award agreements for public companies should also be filed as it exhibits with their 10K's so that shareholders can see them and see what the terms of those basic awards are. Doesn't mean that the company can't vary from what those award agreements say, but it's very typical to post with filings the forms of award agreements that a public company uses.

Megan Monson: Yeah, great point.

Andy Graw: And as well, those award agreements need to be approved by the compensation committee or the board of directors of the company. It's another plan instrument and should definitely have the stamp of approval of a governing body of the company.

Another provision that comes up often is whether to allow for repricing of options and exchanges of other awards. Like other provisions that Megan mentioned, repricing provisions or especially disfavored by shareholder advocacy groups like ISS and Glass Lewis, and thus are not usually included in equity plans of mature companies. However, repricing terms are often included in plans adopted when a company goes public. Listing requirements such as NYSE and NASDAQ listing requirements require shareholder approval of repricing authorization. However, when a company is going public, it has the advantage of being able to get the plan approved by the pre-IPO shareholders, and that approval is sufficient after they go public. So the listing requirements do not demand that the company go back and get shareholder approval again from the post-IPO shareholders.

And then another provision that should also be carefully drawn is a clawback policy or clawback provision within a plan document. This allows for the recoupment of awards that are performance-based in the event that there's a restatement of corporate financials. Companies of course should also have clawback policies. This is an add-on to that. You'd want to have a clawback provision within the plan in order to implement a broader clawback policy that the company would maintain.

Megan Monson: Another thing to consider is if the company has non-US employees and they want to be granting equity to employees in other jurisdictions. It's always important to consider local tax and securities laws. There are many other non-US jurisdictions that offer special tax-advantageous ways to grant options or other awards similar to the US granting incentive stock options. However, there are often documentary requirements and these types of awards would often have their own form of award agreement that would, to Andy's earlier point, be required to be publicly filed, approved by the board and or compensation committee. And so if a company is expecting to make grants in non-US jurisdictions care should really be taken upfront to ensure, one, the plan reflects all the necessary terms and conditions to qualify in those jurisdictions. And two, just making sure that they're not running afoul of any tax securities or employment rules.

Last key provision in the plan that I want to highlight is focusing on the change of control provisions being drafted very carefully. And while this is something that's not specific to public companies, again, it's really important that the definition of what constituted change of control is clear, but also that the consequences for how outstanding awards are treated on a change of control that are drafted in a way that provides the company with maximum flexibility.

One thing that often comes up is whether or not to provide for any sort of accelerated vesting on a change of control in the plan or defaulting to allow the administrator to have discretion with this and individual award agreements. And our preference is the latter because it provides the company some flexibility where they can provide accelerated vesting to some, but not all awards.

Jessica Kriegsfeld: Andy, you mentioned proxy advisory firms like ISS and Glass Lewis. What are proxy advisory firms and how can a public company appease them?

Andy Graw: Well, they are firms that review proxies for the benefit of shareholders generally, and they do play an outsized role in determining what the terms of equity plans should be, as well as the kinds and terms of awards themselves that companies will provide to key employees. So for example, if a company comes up with a proposal for shareholders to adopt an equity plan, shareholder advocacy groups will review it. And if they find that there are problems that they see with the plan that are not in line with what they view as acceptable pay practices, then they will advise shareholders to vote against the proposal. At that point, they will also notify the company as well. And the company then has an opportunity to either modify the plan or make a different proposal to shareholders or even come out with additional information explaining to shareholders why they think that shareholders should vote in favor of the proposal despite the negatives claimed by the advocacy firms.

So there are a number of provisions, as we've talked about throughout this podcast, that advocacy firms find objectionable. We've touched on a couple of those already, evergreen provisions that Megan mentioned, recycling provisions, which is also in a way paying for shares with other shares, repricing provisions. Advocacy groups also will often require particular provisions for awards themselves. So for example, that will typically require that awards have a period of at least one full year for most awards granted under the plan. They will disfavor discretionary accelerated vesting provisions, unless it's in connection with a change of control.

And while it's not uncommon for plans to have a ten-year term, often advocacy firms will require that the term of the plan be less, perhaps five years. They want companies to go back to shareholders for re-approval of a plan rather than keep it open for 10 years. And they will also look at the number of shares that are being asked for approval by shareholders. They will look at what the run rate is for the plan and determine whether or not the number of shares being sought for approval is reasonable.

Megan Monson: And I think related to that, Andy, that's why I think a number of the types of provisions that you've mentioned, evergreen recycling, paying for shares of shares, all of those things kind of tie into items that you'd want to have to go back to the shareholders to approve and be able to evaluate. And so we think that's one of the reasons that proxy advisory services disfavor plans with those features.

Andy Graw: Exactly. And another thing that proxy firms typically require is that what they refer to as full value awards, that would be awards that do not have an exercise price. So we're talking about RSUs, restricted stock units, and restricted stock that they count against a plan share reserve pool at a greater ratio than shares that are subject to stock options. So instead of, for example, a restricted stock award of a thousand shares counting against the share pool for a thousand shares, they would want the number of shares counted against the share pool in that case to be, say, three times the number of shares. So in my example, 3000 shares would count against the share pool even though the actual award was only for 1000 shares.

Jessica Kriegsfeld: Megan, how does the public company approve an equity incentive plan?

Megan Monson: So the first step is approval by the board of directors. However, listing requirements mandate that an equity plan is also approved by the stockholders. So once the board of directors approves, they'll be placed before stockholders for their approval. Something else to keep in mind, it's a related point, is companies should be mindful of the number of shares remaining in their plan and the plan's expiration date so they can plan to submit a new plan to their shareholders at a regular shareholders meeting.

There's also a couple of other steps that they need to be aware, both after the plan is approved and on an ongoing basis. So once the plan is approved, they're required to file a form S-8 to register the securities, and if they have an evergreen provision in their plan, they're also required to file annual S-8S to register the Evergreen shares. And so if you are a company that has a plan with an evergreen feature, I recommend setting a reminder in your calendar for January each year so that you don't forget to file those forms.

There are also annual disclosures in the proxy statement about outstanding equity awards and plan shares that are granted, and for certain executives, there are also form for filing requirements for equity grants, besting in exercising securities. If you are making a plan amendment, it's important to consult with counsel to determine whether that type of amendment requires additional shareholder approval, either under listing rules or applicable law, because there are some differences under the various listing rules that may result in an amendment that requires shareholder approval, such as a plan that does not allow for repricing, but they now want to add in that feature.

Jessica Kriegsfeld: Andy, what are employment inducement awards?

Andy Graw: Inducement awards are, as the name would imply, awards designed to induce new employees to come aboard. The benefit of or the difference, I should say, of an inducement award versus a regular award is that an inducement award can be granted outside of a plan that has been approved by shareholders. So listing rules allow for inducement awards that are outside of the regular equity plan that's been approved by shareholders. Benefit of that is that the inducement awards do not hit the regular equity plan share pool, so those shares approved by shareholders up for use under the equity plan remain available, and you don't have to eat into them by making inducement awards.

Inducement awards come with various requirements, so it's really important for companies to consult with counsel about what all of the requirements for making inducement awards are. Just to give a flavor of it, in general, there is a press release requirement associated with providing inducement awards. Some companies will adopt a separate inducement award plan, and with a pool of shares approved by the board of directors of the company and utilize that plan in order to make awards. And that plan would also be filed with an S-8 registration so that the shares granted under the inducement plan gets a benefit of registration.

Jessica Kriegsfeld: A public company or a company that is considering going public has a number of considerations when designing an equity incentive plan and implementing the plan in practice. Public companies should be mindful of the filing requirements associated with adopting an equity incentive plan and the ongoing filing and disclosure requirements after the plan is adopted. We encourage companies to seek advice from counsel with any questions about drafting an equity plan, administering such a plan, and complying with the public filing requirements. Thank you for joining us on this episode of Just Compensation. We'll see you next time.

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