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Share Reserve and Other Limits in Public Company Equity Plans

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A Practice Note addressing the key considerations when establishing the share reserve and other limits in a public company equity plan, including business and shareholder considerations, the requirements of Sections 162(m) and 422 of the Internal Revenue Code, proxy advisory firm scoring and review, the voting guidelines of institutional investors, and potential shareholder litigation related to director awards. This resource has been updated to reflect the Tax Cuts and Jobs Act which significantly reforms the U.S. Tax Code.

Equity compensation is a valuable tool for recruiting and retaining employees, officers, directors, and other advisors and keeping them invested in the growth and success of the company. Most public companies establish an omnibus equity incentive plan and present it to shareholders for approval to comply with:

- Stock exchange listing requirements.
- The requirements for incentive stock options (ISOs) under Code Section 422 (26 U.S.C. § 422).

For information on when shareholder approval of an equity plan is required, see Practice Note, Shareholder Approval of an Equity Plan by a Public Company (6-554-3367).

Drafting an equity compensation plan that meets the company's business needs, complies with legal requirements, and passes muster with shareholders and other stakeholders can be challenging. An important issue that arises when establishing an equity compensation plan is the appropriate size of the share reserve. While the company must ensure that it has a sufficient number of shares in reserve to make anticipated grants, it also must consider the reaction and response of shareholders, institutional investors, and proxy advisory firms, all of which scrutinize equity plan proposals, and the size of the share reserve in particular, to ensure that they are in shareholders' best interests. In addition to the aggregate share reserve, certain other limits have traditionally been included in equity plans to ensure advantageous tax treatment and guard against shareholder litigation related to director compensation.

TAX REFORM

This Practice Note has been updated to reflect the enactment of the Tax Cuts and Jobs Act (the "TCJA") which has a significant impact on the executive compensation planning landscape. There are two primary changes to Section 162(m) of the Internal Revenue Code (26 U.S.C. § 162(m)) ("Section 162(m)") that substantially impact how public companies design their executive compensation arrangements:

- The elimination of the performance-based compensation exception to the $1 million deduction limitation for compensation paid to covered employees.
- The expansion of the individuals who are covered employees.

Prior to the enactment of the TCJA, most public companies designed their executive compensation arrangements, including their equity plans, to comply with the performance-based compensation exception to the greatest extent possible to ensure maximum deductibility of equity compensation paid to covered employees.

At this time it is difficult to predict what changes companies will make to their equity plans in response to the TCJA and in particular the elimination of the performance-based compensation exception. The tax deduction for performance pay has long been one reason for tying pay to performance and including individual award limits in equity plans, but they are not the only reasons. These provisions, particularly those related to tying pay to performance, are preferred by shareholders and proxy advisory firms and institutional investors will likely continue to look for them in new plans.

Nonetheless some companies may consider:

- Eliminating or diminishing certain onerous provisions that were required under Section 162(m).
- Increasing the compensation committee's discretion.

The TCJA is generally effective for taxable years beginning after December 31, 2017. However, for purposes of the performance-based compensation exception, the TCJA includes a transition rule for written binding contracts that were in effect before November 2, 2017. Arrangements that qualify under the transition rule can continue to operate in the same manner, and compensation will continue to qualify as performance-based exception, provided that the requirements of the exception are met and the arrangement is not subsequently materially modified (written binding contracts that qualify for transition relief, "Grandfathered Plans"). Until further guidance is issued, the application of the transition rule in certain situations is not entirely clear. For more information on the TCJA, see Legal Update, Tax Reform is Enacted With Significant Implications for Executive Compensation and Employee Benefits (W-012-3270).

BUSINESS AND SHAREHOLDER CONSIDERATIONS

A first step when establishing the share reserve is determining how long the share reserve should last and therefore how often the company intends to go back to shareholders to have the share reserve increased. To determine this, the company must first determine its annual burn rate. Companies typically have historical data points to determine this number. However, if a company sets its share reserve based on an annual burn rate, it will need to increase the reserve each year. This constitutes a material amendment to the plan and requires shareholder approval for each increase. For Grandfathered Plans, there is a risk that any increase to the share reserve will be considered a material modification that could jeopardize the ability to rely on the TCJA's transition rule. The Treasury Department has not yet addressed this issue.

If a company plans to seek shareholder approval for an increase in the share reserve less frequently than annually, which is typical, the calculation gets more complicated, as the company must factor in:

- Expected changes to its employee population.
- Expectations regarding its future grant practices, including:
  - the need to offer retention incentives or make-whole awards;
  - different types of equity awards that may be granted in the future; and
  - changes in market practice.

A company's independent compensation consultant can often help with this analysis. For information on the role of compensation consultants in designing compensation programs, see Practice Note, Designing, Determining, and Disclosing Executive Compensation: A Consulting Perspective (6-507-0928).

Companies typically favor a share reserve that is expected to last five or more years because:

- This size provides the company the most flexibility for future grants.
- It is less administratively burdensome, as increases to the share reserve are material amendments requiring shareholder approval under stock exchange listing requirements.
- With respect to Grandfathered Plans, if the plan includes a menu of performance criteria on which performance goals may be based, the material terms of the plan may need to be approved by shareholders every five years in any case to comply with Section 162(m)'s performance-based compensation exception (see Section 162(m) Individual Limits). Until further guidance is issued, the application of the transition rule with respect to shareholder approval is not entirely clear. For example, it can be argued that shareholder approval is only required if the transition rule also exempts new award agreements that are executed after November 2, 2017 pursuant to a grandfathered equity plan (for example, if equity awards are guaranteed to an executive pursuant to a grandfathered equity plan under an executed employment agreement, although the award agreement has not yet been entered into).

However, while maximum flexibility may be attractive to the company, the company's shareholders generally have a different point of view. Shareholders are typically concerned about "overhang" which is the sum of the number of shares authorized under the plan and any shares subject to previously granted awards as a percentage of the company's total outstanding stock. Shareholders object to plans that create large overhang because it dilutes the value of their holdings. Shareholders therefore generally favor a share reserve that is expected to last for no more than two to three years.

EVERGREEN PROVISIONS

In the past, public company equity plans routinely provided for automatic increases in the share reserve at the beginning of each fiscal year. These provisions, called "evergreen provisions" typically provide for automatic increases each year by an amount equal to a stated percentage of the total shares outstanding on the last day of the immediately preceding fiscal year (for example, 3%) or a lesser number as may be determined by the board of directors.

Many pre-IPO companies still include evergreen provisions in their plans. However, because evergreen provisions are generally disfavored by proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis & Co., Inc. (Glass Lewis) (see Proxy Advisory Firms), and certain institutional investors (see Institutional Investors), companies generally remove them before they need to obtain shareholder approval of the plan or an amendment to the plan after the IPO. Evergreen provisions also do not satisfy the requirement under Section 422 (26 U.S.C. § 422) that a plan authorizing the grant of ISOs specify the maximum aggregate number of shares that may be issued through ISOs (see Incentive Stock Options Limit). For more information on executive compensation considerations when contemplating an IPO, see Practice Note, Executive Compensation Considerations in IPOs (W-000-6360).

SPECIAL LIMIT ON FULL VALUE AWARDS

Some plans provide that each share granted under "full value" awards (for example, restricted stock and restricted stock units (RSUs)) will be counted as two or more shares against the plan's share reserve while "appreciation" awards (such as stock options and stock appreciation rights (SARs)) will count as one share. Because proxy advisors place a higher cost on full value awards, this provision can make it easier to secure the approval of ISS and other shareholder advisory groups for increases in the share reserve under the plan (see Proxy Advisory Firms).

SHARE RECYCLING

The plan should address whether shares underlying awards that expire or are forfeited, cancelled, or settled in cash will again be available for issuance under the plan. Best practice, and the approach preferred by proxy advisory firms is not to reissue shares that were previously used to obtain value under the plan (for example, to pay the exercise price).

The plan should also address what will happen to the share reserve if the plan administrator authorizes the assumption of awards granted under another plan in connection with a merger, consolidation, reorganization, or acquisition of property or stock. For example, the plan should specify whether the assumption will reduce the maximum number of shares available for issuance under the plan or be subject to or counted against a participant's annual award limit (see Section 162(m) Individual Limits).

SECTIONS 162(M) AND 422 LIMITS

SECTION 162(M) INDIVIDUAL LIMITS

Prior to the enactment of the TCJA, most public company equity plans were adopted with individual award limits to comply with Section 162(m)'s performance-based compensation exception. A brief discussion of the performance-based compensation remains in this Note because the exception is still relevant for:

- Grandfathered Plans.
- Plans of companies with fiscal years that extend beyond December 31, 2017.

A company with a Grandfathered Plan that wishes to maintain the plan's grandfathered status should be cautious about making any changes to the plan that could be considered a material modification. Additional guidance is needed from the Treasury Department to understand whether increasing the share reserve of a Grandfathered Plan could run afoul of the TCJA's transition rule.

In general, to qualify as performance-based compensation, the payment of the compensation must meet the following requirements:

- **Performance goals.** The compensation must be contingent on the attainment of one or more pre-established objective performance goals.
- **Compensation committee.** The performance goals must be set by the company's compensation committee.
- **Shareholder approval.** Before payment, shareholders in a separate vote must approve the compensation terms, including the applicable performance goals and the maximum amount payable to any covered employee.
- **Compensation committee certification.** Before payment, the compensation committee must certify in writing that the performance goals and any other material terms were in fact satisfied.

While a full discussion of the requirements of the performance-based compensation exception is beyond the scope of this Note, for purposes of the provisions of an equity plan related to the share reserve, it is important to be aware of certain individual limits that must be set out in the plan if the company intends to rely on the performance-based compensation exception.

STOCK OPTIONS AND STOCK APPRECIATION RIGHTS

Many of the most difficult issues that arise under Section 162(m)'s performance-based compensation exception relate to the performance goal requirement, as companies must follow stringent procedures when setting or modifying goals and certifying their achievement. Significantly, stock options and SARs will be deemed to satisfy the performance goal requirement of the exception if, among other requirements, they are granted under a shareholder-approved plan that specifies "the maximum number of shares that may be granted to an employee during a specified period." (26 U.S.C. § 162(m).)

Some public companies previously took the position that an aggregate limit on the number of shares that could be granted under a plan satisfied this requirement. The rationale was that no employee could receive a combination of stock options and SARs that exceeded the plan's maximum share limit. But in final regulations issued by the Internal Revenue Service (IRS) on March 30, 2015 (80 F.R. 16970), the IRS clarified that if a plan document sets out the maximum number of shares that may be granted under a plan but does not include the maximum number of stock options or SARs that may be granted to an individual employee during a specified period, the stock options and SARs will not be qualified performance-based compensation.

The final regulations also clarify that the plan may satisfy the per-employee limit requirement by specifying the aggregate maximum number of shares with respect to which stock options, SARs, restricted stock, RSUs, or other equity-based awards may be granted to any individual during a specified period. It appears permissible under the final regulations for the per-person limit to be the same as the maximum number of shares available under the plan.

If these requirements are met, then neither the grant nor vesting of stock options or SARs must be contingent on attaining a qualifying performance goal to qualify for the exception. The grants must nonetheless satisfy the exception's other requirements. For information on all of the requirements of Section 162(m)'s performance-based compensation exception, see Practice Note, Section 162(m): Limit on Compensation: Qualified Performance-Based Compensation (7-501-5106) and Section 162(m) Performance-Based Compensation Exception Checklist (6-518-5217).

OTHER TYPES OF AWARDS

Grants of other types of awards, such as restricted stock, RSUs, or dividend equivalents, cannot qualify as performance-based compensation unless the grant or vesting of the award is contingent on attaining a qualifying performance goal. In the case of cash awards, which are often authorized under equity plans, payment of the award must be contingent on the attainment of performance goals. If the company wants the flexibility to comply with the performance-based compensation exception for these types of awards, then annual per-employee limits for each award type must also be included in the plan.

Most equity plans satisfy the individual limit requirement by setting out the maximum award that an employee may be granted in any one-year period. While a one-year period is not required under the rules, the limit must be tied to a specified period of time. Tying the limit to a performance period if the length of the performance period is not fixed does not satisfy Section 162(m).

INCENTIVE STOCK OPTIONS LIMIT

ISOs are stock options that provide employees with favorable tax treatment if certain requirements are met. If an equity plan provides for the grant of ISOs, Section 422 requires that the plan include a maximum aggregate limit on the number of shares that can be issued under the plan in connection with the grant of ISOs (26 U.S.C. § 422). Unlike the Section 162(m) limits that apply per specified period (typically one year), the ISO limit is an aggregate plan limit.

The limit may be expressed as a limit specific to ISOs or as a limit on all awards under the plan, including ISOs (T.D. 9144, 2004-36 I.R.B. 413). A plan that provides that the number of shares that may be issued as ISOs under the plan may not exceed a stated percentage of the shares available at the time of each offering or grant does not satisfy this requirement. However, the maximum aggregate number of shares that may be issued may be stated in terms of a percentage of the authorized, issued, or outstanding shares on the date the plan was adopted (Treas. Reg. § 1.422-2(b)(3)). It is not uncommon for the ISO limit to be the same as the total share reserve. Nonetheless, best practice is to set out a separate ISO limit in the plan. For more information on ISOs, see Practice Note, Stock Options Overview: Incentive Stock Options (W-008-0930) and Incentive Stock Options Checklist (7-518-3717).

DIRECTOR AWARD LIMITS

Over the past several years, equity grants made to non-employee directors under equity plans have been the subject of shareholder scrutiny and litigation. In general, shareholders have challenged the fairness of equity awards granted to non-employee directors under shareholder-approved plans.

The procedural posture for these cases has turned on whether the equity plan contains meaningful limits on director compensation. Because the courts view directors as interested parties when it comes to their own compensation, in cases where the plan does not contain a separate meaningful director limit, the courts have applied the entire fairness standard of review rather than the more deferential business judgment standard of review. (See, for example, *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. June 29, 2012) and *Calma v. Templeton*, 2015 WL 1951930 (Del Ch. Apr. 30, 2015).) Where there are meaningful limits on director compensation in the plan that have been approved or ratified by shareholders, the courts have applied the business judgement standard of review.

In April 2017 the Delaware Court of Chancery addressed the nature of a meaningful limit in an equity plan. See *In Re Investors Bancorp Shareholder Litigation*, 2017 WL 1277672 (Del. Ch. April 5, 2017). In this case, the board members submitted an equity plan for shareholder approval which included a limit on the maximum number of shares that could be issued to non-employee directors equal to 30% of all stock options and restricted stock shares available for awards. After the plan was approved, the directors awarded themselves substantial equity awards that both:

- Dramatically increased their overall compensation.
- Were much larger than grants made to directors at peer companies.

While acknowledging the very large awards, because the plan contained meaningful limits on director awards that were approved by shareholders, the Chancery Court applied the business judgment standard of review rather than the entire fairness standard of review.

In December 2017 the Delaware Supreme Court reversed the Chancery Court's decision and, in so doing, overturned several years of Chancery Court precedent. The Supreme Court held that the plantiffs had raised a pleading-stage reasonable inference that the directors had breached their fiduciary duties by making unfair and excessive discretionary awards to themselves. The shareholder ratification defense was therefore not available, making entire fairness the appropriate standard of review.

The decision in *Investors Bancorp* is significant for boards adopting equity plans. Many boards, following prior precedent, include a specific annual director limit in their equity plans for the sake of limiting director discretion and insulating the board from attack. Some companies include multiple limits, applying a higher limit to directors who hold specific board positions, such as chairman of the board or chairman of a committee. These limits may be expressed as a number of shares or a dollar value limit if the company share price is vulnerable to significant volatility. The limits are designed to be high enough to provide flexibility to the company, but not so high as to not be meaningful.

Some companies establish an aggregate compensation limit, that is, a limit that applies to both equity and cash compensation, as in the event of a challenge, the court may evaluate the fairness of the company's director compensation program in its entirety.

While it is still prudent to include meaningful limits on director compensation in equity plans, companies should be aware that discretionary grant decisions will continue to be subject to entire fairness review if the awards are so out of line with the company's prior practice or its peer companies' compensation as to raise a reasonable inference of breach of fiduciary duty. These inferences can also be raised if the board's process is materially weak or the disclosure to shareholders is materially inaccurate or misleading. For more information on the *Investors Bancorp* case, see Legal Update, In re Investors Bancorp: Delaware Supreme Court Overturns Chancery Court Precedent on Director Compensation Review (W-012-6109).

PROXY ADVISORY FIRMS

Proxy advisors play a large role in the proxy voting process. The voting recommendations of these firms, particularly ISS and Glass Lewis, often influence the outcome of shareholder votes. Each of these firms has an evaluation and scoring process for public company equity plans. These evaluation methodologies focus on, among other things, the plan's share reserve.

ISS

In November 2014, ISS adopted a formal scoring system for evaluating equity plan proposals, called the Equity Plan Scorecard (EPSC). Under the EPSC approach, ISS considers a range of positive and negative factors in three categories, with each category assigned a different weight. These categories are:

- Plan cost.
- Plan features.
- Grant practices.

These three categories are balanced and counterbalanced by each other, whereby a low score in one category is offset by a higher score in another. However, certain factors, such as allowing a repricing of underwater stock options without shareholder approval, are considered "egregious" and will result in an "Against" vote regardless of how the plan scores under the other factors. ISS may consider any plan feature egregious if it has a significant negative impact on shareholder interests.

Under the grant practices category, ISS considers, among other things, the estimated duration of the proposed share reserve, which is based on the sum of the new shares requested plus any existing reserve, divided by the company's three-year average adjusted burn rate activity. For this analysis, ISS takes into account the equity plan's share counting formula if non-full value or appreciation awards are to be counted as covering fewer shares than the shares underlying the award.

ISS awards:

- Full points for a share reserve that is expected to last less than five years.
- Half points for a share reserve that is expected to last five to six years.
- No points if the share reserve is expected to last more than six years.

For more information on the EPSC, see ISS: FAQs Regarding US Equity Compensation Plans. For information on ISS's 2018 proxy voting guidelines, see Legal Update, ISS Releases 2018 Proxy Voting Guideline Updates (W-011-5695).

GLASS LEWIS

Glass Lewis's voting policies and procedures are significantly less transparent than those of ISS. Glass Lewis does not publish its specific evaluation criteria but does disclose its proxy voting guidelines each year. Glass Lewis evaluates equity plans based on both quantitative and qualitative factors.

The quantitative analysis assesses the plan's cost and the rate at which the company grants awards as compared to:

- Absolute limits to determine whether the proposed plan is absolutely excessive.
- A peer group to determine whether the proposed plan is more than one standard deviation away from the average plan for the peer group on several criteria, including:
  - shareholder dilution; and
  - projected annual cost relative to the company's financial performance.

When measuring the company's historical grant practices to see if the proposed plan is excessive, Glass Lewis measures dilution over the previous three years. Not all equity awards are treated the same for this purpose. Full value awards, such as restricted stock and restricted stock units, are counted as covering each share underlying the award, whereas non-full value or appreciation awards, such as stock options and stock appreciation rights, are counted as covering less than each share underlying the award because the value delivered under these awards is less than the full value of a share.

The qualitative analysis generally focuses on overarching principles rather than specific categories or formulas. With respect to the share reserve, these include that:

- The company should only seek additional shares when needed and not if the company already has a sufficient number of shares available under its existing equity plans.
- Requested share amounts should be small enough that companies seek shareholder approval every three years (or more frequently).

As part of its qualitative analysis, Glass Lewis considers whether or not the plan contains an evergreen provision.

For more information on Glass Lewis's proxy voting guidelines, see Legal Update, Glass Lewis Releases 2018 Proxy Guidelines (W-011-7432).

INSTITUTIONAL INVESTORS

When seeking shareholder approval for a new equity plan or additional shares for an existing plan, companies must also familiarize themselves with the proxy voting guidelines of their top institutional investors. While some institutional investors follow the vote recommendations of a proxy advisory firm, others consider this information but do not strictly follow the firm's vote recommendations. In fact, on certain hot button issues, such as burn rate, dilution, and evergreen provisions, the proxy voting guidelines of certain institutional investors are more stringent than those of ISS and Glass Lewis.

FIDELITY

Fidelity's voting guidelines provide that Fidelity will generally vote against an equity plan or a proposal to authorize additional shares under the plan if both:

- The company's average three-year burn rate is greater than:
  - 1.5% for large cap companies;
  - 2.5% for small cap companies; or
  - 3.5% for micro-cap companies.
- There were no company- or plan-specific circumstances that lead Fidelity to conclude that the burn rate is acceptable.

Fidelity will also vote against any equity plan that includes an evergreen provision.

VANGUARD

Vanguard's voting guidelines set out factors it considers when evaluating equity plan proposals. Factors against approval include:

- Total potential dilution (including all stock-based plans) exceeds 15% of shares outstanding.
- The existence of an evergreen provision.

BLACKROCK

Blackrock's voting guidelines indicate that Blackrock evaluates equity compensation plans based on:

- A company's executive pay and performance relative to peers.
- Whether the plan plays a significant role in a pay for performance disconnect.

Like Fidelity and Vanguard, Blackrock generally opposes plans that contain evergreen provisions allowing for the unlimited increase of shares reserved without requiring further shareholder approval after a reasonable time period.

SHAREHOLDER ENGAGEMENT

To reduce the risk of any unwelcome surprises when shareholders vote on the plan, a company desiring to adopt a new plan or increase the share reserve of an existing plan should consider engaging its largest shareholders before the applicable shareholder meeting to understand what they are willing to approve. Even with an effective shareholder outreach program, a sizeable or increased share reserve may potentially be voted down. If a company is concerned about this possibility, it should:

- Include meaningful disclosure in its proxy statement setting out the rationale for the desired shares.
- Discuss its concerns with its proxy solicitor.