Five Tips for a Successful Employee Stock Plan Proposal

With share prices at unprecedented lows this year, many companies are faced with the need to add shares to their employee stock plans to meet their projected award levels. However, securing shareholder approval of a new employee stock plan or a share reserve increase has never been more challenging. The major proxy advisory firms, such as RiskMetrics Group ("RMG"), as well as numerous institutional investors, apply stringent guidelines that limit the size of a share request when formulating their voting recommendations or decisions. Typically, they will not support proposals that exceed specified projected dilution levels and will closely scrutinize a company's historical burn rate. Further, these groups will also recommend against proposals where the underlying stock plan contains objectionable features (such as a provision permitting an option exchange program without shareholder approval).

Before submitting a new employee stock plan (or a share reserve increase to an existing plan) to your shareholders for approval, you should analyze your company's current equity compensation profile to formulate a strategy for obtaining a favorable vote. At a minimum, this involves answering the following questions:

- When do your currently active employee stock plans expire?
- How many shares remain available for grant (including any shares that will become available in the future through an "evergreen" provision and estimated cancellations or expirations of currently outstanding awards)?
- How long is your currently available share reserve projected to last?
- What is your current burn rate and overhang and how do they compare to RMG's and your major shareholders' guidelines?

Once you've answered these questions, you'll be ready to assess the likely reception to your proposal. To increase the prospects of a successful vote, you should consider the following five tips. While no one item will be dispositive, developing a deliberate strategy based on these consideration should help ensure that your proposed new plan or share reserve increase is favorably received by your shareholders.

No. 1: Consider improving your equity profile

Where you have a significant number of "underwater" stock options outstanding, it may be appropriate to conduct an option exchange program in conjunction with, or as an alternative to, a new plan or a share reserve increase to reduce your "overhang" profile. We've identified over 125 option exchange programs since 2005, including 60 exchanges in the past nine months. However, properly evaluating the viability and potential impact of an option exchange program requires consideration of a number of complex issues. We've addressed these issues in a previous Thoughtful Pay Alert (see "Implementing an Option Exchange Program" (December 2008)). If appropriate, a successful option exchange program will not only improve your equity profile (by reducing overhang), but may also increase the number of shares available for future grant (by returning shares from exchanged awards to your share reserves).

Another way to reduce "overhang" and increase the number of shares available for future grant is to conduct a cash buyout (at a nominal value) of the "underwater" stock options held by your executives. Under this approach, your executives agree to tender their "underwater" options for cancellation so that the underlying shares may be returned to your share reserves. As with an option exchange, there are several complex issues that must be resolved before you conduct a cash buyout. However, in some situations, a cash buyout may be implemented without shareholder approval and, depending on the size of your executives' "underwater" option holdings, may be a viable way to recapture a significant number of shares.

No. 2: Determine when to seek shareholder approval

Once you've decided to adopt a new employee stock plan or seek an increase to the share reserve of an existing plan, you need to decide when to solicit shareholder approval. Typically, companies will seek shareholder approval of a new or amended plan at their regularly scheduled annual meeting of shareholders.

In some cases, however, circumstances may necessitate seeking approval at a special meeting of shareholders. For example, a projected share reserve shortfall or the expiration of a currently active employee stock plan could occur prior to the date of your next regularly-scheduled annual meeting, thereby disrupting your annual equity award cycle.

While you may be able to bridge the gap until the regularly-scheduled annual meeting with an enhanced cash program and/or use of a non-shareholder-approved employee stock plan for new hires, you may ultimately decide that a special meeting is preferable to risking employee dissatisfaction if you are unable to make your normal annual grants. Another advantage of scheduling a special meeting to seek shareholder approval is that it may allow additional time to implement an option exchange program to improve your equity profile.

No. 3: Consider how the major proxy advisory firms are likely to evaluate your proposal

For many companies, faithful compliance with the proxy voting policies or guidelines of RMG and the other major proxy advisory firms will be critical to obtaining a favorable vote recommendation for your new employee stock plan or share reserve increase. You should expect that these proxy advisory firms will closely scrutinize your overall dilution level, historical burn rate, and past equity grant practices as they evaluate your proposal.

To obtain a favorable vote recommendation, you may need to structure your proposal to fit within these firms' policies and guidelines. For example, you may be required to commit to a burn rate cap if your company's historical burn rate is above RMG's applicable guidelines. RMG will also look to see whether there is a "disconnect" between your CEO's pay and your company's past performance. Consequently, you may need to evaluate the pay-for-performance relationship of your CEO and company to determine or achieve compliance with this policy. To minimize problems (or surprises), we often recommend that a company purchase RMG's software to model an acceptable share reserve level for its proposal.

You may also need to review the terms and conditions of your proposed new employee stock plan (or your existing plan in the case of a share reserve increase) to remove or revise any potentially objectionable provisions, such as:

- A liberal share "recycling" feature (allowing previously-granted and reacquired shares to be granted again);
- The ability to grant "discount" stock options;
- Any "single-trigger" equity award acceleration rights;
- The absence of any minimum vesting requirements for full-value awards; and

- Features that permit stock option repricings or exchanges without shareholder approval.

No. 4: Consider how your major shareholders are likely to respond to your proposal

In today's contentious environment, a critical step in developing a successful employee stock plan or share reserve increase proposal is to understand your shareholder base and, consequently, the flexibility that you may have in designing the proposal. Specifically, you should familiarize yourself with the relevant proxy voting policies and guidelines of the major proxy advisory firms and your largest shareholders, as well as the influence that RMG and other advisory firms have with these shareholders. Depending on what you learn, you may find it helpful to retain a proxy solicitor to assist with your shareholder outreach efforts to maximize the probability of a favorable outcome.

No. 5: Develop a sustainable equity award "budget"

Once your new employee stock plan or share reserve increase has been approved, you should develop a "budget" and strategy for distributing your new shares that serves your equity compensation objectives and can be maintained over a reasonable period (typically, at least two to three years). In our experience, it is not unusual for mature public companies to seek shareholder approval to replenish their employee stock plan share reserves every one to three years. ■

Need assistance?

Compensia has had significant experience in advising companies on seeking shareholder approval for new employee stock plans or increases to the share reserve of existing plans. In addition to being one of the most frequently-engaged compensation advisers to technology and life science companies, we have helped numerous companies prepare such proposals, as well as develop formal work-plans and timelines for submitting them for shareholder action.

About the Author

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