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Pre-IPO Companies have Unique Obligations for Share Authorization Plans

Newly public companies receive special treatment by regulators, proxy advisors and investors in their share authorization plans. Pre-IPO companies should evaluate their options.

Selecting an initial share pool size and design that will likely meet a company's short-and long-term equity usage needs prior to an IPO event is one of the most difficult compensation modeling exercises a company can undertake. This is largely due to the numerous unknown variables that exist at this stage of a company's life. However, companies can position themselves competitively by taking into account the factors identified below in this article.

Initial Share Pool

IRC Section 162(m) Relief Period

- Under a special transition period, a newly public company is not subject to the deduction limit under IRC Section 162(m) if any compensation was paid (i) pursuant to a plan that was disclosed in the prospectus for the public offering and in place at the time of the IPO, and (ii) prior to the shareholder meeting that follows the end of the third calendar year following the calendar year in which the IPO occurs. For example, if the IPO occurs in 2016, the deduction limit will not apply to compensation paid prior to the shareholders' meeting that occurs in 2020 (at which time the transition period ends and shareholder approval is required to preserve the deductibility prospectively for a period of five years). For spin-off transactions, the approval timeframe may be accelerated to the next annual shareholders' meeting following the spin transaction.
- Typically, ISS and Glass Lewis issue favorable vote recommendations on any IRC Section 162(m) proposals. However, pursuant to ISS policies, the entire equity plan document will be reviewed for "problematic" features and the share pool will also likely be evaluated under the planned cost-related calculations. As such, most companies model out the dilution and estimated proxy advisory firm "cost" calculations to determine how the share authorization will fare when evaluated by proxy advisory firms for the first time.
- Outside of the IRC Section 162(m) relief period, some companies ultimately end up seeking shareholder approval of a new or amended share authorization prior to the typical IRC Section 162(m) approval timeframe— either to make the plan more flexible or to seek additional shares.

Duration

- Most companies allocate enough shares in the original pool to allow for at least two or three regular annual long-term equity grants plus any initial founder grants. Given the increased scrutiny from proxy advisory firms and from institutional investors, it is often difficult to seek a share pool in excess of this duration and still receive broad investor support.

    - Note: post-IPO ownership structure will significantly impact a company's ability to be more aggressive on the share pool size and design.
  - Share usage modeling is often required to determine the number of shares necessary for this time period.
- **Size**
  - Most companies typically allocate 3% to 6% of the total common shares outstanding for the share pool, depending on the likely post-IPO dilution levels and whether any founder's grants were made upon the IPO event.

Founder's Grants

- Depending on the need for founder's grants and whether current dilution levels are considered "excessive" or "acceptable" as compared to size and industry levels, some companies allocate an additional 3% to 6% of the common shares outstanding for special one-time equity grants to key executives.

Acceptable Dilution Levels

- Large cap companies typically target an overall "simple" dilution level of 15% or below, including existing overhang, plus founder's or retention grants, and the overall share pool.
  - Small or medium cap companies have some flexibility to exceed this level of dilution; however, industry norms should also strongly be considered.
- Additionally, companies also typically benchmark projected dilution levels against median industry and index-related standards. Since the corporate governance environment has dramatically changed over the past few years, it is important to look at the most recent comparative dilution data available.
- "Simple" dilution is the sum of the total amount of shares available for grant and outstanding under options and other equity awards (vested and unvested) expressed as a percentage of total common shares outstanding.

Shareholder Value Transfer (SVT) Cap

- As previously noted, ISS will evaluate companies' dilution levels using its SVT cost-related analysis the first time the equity plan is brought before shareholders for approval, even for IRC Section 162(m) purposes.
- As such, most companies model out possible share authorization sizes and designs that are likely to meet ISS' applicable scoring standards.
- The inclusion of an evergreen provision in an equity plan document will almost always result in a company failing to score high enough under the "plan cost" pillar of ISS' new Equity Plan Scorecard approach. For purposes of an SVT analysis, ISS will multiply the perceived highest annual cost over the expected share pool duration, which is ten years for most plans.

Key Share Authorization Plan Document Provisions

Plan document provisions are evaluated by proxy advisory firms whenever they are presented to shareholders as a proxy ballot item. ISS also evaluates plan document provisions as part of the compensation section of its QuickScore governance ratings. While not exhaustive, the following provisions typically receive the highest degree of scrutiny from investors and proxy advisory firms.

Share Authorization Design

- A majority of companies adopt the most flexible share authorization language initially (i.e., an all full-value award share authorization).
  - All shares are counted on a 1-for-1 basis (as opposed to using a fungible share ratio where full-value awards are counted against the share pool at a higher ratio, such as a 3-to-1 ratio).
- Despite the overall impact on dilution and on ISS' SVT analysis, some companies ultimately move forward with an evergreen share authorization design, which allows companies to avoid seeking shareholder approval until the plan duration expires. While favorable in some regards (i.e., a company can avoid going back to shareholders with a new or amended share request for the duration of the plan), such provisions tend to result in poor overall share pool management in the long term. Specifically, companies with automatic share replenishments often end up with what investors deem to be "excessive" dilution and run rate levels. This is not ultimately problematic until a company becomes more widely held and needs outside investor support to obtain majority approval for a new or amended share request. As such, the decision to use an evergreen feature should be evaluated on a company–by-company basis, and not based upon a general rule of thumb.

Liberal Share Counting

- Most companies also incorporate liberal share counting language at the time of the IPO event (i.e., shares withheld for taxes or tendered to pay the exercise price roll back into the pool).
- Inclusion of liberal share counting language results in less favorable scoring for one lightly-weighted question in the QuickScore analysis and for one of the inputs in the "plan features" pillar of ISS' Equity Plan Scorecard approach.

Hard-Coded Minimum Vesting Provisions

- Prior to ISS' new Equity Plan Scorecard approach, the prevalence of these provisions was largely a carryover from Fidelity's old proxy voting requirements. While Fidelity no longer looks at these provisions in their voting methodologies, now that ISS looks favorably upon their inclusion, we are again seeing an increase in the provisions in new or amended equity plan documents.
- Despite being preferred by investors and proxy advisory firms, most companies do not include these provisions in their original IPO plan document because they decrease a company's flexibility in designing different types of awards.
- If a company does include minimum vesting provisions, it is important to also add a carve-out provision (e.g., 5% the pool can be granted without any such minimum vesting requirements and still currently receive credit from ISS and other external observers).
- The inclusion of hard-coded minimum vesting provisions for stock options and full-value awards also results in favorable scoring for two lightly weighted questions in the compensation section of ISS's QuickScore analysis (one question addresses stock options and another, full-value awards).

Liberal Change-in-Control (CIC) Definition Provisions

- Most investors and ISS only want to see equity acceleration upon a true CIC event (i.e., acquisition triggers of 20% or greater, upon consummation of a deal/merger vs. shareholder approval). Absent such approved CIC triggers, investors and ISS will flag provisions as "liberal," especially when combined with single-trigger equity acceleration.
- Violating ISS' Liberal CIC Definition Policy can result in a negative vote recommendation for any proxy ballot items related to an equity plan (i.e., share authorization requests or even IRC Section 162(m) proposals).

Repricing Provisions

- Both the NYSE and Nasdaq have listing exchange rules preventing issuers from “repricing” underwater stock options or stock appreciation rights (SARs) without shareholder approval. ISS has its own definition of repricing events, which is more comprehensive than those of the listing exchanges and includes cash buyouts of underwater stock options. As such, careful attention should be given to any repricing provisions included in an equity plan document.
- Additionally, failure to prohibit cash buyouts of underwater stock options or SARs, or to include SARs in the repricing definition when they are grantable as an incentive vehicle, can result in a negative ISS vote recommendation for equity plan related proxy ballot items and negative scoring in the compensation section of ISS’ QuickScore analysis.

Single- vs. Double-Trigger Equity Acceleration

- Beginning in the 2015 proxy season, it is now a majority market practice to include a provision calling for either the acceleration of outstanding equity only if not assumed/converted or replaced or containing pure double-trigger requirements. Plans that contain hard-coded automatic single-trigger equity acceleration (i.e., calling for acceleration upon a CIC event) will be scored negatively by ISS as one of the inputs in the “plan features” pillar of the Equity Plan Scorecard, and will certainly be noted by Glass Lewis and other external observers as not in line with their preferred practices. In fact, many institutional investors list the inclusion of single-trigger equity acceleration provisions in plan documents or award agreements as one of many factors used to determine how to vote on proxy ballot items.
- Additionally, single-trigger equity acceleration for the Chief Executive Officer’s outstanding equity awards is scored negatively in the compensation section of ISS’s QuickScore analysis.
- However, outside of the ISS and Glass Lewis policies, single-trigger equity acceleration provisions are common for entire industries and/or for those that may be considered a potential takeover target. As such, the decision of whether to include such a provision should be made on a case-by-case basis.

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