Published on *The National Law Review* https://natlawreview.com

Current Compensation Issues (Part 1 of 7): Considerations with Respect to Upcoming Equity Grants

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Today's economic environment has resulted in substantial loss of value to many shareholders and executives of publicly traded companies (i.e., the latter losing substantial value in their stock holdings, and too, losing prospective realizable pay as a result of unattainable performance goals within their outstanding performance-based awards). In most situations, the shareholders and the executives are aligned in such loss. But a problem is that substantial loss at the executive level could increase undesired poaching and turnover of key executives at a time when executives should be focused on navigating the company through a reopening of the United States economy. To overcome this problem, compensation committees of publicly traded companies ("***Compensation Committees***") will likely need to consider adjustments to the company's compensation framework in order to continue to incent and retain executives. To that end, this Part 1 (of a 7-part series) provides thoughts that the Compensation Committee should consider with respect to upcoming equity grants.

Due to Low Stock Prices, Reconsider the Formula Associated with Grants of Equity that are Initially Denominated in Dollars

As background, it is common for Compensation Committees to first denominate equity awards as a dollar amount and then convert that dollar amount into shares (i.e., the company could have a practice or a contractual requirement that annual grants of equity awards be equal to 45 percent of the executive's base salary). Such is commonly referred to as a "value-based grant." Typically, a value-based grant requires a conversion from dollars to equity pursuant to a formula, with: (i) full-value awards being converted on a dollar-for-dollar basis with respect to the stock price on the date of grant; and (ii) stock options and performance-based awards being converted pursuant to a Black-Scholes formula or Monte Carlo simulation. For example:

Assume the company's stock price is trading at $1.00 per share, the executive has a base salary of $100, and a contractual requirement exists that the executive will receive an annual equity grant equal to 45% of his or her base salary. In this example, an award of restricted stock with a time-based vesting schedule would result with the executive receiving an award covering 45 shares. In comparison, a Monte Carlo simulation would be used to convert dollars into an RSU containing a relative total shareholder return ("***TSR***") performance schedule, and the result is that the executive would receive an award covering more than 45 shares. And a Black-Scholes formula would be used to convert dollars into a stock option containing a time-based vesting schedule, resulting with the executive receiving a stock option covering more than 45 shares.

Due to depressed stock prices in today's economy, there is a concern that value-based equity grant practices will result with executives receiving too many shares, which could cause a windfall to such executives if the company's stock price were to increase as the economy rebounds. This type of assertion can be defended if the company has an annual grant policy (either a formal document or an operational practice of consistently effectuating equity grants at the same time each year). To combat such assertions, the alternatives of the Compensation Committee include (listed in no particular order):

- *Approach No. 1 – Delay Grants*. The Compensation Committee could delay the timing of the equity grants until a later time when more facts regarding the company's stock price become known. Before adopting this position, care should be taken to address any contractual requirements that equity grants occur within certain time periods (e.g., an executive has a provision in his or her employment agreement that requires equity grants to occur within the 10-day period immediately following the annual shareholder meeting).

- *Approach No. 2 – Convert Using a Trailing Average Stock Price*. Assuming no contractual requirement to the contrary, and in order to apply a smoothing effect to the recent drop in stock price, the Compensation Committee could effectuate the conversion of dollars into shares using a trailing average stock price (e.g., six months, twelve months). And use of a trailing average stock price would also be permitted with respect to converting dollars into stock options (though once the number of shares are known pursuant to the conversion, the exercise price cannot be based on more than a 30-day average).

- *Approach No. 3 – Convert Using Some Other Formula*. Assuming no contractual requirement to the contrary, any formula could be used by the Compensation Committee. The simple goal is to ensure that the chosen formula can be communicated to, and deemed fair by, the executives.

Save Money, Time and Expense by Avoiding Future Underwater Stock Options

Underwater outstanding stock options (i.e., the exercise price is greater than the fair market value of the underlying stock) are a problem because they strain the share reserve of the equity incentive plan and provide minimal to no retention value to the optionee. And any repricing of underwater stock options to lower the exercise price, for example, to today's fair market value of the underlying stock is expensive (due to compliance with the SEC's tender offer rules), creates negative shareholder disclosure (i.e., why should optionees get a reset when the shareholders did not receive a reset) and requires shareholder approval in most instances.

- *Possible Solution to Consider*. To avoid future underwater stock options, any new grants could have an automatic forfeiture provision within the vesting schedule of the option award agreement. In concept, the automatic forfeiture provision would be structured such that, if the stock price ever falls by $X.00 or an amount based on a certain formula, then the stock option (both vested and unvested) is automatically forfeited. A benefit of this program applies to companies with equity incentive plans that contain liberal share counting because the forfeited shares revert to, and act to replenish, the equity plan's share reserve. And with the right communication strategy, employees should not be bothered with such a forfeiture because, from their perspective, the underwater stock options had no retention value.

- *Risk to Vet*. The following risk should be vetted to ensure there is no "make whole" grant following forfeiture of the underwater stock option. As background, NYSE and NASDAQ listing rules provide that a cancellation followed by a required regrant is deemed a repricing subject to vetting under the shareholder approval requirements. Therefore, if an option was forfeited due to a stock-price forfeiture provision and a make-whole grant was provided to the executive, then such make-whole grant could be deemed to be a repricing of the forfeited stock option. A simple operational solution to this issue is to avoid any new grants outside of the company's annual grant policy (whether such policy be formal or informal).

Delay Performance-Based Equity Grants for Three to Six Months Until Performance Targets Can Be Assessed Accurately

If the company's equity incentive plan does not require performance-based equity awards to be granted within the first 90 days or so of the fiscal year, then the Compensation Committee could delay effectuating grants for three to six months until performance targets can be determined with more accuracy. However, companies will want to review their equity incentive plan because some equity incentive plans require the Compensation Committee to effectuate performance-based equity grants within the first 90 days of the company's fiscal year (as background, prior to the elimination of the performance-based exception to the $1 million deduction limit, some equity incentive plans had hard-wired Section 162(m) operational requirements within the equity plan document (thus making them mandatory requirements) and never amended the equity plan document to delete such provisions).

Use Relative Metrics Instead of Absolute Metrics

In order to lessen the negative impact of stock price return and instead focus the executives on competing against the company's peer group, consider using relative metrics instead of absolute metrics (e.g., use a relative TSR formula instead of an absolute TSR formula).

Bolster Provisions to Allow for Positive Discretion

Consider adding or bolstering provisions that would provide the Compensation Committee with significant discretion to adjust performance metrics while the award is outstanding. The idea is to give the Compensation Committee more discretion than it would otherwise have had in prior years.

National Law Review, Volume X, Number 118