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2015 Compensation Season Litigation Preview: It's All About Share Counting

The most recent spate of shareholder suits allege that companies have issued stock based compensation awards that are unauthorized under the terms of a shareholder-approved plan. These suits range from claims that companies omit or inaccurately disclose plan terms when seeking shareholder approval of the plans, to claims that companies tally votes improperly when determining whether a plan has been approved, to claims that companies blow through individual or aggregate share limits set forth in stock plans. To help mitigate the risk of such suits this compensation season, we recommend that public companies consider the following.

Voting Standards. Companies should make sure that they understand the voting standards applicable to shareholder approval of their stock plans and that they have obtained the requisite number of votes for the plans prior to issuing any awards. While this may seem obvious, plaintiffs were recently able to enjoin a shareholder meeting for Cheniere Energy in part because the plaintiffs claimed that a prior increase in the number of shares available for grant was not properly approved by a majority of shareholders. The basis for the claim was that the by-laws of Cheniere did not expressly permit the exclusion of abstentions in calculating if a majority of votes had been attained. Instead, the by-laws effectively counted such votes as "no" votes against the plan and, in the case of Cheniere, if the abstentions had been counted as "no" votes, then the plan would not have been approved by shareholders. Companies are advised to make sure they understand the voting standards set forth in their by-laws and that, if the by-laws do not set forth the desired standard, to amend the by-laws to reflect the desired voting standard.

Share Limits. Section 162(m) of the Internal Revenue Code (*i.e.*, $1 million annual deduction limit for named executive officers (other than the CFO) for non-performance based compensation) requires companies to set forth in their shareholder approved plans the maximum number of shares (including separate limits for the number of options and SARs) that may be earned under the plan for covered employees for a particular period of time. Companies also include plan limits for the aggregate number of shares that may be granted under the plan and the number of awards that may be granted as incentive stock options. Companies should make sure that all limits set under the plans are high enough to take into account regular grants as well as special grants, such as retention grants, grants to new hires and grants to promoted employees. In setting these limits, companies should take into account the potential for significant drops in stock price over the anticipated life of the plan. While some companies historically established limits that applied for multiple (*e.g.*, three year) cycles, the limitation on shares should be for a one-year period as one-year limits are often easier to administer. In counting shares issued, depending on the construction of share counting provisions, companies should take into account the maximum number of performance shares that may be earned under an award – not merely the target number of shares. Finally, companies should be sure to set limits that take into account share counting rules such as so-called "fungible share pools" under which issuing a stock option to purchase a share may be counted as one share against the limit but issuing restricted stock or RSUs may count as three or four shares.

Disclosure. To avoid claims that shareholder-approved plans were improperly approved due to inadequate disclosure, companies seeking approval for stock plans should disclose how the company determined the number of shares that they are requesting shareholders to approve, the dilutive impact of the additional shares, including historical and expected share usage rates, the number of shares available under existing plans and the reasons for adopting a new plan as opposed to amending an existing plan, in each case, if the company determines that such information would be material to a shareholder's vote. To avoid future claims regarding these disclosures, appropriate assumptions such as assumed stock price and number of participants should be included.

Disinterested Directors. To reduce the likely success of claims by shareholders that directors should not be afforded business judgment rule protection with respect to decisions they make regarding stock plans by virtue of being interested, companies should include in stock plans in which non-employee directors are eligible to participate a separate limitation for grants to directors under the plan or provide for awards to directors under a separate plan document. The more specific a plan's limitations the more likely that a board's compensation decision will be labeled disinterested and qualify for protection under the business judgment rule.

Compliance Person. To avoid having these issues fall through the cracks between human resources, finance and legal functions, companies should designate a single individual or group of individuals as the person(s) responsible for ensuring that plans are properly voted upon and approved under the applicable standards and that the company is adhering to all share limits set forth in a plan.

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