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The Impact of COVID-19 on Executive Compensation

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Editor's note: Debra B. Hoffman, and Ryan J. Liebl are partners and Katherine H. Dean is counsel at Mayer Brown LLP. This post is based on their Mayer Brown memorandum. Related research from the Program on Corporate Governance includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

The majority of the benefit and compensation provisions of the Coronavirus Aid Relief and Economic Security Act (the "CARES Act") provide critical relief to companies and rank and file employees in light of the COVID-19 pandemic (see our previous blog posts on the impact of the CARES Act on health and welfare plans, on the impact on retirement plans, and on executive compensation, employment, leave and payroll tax issues). In addition to supporting their general employee population, most company boards of directors (or applicable board committees) are also grappling with the unique issues relating to compensation and benefits of their executive employees at an uncertain time when such employees are critical to the company's ability to weather the storm. The following is a summary of key executive compensation issues that boards and executives may want to consider during these trying times.

Pay Reductions

Some companies have considered (or implemented) pay reductions either on a case-by-case basis or across the executive ranks, and some executives have voluntarily chosen to take pay reductions. Consideration should be given to the effect of such reductions on various executive arrangements.

- Certain arrangements, such as employment agreements and severance arrangements, may have "good reason" provisions that are triggered by reductions in base pay or incentive compensation without an executive's consent. This could provide an executive with the ability to terminate employment and receive a generous severance package. The exact language of the definition should be considered to ensure that any reduction is implemented appropriately (e.g., consider whether across-the-board pay cuts, or obtaining written consent, could avoid triggering "good reason"). Although it may be possible to "cure" the good reason event by increasing the applicable compensation that was reduced, companies may not be in a position to do so and an increase for one individual affect the analysis for and claims by other executives.
- A salary reduction could have a negative effect on an executive's golden parachute tax calculations in the event of a future change in control. Golden parachute taxes are based on an average of five years of compensation such that a salary reduction will reduce the average and increase the amounts that may be subject to golden parachute taxes.

- Any current reduction of compensation in exchange for some other right to future compensation for an executive must be reviewed carefully for tax compliance to ensure that the arrangement does not violate applicable tax rules, most notably Section 409A of the Internal Revenue Code (relating to deferred compensation). For example, if a company agrees with an executive mid-year in 2020 to reduce his or her compensation for the remainder of 2020 in exchange for payment of the foregone salary plus interest in a future tax year, it would likely trigger adverse tax consequences for the executive under Section 409A. There are ways to structure such an arrangement that would not give rise to adverse tax consequences but, as is often the case, the arrangement must be carefully structured so as to ensure compliance with the tax rules.

Performance Awards

Many companies are either in the process of, or have just completed the process of, setting performance targets and metrics for the current performance period (both with respect to long-term and short-term arrangements, such as performance equity and annual bonuses). In addition, performance relating to awards granted in prior years can be seriously adversely affected by the current crisis.

- If the process for current awards is not yet complete, companies should consider waiting to finalize the targets and metrics until market and other business conditions stabilize so that the targets and metrics that are set will more likely reflect the proper incentives and goals for executives in the new “post-pandemic” business climate.
- Since the performance-based compensation exception to Section 162(m) of the Internal Revenue Code was repealed as part of the Tax Cuts and Jobs Act in 2017, companies no longer need to establish performance goals within ninety (90) days of the beginning of a performance period. In addition, except in limited situations with respect to Section 162(m) grandfathered awards, a company is not restricted by the provisions of Section 162(m), which previously precluded the exercise of positive discretion with respect to the determination of the amount of compensation payable based on satisfaction of the performance goals.
- Even though the performance goals do not need to be set within the first 90 days of a performance period, it may be appropriate for many reasons to establish the goals when the performance outcome is substantially uncertain. In particular, in the case of public companies, the goals would need to be set while the outcome is substantially uncertain in order for the compensation to be treated as performance or incentive compensation for public disclosure purposes.
- Given the recent changes to Section 162(m) noted above, most companies now reserve the right to change targets and metrics with respect to performance-based compensation during and after the end of the performance period. Thus, if the targets have been set, companies may want to exercise discretion to make changes to that targets that were previously set. It may, however, be appropriate to wait to make such changes until the market and business stabilizes so as to avoid multiple adjustments.
- If performance goals are adjusted for any previous grant of cash or equity, companies also need to consider whether any such adjustments will trigger changes to the accounting treatment.

Relative vs. Absolute Performance Goals

To the extent that companies are using one or more performance goals based solely on the performance of the company itself, companies may want to consider whether relative performance goals should now be considered. It can be hard for companies to set an appropriate performance goal based on the performance of the company itself in such an uncertain economic environment, but goals that measure performance compared to a group of peer companies may have more appeal by rewarding management for outperforming peers. Even if relative goals are used, however, companies should consider whether a base company performance is required before awards would vest or be earned even if the company outperforms its peers.

Equity Plan Share Reserves

With the downturn in the stock market, we anticipate most companies will increase their burn rate (that is, the rate at which they use the shares reserved for issuance under their equity plans) merely by providing compensation at the same levels that they did before the crisis began. Accordingly, many companies will likely need to request shareholder approval for more shares for equity plans in the next year as a result of such higher burn rates.

- Granting equity awards when a company's stock price is suppressed (requiring more shares to provide the same value) could result in a faster depletion of the share reserve under the company's equity plan, thus reducing the ability to make future grants.
- Additionally, as discussed below, stock options may again become more popular as a long-term retention tool in the downturn because of the long-term return potential. However, grants of stock options require more shares than full value awards (such as restricted stock or restricted stock units, whether performance or time vested) with the same fair value on the date of grant.
- Even broad-based equity plans like employee stock purchase plans will likely burn through shares faster because the applicable limits of such plans are based on dollar amounts and more shares will be able to be purchased using the same dollar amounts.

Appeal of Stock Options

Stock options have decreased in popularity as a type of equity award for executives of public companies over the last decade. As shareholders have increasingly demanded pay-for-performance, the proxy advisory firms (such as ISS and Glass Lewis) have taken the position that time-vested stock options were not considered performance awards. As such, more and more companies have abandoned stock option grants in favor of performance-based full value awards.

- With the downturn, stock options may appeal to companies as a long-term retention tool for executives. Because the value of options is realized as the market price of the stock increases as compared to the grant price, options granted during a downturn have tremendous upside potential for executives who stick with the company long-term when the stock price increases. Options are often exercisable for a period of ten years, which would give an executive a long period of time to create value for himself or herself and for shareholders. Because the proxy advisory firms will only recognize the award as performance-based if performance goals are added, a company granting stock options

may want to add performance goals for vesting of such options, which would achieve both goals of providing good retention value and incentivizing performance.
- Many executives who received stock option grants during the last downturn in 2008 and 2009 were able to receive significant upside over the years as the stock price improved for them and for shareholders.

Repricing of Previously Granted Stock Options or Stock Appreciation Rights (SARs)

Some companies that previously granted stock options or SARs over the last several years while the market was high are considering repricing those awards in light of market performance. Underwater options and SARs can create significant problems for public companies as such awards can be outstanding for up to ten years as noted above and count against the plan reserve during such time (reducing the number of shares that can be used for current awards). Additionally, underwater options and SARs lose retention value if an executive no longer feels that they will regain value.

- Almost all equity plans of public companies have prohibitions on repricing of stock options or SARs without stockholder approval. Repricing includes either lowering the exercise or base price, substituting the award with a new award with a lower exercise or base price, and/or cancelling the award and replacing with another type of award or cash.
- In addition, repricing of an underwater stock option or SAR (whether of a public company or a private company) would most likely be treated as a modification of the award and would have serious negative implications under Section 409A of the Code if not done correctly to preserve the exemption from Section 409A of the Internal Revenue Code.
- Whenever adjustments are made to stock options or SARs, the accounting treatment of the adjustment needs to be reviewed by the company's accountants.

Changing Deferral Elections; Accelerated Payment of Nonqualified Deferred Compensation

Some companies may be interested in exploring the possibility of ceasing deferral elections relating to nonqualified deferred compensation and/or accelerated payment of nonqualified deferred compensation to assist executives with financial obligations during the downturn. Typically, cessation of deferral elections that are made during the current year would be treated as an impermissible acceleration of the compensation otherwise subject to the deferral election. Generally, accelerated payment of nonqualified deferred compensation, whether indirectly by ceasing deferral elections or by actually accelerating a distribution, is not permitted under Section 409A and any such acceleration would have adverse tax consequences to the executive. There may be certain situations where payments could be accelerated (for example, in the case of a hardship) but such payments should be carefully scrutinized to determine whether and the extent to which the payments can be accelerated.

Disclosure Issues

Regardless of what actions are taken with respect to executive awards, in the case of a public company it is always important to consider whether and to what extent the action needs to be disclosed. Some actions must be disclosed at the time they are taken and others may be require deferred disclosure or disclosure in the company's next proxy statement. Of course, it is always important to consider how best to describe the action to accurately tell the story behind the action.

Financial Needs of Executives

Executives are almost always heavily invested in the stock of their employer and almost certainly lost a lot of value in the recent decline of the stock market along with shareholders generally. To the extent that Executives need additional cash for any reason at this time, companies may need to consider whether it is willing or able to help with requests from an executive for a way to obtain additional cash in the downturn. While the first choice to obtain cash would be to sell shares, an executive may not be able to simply sell shares at this time either because of trading restrictions, bad optics of selling the company's shares, or personal reasons relating to the low value of the company shares. If selling shares is not available, executives may want to pledge the previously owned shares in order to obtain a loan, but many companies have adopted anti-pledging policies that would need to be reviewed and considered if the executive want to pledge such shares. Additionally, although direct loans from the company could have appeal as a way to obtain cash without the need to pledge shares, public companies are prohibited by the provisions of the Sarbanes-Oxley Act of 2002 from lending money to its executives. Finally, the CARES Act does contain provisions that allow employees to access additional funds in their qualified retirement plan accounts provided certain requirements are met, as summarized here.