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Executive Compensation: Moving Forward in a COVID-19 World

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Employers reacted in a variety of ways to cope with the unprecedented financial impact of COVID-19. Many of the initial executive compensation responses were designed as cost-cutting measures that would ease cash flow burdens and provide flexibility in uncertain times. Now, as the “new normal” American workplace begins to take shape, employers must begin to shift their focus to whether their current executive compensation practices are designed with sufficient incentives to retain key employees and to spur recovery and sustained growth. This post reviews the range of cost-cutting measures companies have enacted over the past few months, and provides guidance on executive compensation issues employers should consider as they move forward in a COVID-19 world.

Cost-Cutting Measures

The financial distress caused by COVID-19 created a need for many employers to cut costs, including via pay cuts and layoffs, but also via other routes such as hiring/promotion freezes, suspension of pay raises, and creative uses of leave programs (e.g., allowing employees to volunteer to take extended unpaid leaves). Below is a summary of select executive compensation issues stemming from some of the more common cost-cutting measures employers have utilized:

1. Salary Reductions. For executives who are parties to employment contracts, attention should be given to employment contract terms to avoid inadvertently triggering severance and/or other employer obligations. For example, some executive employment contracts provide for “good reason” termination triggers that allow an executive to resign and receive severance if there is a material adverse change in employment terms (e.g., a material reduction in base salary and/or bonus opportunity). Before implementing (or not implementing) any salary reductions, employers should consider the optics of a salary reduction. Reductions that are too extreme may cause alarm, whereas insufficient reductions may result in complaints of inequity. In connection with salary reductions, and as discussed further below, employers may also want to consider granting additional equity or phantom equity.

2. Salary Deferrals. Some employers have offered a “catch up” or opportunity to “defer” foregone salary reductions into a future tax year. Whenever an employer promises a right to compensation (i.e., deferrals) in a future tax year, consideration must be given to structure such arrangements in compliance with Section 409A of the tax code. Failure to comply with Section 409A may result in severe adverse tax consequences for the executive.

3. Layoffs. Layoffs have also been a common response for many employers, but for layoffs involving groups of employees, consideration should be given to whether additional requirements under the Older Workers Benefit Protection Act, Worker Adjustment and Retraining Act ("WARN"), and/or any applicable state laws will be triggered. For a list of federal and state WARN considerations during the pandemic, see our previous post.

What To Do with Underwater Stock Options?

The financial stress caused by COVID-19 uncertainty has resulted in lowered valuations for many employers, both public and private, such that a significant portion of employer stock option compensation may be "underwater" (i.e., where the exercise price per share of an option is higher than the fair market value of the underlying shares). The following are potential solutions for underwater options:

1. Wait and See. Wait and see if valuations increase as the economy reopens and, for public companies, the stock market stabilizes.

- Pros: No further dilution or cash drain for investors.
- Cons: Underwater options have no retention value, and outstanding grants continue to count against shares available under the employer's equity plan.

2. Cash Bonus. Provide a cash bonus or cancel options for a cash payment, perhaps including the opportunity to participate in a cash bonus plan that is payable on a change of control (i.e., on a change of control, the executive is entitled to a share of transaction proceeds).

- Pros: Immediate morale boost and retention value for employees. Shares may be added back into the equity plan pool if grants are cancelled.
- Cons: May not be feasible for the employer to use cash. Cash payments are taxable. The rules governing tender offers may be implicated by a proposed exchange with more than a few senior employees.

3. Additional Equity. Provide additional equity awards without cancelling existing grants.

- Pros: New equity grants will have retention value (even if they do not fully replace existing underwater options).
- Cons: New grants will dilute existing investors. Additional grants will further deplete the equity plan's available share pool and may require increasing the share pool.

4. Repricing. Reprice existing underwater options on a one-for-one basis.

- Pros: Straightforward and easily understood by employees. Options retain their retention value.
- Cons: A one-for-one repricing may result in an accounting charge and multiple repricings can create a "floating" exercise price, which would potentially create adverse tax consequences under Section 409A of the tax code. The tender offer rules may also be implicated. A reduction of an option's exercise price is a "modification" for incentive stock option ("ISO") purposes, which would reset the holding periods associated with affected ISOs.
- Additional Considerations: Public companies should consider any applicable stock exchange

shareholder approval rules that may apply to repricings. Employers must also first confirm there are no existing arrangements (e.g., agreements with investors) or corporate governance documents (e.g., within the company's bylaws or charter documents) that prohibit repricing or would require shareholder approval.

5. Option Exchange. Exchange underwater options for new options on a value-for-value basis based on a Black-Scholes or other valuation methodology.

- Pros: Flexibility to push out vesting schedules for new options or add performance vesting. Accounting rules generally require comparing the fair value of stock options immediately before and after the modification with any incremental value created by the exchange resulting in a compensation cost expensed over the remaining vesting period. However, if structured as a value-for-value exchange, there should not be any additional accounting charges.
- Cons: Less easy to explain to employees than other potential solutions. Multiple repricings can create a "floating" exercise price that would potentially create adverse tax consequences under Section 409A of the tax code, and the tender offer rules may be implicated.
- Additional Considerations: Public companies must address any applicable stock exchange shareholder approval requirements. Employers must also confirm there are no existing arrangements or corporate governance documents that prohibit an exchange or would require shareholder approval.

Note on Tender Offers: The tender offer rules under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), are implicated when an option modification or exchange is voluntary (i.e., the security holder must make an investment decision with respect to the proposed modification or exchange of their security). For option repricings, exchanges, or buy-backs, the program will generally need to comply with the tender offer rules, unless the exchange is limited to a small group of senior executives. The tender offer rules under the Exchange Act require private companies to comply with specific requirements. These include holding the offer open for 20 business days and compliance with certain disclosure requirements.

Addressing Other Retention Concerns Going Forward

As the country begins to reopen, opportunistic employers will increase efforts to recruit executive-level talent. In addition to granting additional equity or cash bonus opportunities (as discussed above), there are other measures that employers may employ in order to help retain key employees and prepare for possible executive transitions:

1. Adjusting Performance Metrics. Consideration should be given to whether it is appropriate to adjust current-year and future-year performance metrics given the impact on company performance to date. Employers should review their compensation plans and arrangements to ensure that the company has the ability to make adjustments.

2. Restrictive Covenants. Employers should evaluate their existing restrictive covenant arrangements (e.g., non-compete and non-solicit agreements), if any, to ensure that such arrangements provide sufficient protection in the event of an executive's departure. The validity of the scope and duration of such restrictive covenants will depend on each employer's facts and circumstances, but consideration should also be given to applicable state laws. For example, employers in Massachusetts may need to provide additional consideration in order to obtain an enforceable non-compete restriction.

3. Succession Planning. Employers should update their succession plans in order to provide for an orderly and efficient transition in the event of a senior executive's departure.

Closing Thoughts

COVID-19 will continue to present challenges for employers as they navigate the "new normal," including executive compensation issues. However, with careful planning and a focus on balancing cost and retention goals, employers will be able to position their companies for future success.

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