COVID-19: Focus on Executive Compensation

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The impact of the COVID-19 pandemic on the business community is unprecedented. Every company and executive is questioning the effects the disease will have on their business, employees, customers, and local and global economies. While it is still too early to know the long-term ramifications of the disease, the more immediate implications for businesses are already evident, including a lockdown of large swaths of the U.S. and global economies, disruption to supply chains, widespread layoffs and furloughs of employees, and economic distress and liquidity issues that have materially damaged the value of many categories of assets.

While it may be premature to focus on some aspects of how the pandemic is affecting (and will affect) executive compensation in the long term, it is not too soon for employers and executives to begin thinking about some of the issues that are already surfacing or will likely come up in the months ahead so that they know what options are available to them and can plan accordingly.

As summarized below, some of the changes to executive compensation we have seen so far, and expect to see more of, are driven by employers' desire to preserve cash flow through, for example, employee pay cuts and deferrals of compensation. Many employers are also beginning to explore how to address the dramatic reset in economics for performance-based compensation and equity awards in light of the changed economic landscape.

As employers begin to look past the immediate crisis and prepare for an eventual reopening of their workplaces and businesses, they will also begin focusing more on how best to retain and continue to incentivize their management teams in a difficult and uncertain economic environment. Revising performance metrics to account for the changed economy, addressing "underwater" options or other equity-related awards, and granting new awards will all be on the table.[1]

A. Preserving Company Cash and Liquidity

1. Pay Cuts

In response to the COVID-19 pandemic, executives may be asked to reduce their cash compensation or waive their rights to payment or settlement of awards in order to help preserve cash. While such initiatives should be carefully considered with HR and legal counsel to make sure any changes comply with applicable state and local wage and labor laws, unilateral changes to executive pay plans may also implicate individual contractual arrangements. Before making a unilateral change, companies and their legal counsel should review any applicable executive employment and severance agreements to determine the impact, if any, of a reduction in base salary or waiver of other payments. Since many executives have "good reason" provisions in their existing employment or severance agreements that are triggered by reductions in base pay or incentive compensation unless the executive provides consent, a unilateral reduction without such consent might permit the executive to terminate his or her employment and receive severance (typically subject to notice and an opportunity for the employer to cure), which could result in an additional outlay of cash by the company. Some "good reason" provisions exclude reductions that are not "material" or do not, for example, exceed a certain threshold (e.g., 10–20%) or that are part of an across-the-board pay cut applicable to all senior executives. Because arrangements can vary widely, each executive's "good reason" definition and related provisions should be reviewed in advance to determine whether the executive's consent is required and, if so, whether such consent should be sought.

[1] Because the magnitude of the economic and legislative changes are too voluminous to be included in a single summary article, below we have embedded links to other relevant and more detailed client alerts that we and other Lowenstein attorneys have prepared regarding the legal impacts of COVID-19 on executive compensation.

A request by the employer to reduce cash compensation may also lead to a negotiation of the terms of the pay cut (e.g., the amount and duration of the cut), and in some cases executives may be able to negotiate a trade-off or other inducement to provide consent. Modifications to existing compensation arrangements can raise other complexities, including under Section 409A of the Internal Revenue Code of 1986, as amended (IRC) (Section 409A) (as discussed below).

The impact of a cut in base salary on other compensation and benefits programs should also be considered. For example, annual bonus target values are often calculated as a percentage of base salary, and severance, pension contributions, and other benefits may also key off of base salary and may therefore be impacted.

Finally, for executives who may be subject to the IRC's Section 280G "golden parachute excise tax," a salary reduction may increase excise tax exposure in the event of a future change in control, since such excise taxes apply to amounts paid in excess of a "base amount," which in general is calculated as the average taxable compensation received for the most recent five tax years ending before the date of the change in control. A salary reduction will likely reduce the "base amount" for changes in control in 2021 or later, which would therefore increase the amounts potentially subject to excise taxes.

2. Deferrals of Compensation

Employers looking to conserve cash may also consider deferring compensation or further delaying payments of existing deferred compensation. The rules of Section 409A, which govern the time and form of payment of nonqualified deferred compensation, are complex and impose strict limitations. Failure to comply with Section 409A could lead to accelerated income tax, a 20% additional tax, interest and penalties on the employee, or potential liability of the employer for failure to report compensation and withhold taxes. In order to avoid these undesirable consequences, employers should ensure that they are complying with the rules of Section 409A.[2]

Any current reduction of compensation in exchange for some other right to future compensation may implicate Section 409A. For example, a company's agreement with an executive in midyear 2020 to reduce his or her compensation for the remainder of 2020 in exchange for payment of the forgone salary and/or bonus plus interest in a future tax year could trigger adverse tax consequences for the executive under Section 409A. There are ways to structure such an arrangement to avoid adverse tax consequences, but, as is often the case, the arrangement must be carefully structured so as to ensure compliance with the tax rules.

Permissible Delays: "Going Concern" Exception

Employers that seek to further delay an existing deferral of compensation already subject to Section 409A will also need to consider carefully what limitations and exceptions may apply under Section 409A to allow for such a delay. For example, if making a payment of deferred compensation "would jeopardize an employer's ability to continue as a going concern," Section 409A permits the employer to delay making the payment until the company's financial viability is no longer in jeopardy. If the payment is made during the first taxable year in which the company's financial viability is no longer in jeopardy, it will be treated as being made at the time specified by the arrangement. For payments structured as short-term deferrals under an exception to Section 409A, the rules similarly permit a delay in payment (if paying would jeopardize the employer's ability to continue as a going concern), as long as payment is made as soon as reasonably practical once the employer no longer has such financial concerns.

The determination of whether making a payment would have jeopardized the employer's ability to continue as a going concern is likely based on the facts and circumstances. It appears the concept is intended to be broader than insolvency; for example, it could include breach of a loan covenant. However, there is little guidance on how to apply this exception. Note also that while Section 409A may permit delay in these circumstances, if the applicable contract or plan does not permit such delay, an employer would be in breach of its contractual obligation to make payment if it unilaterally delays payment.

Other Section 409A Implications

Apart from employer efforts to defer or delay payments, some executives may want to accelerate payments that have been deferred, and employees generally may want to know under what circumstances a furlough may constitute a "separation from service" that triggers payment of an existing nonqualified deferred compensation payment. For more detail on these types of issues, see "Deferred Compensation Considerations in the Wake of the COVID-19 Pandemic."

[2] The rules of Section 409A are, again, complex and are technical. Employers should consult with legal counsel before making changes to compensation or accelerating or delaying any payments, and to determine whether, for example, any nonqualified deferred compensation payments are due as a result of a change in employment status.

B. Retaining and Incentivizing Management

As companies shift their focus from shutting down operations and keeping employees at home to reopening and restarting operations (with social distancing), so too will the focus shift from shorter-term concerns like preserving cash flow to longer-term concerns such as retaining key executives and employees and incentivizing them to perform in a very challenging economy.

1. Addressing "Underwater" Equity Awards

In recent weeks, many companies, both public and private, have seen their stock prices and values decline due to the economic disruption caused by COVID-19. As a result, outstanding equity interests may no longer provide adequate incentives to employees. Partial-value equity awards (such as stock options, stock appreciation rights (SARS), and "profits interests" (as discussed further below)) that participate only in the "upside" or appreciation above a certain value are most impacted by this decline in stock price and value. Unlike restricted stock and restricted stock units (RSUs), which are full-value awards that participate "from dollar one" and provide some economic value and downside protection (assuming the company remains solvent), partial-value equity awards have zero value if the stock price falls below the strike or exercise price. Options with an exercise or strike price above the current fair market value of the company stock price are often referred to as "underwater options" (and this concept applies to other partial-value equity interests where the participation threshold is greater than the current value of the entity issuing the interest).

In our experience, most employers feel it is too early to address underwater equity and are taking a "wait and see" approach to outstanding grants, with the expectation that the issue may need to be revisited when the economic climate stabilizes. If and when a company decides that a more proactive approach is necessary to retain and motivate executives, there are multiple strategies available to address underwater equity, each with its own "pros and cons," as explained at a high level here.

Strategies to Address Underwater Stock Options

i. "Option for Option" Exchange – Underwater stock options can be cancelled and replaced with new stock options that have an exercise price that is equal to or greater than the stock's current fair market value. In an "option for option" exchange, the exchange ratio may be, but does not have to be, less than 1:1 (to reflect the reduced exercise price), and the terms of the new options can be different from those of the old options (e.g., new vesting and forfeiture conditions can be added).

- What are the pros and cons of doing this?
  - Pros: Options with a reduced exercise price retain their incentive and retentive value (meaning there is less need for cash compensation), and cancelled shares that are not reissued may remain available for future issuance under the equity plan (without the need to increase the reserve and the "overhang," which is a measure of the potential dilution to which common shareholders are exposed).
  - Cons: An option exchange may be negatively perceived by shareholders, and some companies may require shareholder approval (especially public companies); there may be potential accounting charges if the exchange is not "value for value" (i.e., if the new options are valued higher than the old options).

ii. Stock Option Repricing – A company can reduce its underwater stock options' exercise price(s) to the stock's current fair market value by amending the relevant option agreements.

- Difference from an exchange: Unlike the option-for-option exchange mentioned above, the underwater options are not cancelled; instead, the option agreement is amended to change the exercise price, and the other terms (e.g., vesting, forfeiture) stay the same. A reduction in exercise price generally does not require option holder consent (other than for incentive stock options), although consent should still be documented, and there is no net decrease in outstanding options (or addback of shares to the equity plan). Note, however, that shareholder approval may be required for certain public companies to reprice options, depending on the terms of the equity plan.
  - Pros: Compared with an option exchange, as mentioned above, it is relatively simple to reprice options, since no other terms of the option (other than the exercise price) are being changed.
  - Cons: A company should consider whether it sees the fair market value of its stock rebounding and whether such a repricing is necessary to properly incentivize employees.

See "COVID-19: Considerations in Stock Option Repricing."

iii. Stock Option for Other Securities Exchange – Underwater stock options can be cancelled (or left in place) and can be replaced (or supplemented) with a different type of equity-based award (e.g., restricted stock, RSUs, or phantom stock).

iv. Restricted Stock or RSU Swap – A company cancels its underwater options and replaces them with restricted stock or RSUs.

- Pros: Because restricted stock and RSUs (as more fully described below) are "full-value awards" (that participate from "dollar one"), they retain at least some incentive and retentive value even if the stock price further declines (whereas newly issued options can also become "underwater" if the company's value declines further).

- Cons: RSUs are not eligible for long-term capital gains treatment, and taxes may be owed upon vesting and before the shares can be readily sold (i.e., pre-liquidity).

v. Refresh Options (Make-up Grant) – A company can also simply grant new stock options (or other equity-based awards) at the current value to employees to supplement the existing underwater options (which would be left in place).

- Pros: New grants can provide incentive/retentive value at a reduced exercise price with new vesting and other terms.
- Cons: This further dilutes shareholders (i.e., if the stock price surges, the original underwater options could be back "in the money" along with the new grant), uses up share reserve under the equity plan, and increases share overhang; also, allowing option holders to keep old awards and get new awards may be viewed as "rewarding failure" (although the decline in stock price is likely not a direct result of management's actions but more likely is driven by current market conditions).

Strategies to Address Other Forms of Underwater Equity Awards

While stock options may be more widely held, other forms of equity interests have also been heavily impacted by the decline in stock values. Worth noting are "profits interests" issued by limited liability companies (and other entities taxed as partnerships) and common stock held by founders and employees in venture-backed companies where the liquidation preference exceeds the current value of the company.

"Top Up" Profits Interests

Profits interests are potentially tax-favorable interests issued by a partnership to service providers that allow the recipients to participate in the future profits of the entity, including the appreciation, if any, above the entity's value as of the date of grant (the so-called "participation threshold"). Widely used in the private equity industry, profits interests are economically very similar to stock options in a corporation (with the "participation threshold" being similar to the exercise price for a stock option). As "partial interest" awards (with no downside protection), like stock options, they are also disproportionately impacted by decreases in asset values.

As with underwater stock options, the issuer of an underwater profits interest may also look for a way to reestablish the compensation incentive of such interest. Given the complex partnership tax rules governing profits interests, the parties should proceed carefully to make sure any modification to the profits interest is done properly to preserve the tax status of such profits interest. While it may seem obvious simply to amend the original interest to provide for a lower threshold, an alternative approach, for profits interests that were granted within the prior two years (and thus have not yet satisfied the holding period under safe harbor profits interest rules), would be to keep the underwater profits interest outstanding and grant a new "top up" profits interest that would entitle the holder to the difference between the current reduced value and the original higher value. This approach produces the same economic result as an amendment to the profits interest agreement.

Management Carveout Plans

Many venture-backed companies may now find that the liquidation preference associated with the preferred shares they have used to raise venture money exceeds a reasonable estimation of what the company's value may be upon a future sale. In other words, there is a "liquidation preference overhang." As a result of a liquidation preference overhang, a company's common stock, typically held by its founder and employees, is essentially worthless. Companies with a liquidation preference overhang may want to consider new ways to motivate and retain their employees.

There are a number of ways to address this problem. One common solution is to create a "bonus plan" or "carveout plan," which typically establishes that a certain amount of the proceeds from a sale transaction will be distributed to employees before the preferred stock liquidation preferences are satisfied. These plans are often referred to as management carveout plans.

A typical management carveout plan sets aside a pool of money "off the top," with the amount determined based on a certain percentage of sale net proceeds (which could, for example, be a sliding scale), and a portion of the payout possibly being tied to payments from the transaction escrow and/or earn-out payments, if any. The terms and conditions of a carveout plan can vary widely and typically are presented by the board (with the input and consent of the investors), and in some cases may be negotiated with the participants. To prevent a "double dip," some plans provide that the value received on the common stock owned by a management carveout plan participant is an offset (or a cutback) to any payout under such plan. Note that the deferred compensation rules of Section 409A impact these sorts of plans, which must be structured carefully in light of tax and other legal implications.

Conclusion

The alternatives described above are simply some choices that employers can consider utilizing in order to conserve cash or retain and incentivize employees going forward, but are not intended to be an exhaustive list. As employers look to rebuild and recover in the new economic climate, they should consult with legal counsel before entering into any new or revised arrangements, given the complexities involved.

To see our prior alerts and other material related to the pandemic, please visit the Coronavirus/ COVID-19: Facts, Insights & Resources page of our website by clicking here.

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