COVID-19: Certain Executive Compensation Considerations

MARCH 2020

Background

- **The COVID-19 pandemic has caused significant worldwide financial disruptions, including:**
  - Historic declines in all major equity indices
  - Disruption to corporate financial forecasts and guidance
  - Strained corporate liquidity

- **Each of these issues poses challenges for corporations, including with respect to maintaining adequate incentive compensation programs to drive business performance and retain the focus of key leadership and talent**

2020 Equity Grant Timing

- **Most companies make annual equity grants in the first calendar quarter (e.g., February or March)**

- **COVID-19 pandemic hit in the middle of grant season, shortly after many companies had made grants and shortly before others were planning to make grants**

- **If grants already made:**
  - Current values may be significantly lower than intended values
  - Performance metrics based on pre-COVID-19 forecasts may now be unachievable
  - Stock options may be deeply "underwater" with exercise prices significantly above current share prices

- **If grants not made yet, it may be advisable to delay until market volatility subsides to ensure delivery of appropriate values and to provide time for business forecasts and performance metrics to be reassessed to reflect new economic reality**
  - A hybrid approach may also be taken where time based grants are made on normal schedule to deliver some portion of overall grant value with a delay in performance based grants until post-COVID-19 performance metrics can be developed
  - It may also be feasible to grant some or all of the awards in the form of cash settled awards if liquidity permits

- **If grants will be delayed:**
  - Incentive plan terms should be evaluated for any limitations on the timing for establishment of performance goals
    - Under prior tax law this may have been problematic, but should now be achievable
  - Incentive plan share limits must be reviewed since they may have been set when stock prices were higher
  - Rationale for change in grant timing should be clearly explained in next year's proxy statement

Adjustments to Currently Outstanding Grants

- **As of now, most clients are taking a "wait and see" approach toward outstanding grants, with an understanding that value gaps and unachievable performance metrics may need to be revisited when the climate stabilizes**

- **Supplemental Equity Grants:**
  - Incentive plan limits must be examined to ensure grants are within plan limits (both overall pool and individual limits)
    - Grants in excess of plan limits are a common focus for shareholder litigation
  - For named executive officers included in Summary Compensation Table, supplemental grants may lead to outsized reported compensation in the applicable proxy statement because both original and supplemental grants are valued at grant date fair value regardless of current market value

- **Adjustment of Performance Goals:**
  - Incentive plan terms must be examined to determine whether post-grant adjustments are required or permitted
    - Adjustments are problematic for grants intended to qualify under old 162(m) tax deduction rules (for example, if the grants are grandfathered), although most of these types of awards have already vested and/or the business rationale for adjustment may outweigh the benefit of maintaining tax deductibility
  - Adjustment will often be considered "modification" of the award for accounting purposes
    - For named executive officers included in the Summary Compensation Table, this would result in supplemental reported compensation even though the original grant has already been reported in a prior year
    - Would also lead to incremental accounting expense for financial reporting purposes
  - Because post-grant adjustments are problematic with proxy advisors, it is preferable, all else equal, to adjust only once when there is clear line of sight on new metrics (rather than making multiple adjustments) and to clearly explain any adjustments to investors in the applicable proxy statement
    - Performance goal adjustments are likely to be fairly common given the current climate

Adjustments to Currently Outstanding Grants

- **Stock Option Repricing:**
  - Unless a company's incentive plan **expressly** permits stock option repricing (lowering the exercise price), which is very rare, both NYSE and NASDAQ rules require shareholder approval to implement a repricing
  - For this purpose, "repricing" is defined broadly to include:
    - Actual reduction of the exercise price
    - Cancellation or repurchase of an option at a time when exercise price exceeds the share price in exchange for any form of consideration (whether cash or a new equity grant)
    - Any other action that is considered a repricing under GAAP
  - Repricing would also result in a modification of the award for accounting purposes, resulting in a deemed new grant with corresponding Summary Compensation Table inclusion and accounting charge for financial statement purposes
  - Option repricing is also viewed negatively by proxy advisory firms

Share Pool Planning for the Future

- **Significant equity market declines may mean that a company's remaining equity plan share reserve is insufficient to delivery necessary values in future years**
- **Companies should model future grant needs to determine if they will need to obtain shareholder approval for a supplemental share reserve sooner than originally anticipated**
  - If so, proxy statement should clearly explain rationale for early share request and plans for share usage
  - Plan terms should be reexamined for compliance with current "best practices" to ensure best chance for approval
  - Additional share authorization may also be desirable to allow companies facing liquidity constraints to use equity in order to conserve cash
- **It is unclear whether proxy advisors will adjust their models to account for recent events, which could make obtaining shareholder approval of additional share reserves more challenging**
  - Outreach to key shareholders may be more important than normal to obtain a successful vote
- **In the absence of obtaining a supplemental share reserve, usage of the existing reserve may be slowed by switching to cash-based awards for some or all grants if liquidity permits**

Liquidity Preservation Measures

- **In light of liquidity constraints and business disruptions, many companies have implemented (and others are considering) either targeted or across the board compensation reductions**

- **In connection with these actions, the terms of any applicable employment agreements and severance plans should be considered**
  - Some company agreements/plans may provide for the ability to reduce compensation in connection with cost reduction measures (some set a cap on the acceptable reductions)
  - Others agreements/plans do not, which would result in the need to obtain employee consent to avoid breach of the agreement or the triggering of severance rights (such as good reason or constructive termination) based on compensation reductions

- **It may be possible to structure changes in compensation plans to maintain economic values and incentives for employees while at the same timing maintaining corporate liquidity**
  - Restructuring annual bonus program to be payable in whole or in part in equity (but equity plan terms, including share authorization constraints and minimum vesting conditions, should be considered)
  - Deferring payment of certain compensation (e.g., annual bonuses) to future years
  - Compliance with tax rules (including section 409A) must be considered in connection with these types of changes

- **Impact of salary reductions on other compensation programs should be considered**
  - Annual bonus target values are typically a percentage of base salary (the relevant salary amount may be salary level at the beginning or end of the year, salary actually paid or may be unspecified)
  - Severance, pension and other programs may also be impacted

- **Depending on magnitude of proposed changes, companies may be required to disclose these measures in a Form 8-K**
  - Even if not required, a Form 8-K may be desirable in some cases to get “credit” for executive pay reductions

Monitoring Legislative Developments

- **Congress is currently negotiating legislation regarding fiscal stimulus in response to COVID-19**
- **Legislation is expected to include funding for government loans to, or equity stakes in, companies in need of government assistance**
- **Preliminary drafts of the legislation have included:**
  - Limitations on compensation increases and/or compensation levels for executives of recipient companies
  - Limitations on severance that may be paid to terminated executives

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