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Executive Compensation and The Covid-19 Pandemic

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The Covid-19 pandemic, and the resulting impact on the global economy, is testing the framework of companies' long-term and short-term incentive compensation programs. Many companies are in the midst of their annual compensation review and approval cycles, with compensation levels and performance targets being determined at the same time proxy disclosures are being prepared. In addition, previously granted awards already may have been severely impacted by market conditions. On a very human level, employee and executive compensation is top of mind for many right now, as reasonable concerns about the individual impact of the crisis reverberate with executives and others in the work force.

This article discusses the specific issues related to incentive compensation that companies and their external legal, tax, and accounting advisors should be considering in the context of current events.

TIMING OF COMPENSATION DECISIONS FOR 2020 AWARDS NOT YET AWARDED

The current time period is one in which many calendar year companies set performance targets under their short-and long-term incentive plans for the current fiscal year and approve new annual equity compensation awards.

Companies that have not yet made compensation decisions regarding 2020 awards may consider delaying their approvals until their stock price stabilizes and more is known about the impact of Covid-19 on the company. Companies that choose to delay compensation approvals should consider the impact a delay may have on employee morale and should clearly communicate and explain the reasoning behind any delay. Additional implications of delaying compensation decisions, or modifying existing compensation, are discussed in more detail below.

Overview of Section 162(m) and Performance-Based Compensation

While an in depth discussion regarding §162(m)[1] is outside of the scope of this article, an overview of §162(m) and the performance-based compensation exception may assist in framing several of the matters discussed in this article.

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Page Griffin regularly advises companies, executive management teams and individual executives with the design, implementation and termination of compensation and benefit arrangements, including executive employment and severance agreements; retention, severance and change-in-control plans; cash and equity-based incentive programs; and nonqualified deferred compensation plans. Mr. Griffin also frequently advises clients regarding SEC rules governing executive compensation disclosure and corporate governance matters arising in the executive compensation context, and tax rules applicable to deferred compensation, excise tax on excess parachute payments and limits on the deductibility of executive compensation.

[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

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Section 162(m) prohibits publicly held companies from deducting more than one million dollars per year in compensation paid to certain covered executives. Prior to the Tax Cuts and Jobs Act[2] (TCJA), publicly held companies could deduct compensation in excess of the one million dollar per year limit to the extent that the excess constituted qualified-performance based compensation. The TCJA eliminated the performance-based exemption for taxable years beginning after December 31, 2017, unless the compensation arrangement is grandfathered under the transition rule.

Compensation paid in taxable years beginning on or before December 31, 2017, and compensation paid pursuant to a written binding contract that was in effect on November 2, 2017, which is not materially modified on or after that date, is not subject to the one million dollar annual deduction limitation if it is qualified performance-based compensation.[3] In relevant part, to qualify for the performance-based compensation exception, the performance goals applicable to the compensation must be contingent on the attainment of one or more pre-established objective performance goals and the goals must be established in writing prior to or shortly following the commencement of the performance period (generally, the earlier of 90 days following the beginning of the period or prior to 25% of the performance period elapsing).

Delay in Establishing Performance Goals

With the elimination of the performance-based compensation exception under §162(m), companies now have greater flexibility in establishing performance goals for senior executives beyond the 90-day period from the beginning of the performance period. In light of the uncertainty caused by current events, it may be prudent to wait until later in the fiscal year to establish performance targets applicable to the 2020 performance-based compensation. However, for publicly held companies, any delay in establishing performance targets should be weighed against the risk that the awards may not be viewed as performance-based compensation by shareholders and shareholder advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis to the extent that the targets are substantially certain to be achieved when established.

Absolute vs Relative Performance Metrics

For those companies who historically use absolute performance metrics such as absolute total shareholder return, consideration may be given to moving to relative metrics such as relative total shareholder return. The move to relative measures would reward management for performance compared to a peer or industry group and may lessen the risk of penalizing management for the impact of the Covid-19 pandemic when compared to company-centric measures. To the extent that companies continue to use absolute measures, consideration should be given to setting performance targets that would not be viewed in hindsight by shareholders or proxy advisory firms as "easy to attain" when compared to pre-Covid-19 pandemic hurdles.

Discretionary Adjustment Provisions

Consideration should be given to including discretionary adjustment provisions in the awards that would allow for adjustments to performance targets to account for unexpected or irregular results of the Covid-19 pandemic, which is likewise permissible without negative tax ramifications, even for senior executives under current §162(m) rules. While it may be prudent for companies to have broad discretionary authority, as noted below, shareholders and shareholder advisory firms may prefer discretionary adjustment provisions that are narrow in focus.

Pricing and Burn Rate

For those companies that have a practice of valuing awards based on a target dollar value rather than a fixed number of shares, consideration should be given to revising this practice so as to mitigate the impact of an extraordinarily low stock price. Valuing grants based on a target dollar value at a time when the company's stock price is depressed may result in a significant drain on the equity plan share reserve. This also may result in additional scrutiny from shareholders and proxy advisory firms if they perceive that the grants provide a windfall to management if stock price returns to pre-pandemic levels.

Method for Pricing Awards

To the extent that grants are valued based on a target dollar value, companies may wish to consider valuing the grants based on a trailing average stock price as opposed to a closing price on the day of grant or other spot price. A trailing average stock price approach to valuing the grants may smooth over pandemic-driven extremes in pricing that may arise from spot stock prices. Longer trailing averages may be used for full value awards such as restricted stock units. Note, however, for stock options and stock appreciation rights, §409A generally provides that fair market value may be determined by a trailing average stock price of no more than 30 days unless the options

[2] TCJA, Pub. L. No. 115-97.

[3] TCJA §13601(e); Prop. Reg. §1.162-33(g), 84 Fed. Reg. 70,356, 70,384 (Dec. 20, 2019).

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or stock appreciation rights are structured to comply with §409A.[4]

To the extent the company wishes to use a trailing average stock price to establish fair market value of options, it will need to specifically identify the grantees and the number of shares underlying the award that each individual will be entitled to receive prior to the start of the measurement period. In addition, prior to the commencement of the designated period, the company is required to specify the applicable averaging period that will be used and also designate the class of shares that are subject to the awards. The commitment to grant the awards on the terms specified prior to the beginning of the designated period must be irrevocable. Unless foreign law requires an alternative formula, the trailing average selling price must be calculated either as (a) the arithmetic mean of the selling prices on all trading days during the specified period or (b) such arithmetic mean weighted based on the volume of trading on each trading day during the period. Where foreign law requires that the exercise price be based on a specific averaging method and period, such method will be deemed to comply with the acceptable methods of determining fair market value under §409A so long as the averaging period does not exceed 30 days.

Any adjustments to valuing grants should be made only after a review of the applicable plan terms as, for example, the plan may need to be amended to permit the use of a trailing average stock price. An amendment of this nature generally would not require shareholder approval.

Insufficient Plan Share Reserves

Even where a company changes its valuation methodology for equity awards, it may be the case that companies need to seek shareholder approval for an increase in the number of shares available in the equity plan share reserve as a result of the decline in stock value and a corresponding increase in burn rate. To the extent that the decline in stock price results in a company not being able to grant all or a portion of awards in the 2020 grant cycle, awards may be granted subject to shareholder approval of the shares underlying the awards or grant cash-settled awards (though it may have a negative accounting impact). Cash-settled awards will not require shareholder approval, but they generally have less favorable accounting treatment than stock-settled awards.

Disclosure Matters

Item 5.02(e) of the Securities & Exchange Commission (SEC) Form 8-K requires publicly held companies to file a Form 8-K within four business days following: (i) the entry, adoption, or commencement of a material compensatory plan, contract, or arrangement as to which the company's principal executive officer, principal financial officer, or a named executive officer participates or is a party to; (ii) such plan, contract or arrangement is materially amended or modified; or (iii) a material grant or award under any such plan to any such executive is made or materially modified. The filing is required to disclose a brief description of the terms and conditions of the plan, contract, or arrangement and the amounts payable to the executive thereunder.

Companies generally grant both equity and cash awards under a shareholder-approved omnibus incentive plan, the material terms of which were required to be disclosed to shareholders in accordance with Schedule 14A under the Securities Exchange Act of 1934[5] (Exchange Act). To the extent that any delay in establishing performance goals, changing performance metrics, including discretionary adjustment provisions, or adjusting the methodology under which awards are valued, are consistent with the terms of the omnibus incentive plan (which are generally drafted very broadly), then the company will generally not need to disclose these matters on Item 5.02(e) of Form 8-K.

ADJUSTMENT OF PERFORMANCE TARGETS FOR OUTSTANDING MID-CYCLE AWARDS

Discretionary Adjustments and Adjustments for Extraordinary Events

For awards that already have been granted and for which the performance periods have not been completed, companies may be able to exercise discretion to adjust performance targets through either preexisting discretionary adjustment provisions or adjustment provisions triggered by extraordinary or non-recurring events. To the extent that existing awards do not already have these provisions, the plans or agreements generally may be amended to provide the compensation committee with this authority. An amendment to include these provisions would generally not require shareholder approval under the New York Stock Exchange and the Nasdaq stock market listing rules although, as discussed below, disclosure pursuant to Form 8-K may be required.

Shareholder Considerations

Proxy advisory firms such as ISS and Glass Lewis consider the application of compensation committee

[4] Reg. §1.409A-1(b)(5)(iv)(A).

[5] Pub. L. No. 73–291 codified as 15 U.S.C. §8a *et seq.*

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discretion to adjust performance targets or ultimate payments when conducting a qualitative review of pay-for-performance. However, these advisory firms should carefully consider the company's justification for the use of discretion and, assuming the as-adjusted targets are meaningful (i.e., the compensation retains its character as performance-based), then latitude should be provided given the unusual and widespread impacts of the Covid-19 pandemic.

Grandfathered Compensation

To the extent that any applicable performance period commenced prior to November 2017, external advisers should be consulted to determine whether any adjustments would cause the award to lose grandfathered status for purposes of the §162(m) transition rule under the TCJA. In addition, discretionary adjustments may have negative accounting impacts.

Disclosure Matters

As discussed above, shareholder-approved omnibus incentive plans typically contemplate discretionary adjustments and any adjustment under the plan generally will not be required to be disclosed in an Item 5.02 disclosure on a Current Report on Form 8-K but the adjustments will need to be addressed in the company's compensation discussion and analysis in respect of the year in which the adjustments occurred. However, many omnibus incentive plans that were adopted prior to the TCJA permitted the use of negative discretion only. As noted above, while a plan may be amended to permit positive discretion without requiring shareholder approval, if the plan amendment has not been previously disclosed then the exercise of positive discretion would likely need to be disclosed on an Item 5.02(e) disclosure on Form 8-K within four business days following the date of the amendment.

DELAYING SETTLEMENT OF PERFORMANCE-BASED COMPENSATION EARNED FOR COMPLETED PERFORMANCE CYCLES

To the extent that performance-based compensation earned in 2019 has not been paid or settled, companies may desire to change the form of payment or delay the payment or settlement. Any such changes may result in the imposition of penalty taxes under §409A and otherwise have accounting impacts. Companies should consult with their legal and accounting advisers prior to changing the form of, or delaying these payments.

Many performance-based compensation vehicles (particularly annual bonus programs) are structured to be exempt from §409A as short-term deferrals, i.e., the compensation vests and becomes payable no later than the later of: (i) the 15th day of the third month following the end of the employee's taxable year that includes the date on which the right to payment is no longer subject to a substantial risk of forfeiture; and (ii) the 15th day of the third month following the end of the employer's taxable year that includes the date on which the right to payment is no longer subject to a substantial risk of forfeiture.[6]

To the extent that the performance-based compensation for 2019 is structured to provide that the right to payment is conditioned on continued employment through the payment date, then calendar year companies are able to delay payment until March 15, 2021. If, however, the performance-based compensation is structured to provide that the compensation vested on December 31, 2019, based on the attainment of the applicable performance metrics and continued employment, in either case, through that date, then the compensation would generally need to be paid to the employee by March 15, 2020. Finally, if the performance-based compensation is structured to comply with §409A because it designates the year of payment, then companies would be able to delay payment until no later than December 31, 2020.

Companies may also delay payment without violating §409A to the extent that payment of the amounts would jeopardize the company's ability to continue as a going concern. The IRS has not given much guidance to aid in determining whether or not the making of a payment jeopardizes the company's ability to continue as a going concern, as it is a facts and circumstances determination. However, the scope of the concept of jeopardizing the ability of the company to continue as a going concern is intended to be broader than threatened insolvency and may include, for example, breach of a loan covenant.

REPRICING AND EXCHANGES

Given market volatility and broad declines in stock prices, stock options granted prior to the Covid-19 pandemic may be underwater and no longer provide the intended incentives for management. As a result, companies may wish to explore repricing the underwater stock options to "reset" the options or exchange the options for different forms of equity compensation, such as restricted stock units or shares of restricted stock. Repricing or exchanges may be warranted but, for the reasons discussed below, consider-

[6] Reg. §1.409A-1(b)(4)(i)(A).

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ation should be given to a wait and see approach prior to requesting that shareholders approve repricing options.

Stock Exchange Listing Rules

New York Stock Exchange and the Nasdaq stock market listing rules require a company to obtain shareholder approval for a stock option repricing or exchange unless the applicable equity plan expressly provides that the company can reprice or exchange underwater options without shareholder consent.[7] The New York Stock Exchange and the Nasdaq generally define ''repricing'' as: (i) lowering exercise prices following grant; (ii) cancelling underwater options in exchange for another option or for restricted stock or other forms of equity (other than in connection with a merger, spin-off or other similar corporate transaction); and (iii) any other action treated as a repricing under GAAP.[8]

Methods of Option Repricing and Exchanges

There generally are four methods for option repricing or exchanges: (i) one-for-one repricing; (ii) option-for-option exchange; (iii) restricted stock/restricted stock unit exchange; and (iv) cash exchange.

In a one-for-one repricing, the company will unilaterally lower the exercise price of the option to the then-current fair market value, which may be accomplished by amending the applicable award agreement or by cancelling and regranting the option. In an option-for-option exchange, underwater options are exchanged for new options with an exercise price equal to the then-current fair market value. However, the exchange ratio applicable to the options is less than one-for-one repricing. The intent of the option-for-option exchange is that the value of the new options is equal to or less than the value (on a Black-Scholes valuation or other valuation basis) of the underwater options. In an restricted stock or restricted stock unit exchange, underwater options are cancelled and replaced with restricted stock or restricted stock units with the same or lower aggregate value. Finally, in a cash exchange, underwater options are cancelled in exchange for cash based on a Black-Scholes valuation or other valuation basis.

[7] The New York Stock Exchange Listed Company Manual, §303A.08; Nasdaq Stock Market Listing Rules, Rule 5635(c); Nasdaq Interpretive Material IM-5635-1.

[8] The New York Stock Exchange Listed Company Manual §303A.08; Nasdaq OMX Listing Center, Nasdaq ''Frequently Asked Questions,'' https://listingcenter.nasdaqomx.com/MaterialHome.aspx?mcd=LQ.

Shareholder Approval and Proxy Solicitations

Companies seeking shareholder approval for a repricing or exchange will be required to disclose the following under §14(a) of the Exchange Act: (i) a description of the repricing or exchange program, including a description of who is eligible to participate, the securities subject to the exchange offer, the exchange ratio, and the terms of the new securities; (ii) a table disclosing the benefits or amounts, if determinable, that will be received or allocated to named executive officers, current executive officers (as a group), current directors who are not executive officers (as a group), and all employees (including current officers who are not executive officers as a group); (iii) a description of the justifications for the repricing/exchange program and alternatives consider by the board; and (iv) the tax consequences and accounting treatment of the repricing or exchange.[9]

Proxy Advisor Considerations

Repricing and exchanges generally are disfavored by institutional shareholders and proxy advisory firms. This is in part due to the fact that the last two significant waves of stock option repricing which occurred in 2001-02 and 2009 were followed by rebounds in stock prices.

Proxy advisor firms generally consider the following when assessing repricing or exchanges: (i) historic trading patterns (i.e., whether or not the stock is so volatile that options are likely to be in the money in the near term); (ii) the justification for the repricing or exchange, including an assessment of whether or not the decline was beyond the control of management; (iii) the type of repricing or exchange (with a preference for value-for-value exchanges); (iv) the disposition of shares in respect of the surrendered awards (i.e., are they added back to the plan reserve); (v) the timing of the repricing (e.g., was it within a year following a drop in stock price); and (vi) the term and exercise price of the repriced or exchanged options.

In addition, in its United States Proxy Voting Guidelines for meetings on or after February 2, 2020, ISS provides that: (i) executive officers and directors should be excluded; (ii) repricing underwater options after a recent drop in stock price ''demonstrates poor timing and warrants additional scrutiny;'' and (iii) the exercise price of surrendered option should be above the 52-week high for the stock price.

Tender Offer Rules Implicated

Option repricing and exchange programs (other than an option-for-option repricing that only reduces

[9] 17 CFR §240.14a-101.

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exercise price which is effectuated unilaterally by the company) implicate the tender offer rules of Rule 13e-4 under the Exchange Act and Regulation 14E[10] to the extent the company has a class of equity registered under §12 of the Exchange Act or is required to file reports under §15(d) of the Exchange Act. The tender offer rules may not apply if the option repricing or exchange program is offered to a small number of financially sophisticated option holders, such as executive officers (i.e., individually negotiated arrangements). However, this is a facts and circumstances determination based on both the number of participants and their positions and sophistication.

To the extent that the repricing or exchange program constitutes a tender offer, the SEC has exempted compliance with the ''all holders rule'' and the ''best price rule'' in the context of an option repricing or exchange where: (i) the company is S-8 eligible; (ii) the original options were issued under an ''employee benefit plan'' and the offered securities will be issued under an ''employee benefit plan'' (in each case, within the meaning of Rule 425 under the Securities Act of 1933);[11] (iii) the repricing or exchange is conducted for compensatory purposes; (iv) the issuer discloses the essential features and significance of the offer (including risks); and (v) the issuer otherwise complies with Rule 13e-4 under the Exchange Act.

Tax Considerations

Repricing and exchanges will cause options that were granted prior to November 2, 2017, and were intended to qualify as performance-based compensation under §162(m), to lose grandfathered status under the TCJA transition rule as the repricing or exchange will constitute a material modification. If the options were intended to qualify as incentive stock options within the meaning of §422 of (ISOs) and the repricing or exchange offer is open for 30 or more days with respect to ISOs, then the ISOs may lose ISO status and become nonqualified stock options. If the repricing or exchange offer is open for less than 30 days, holders of ISOs who participate in the offer will be deemed to receive a new grant of ISOs (to the extent that the new option is intended to be an ISO) and the two-year holding period for ISOs will restart.

As noted above, options granted with an exercise price at least equal to the fair market value of the underlying shares of stock on the date of grant are generally exempt from §409A. To the extent that the exercise price of an option is modified such that it is less than the fair market value of the underlying shares on the date of the modification then the modification may be deemed the grant of a discounted option subject to immediate taxation and penalty taxes under §409A. Further, to the extent there are multiple repricings, the options may be viewed as not having a fixed exercise price and then considered nonqualified deferred compensation.

Disclosure Considerations

To the extent that named executive officers participate in the repricing or exchange, the repricing or exchange should be disclosed and described in the company's compensation discussion and analysis in respect of the year in which the repricing or exchange occurred. In addition, the repricing or exchange should be described in the narrative disclosures to the compensation tables required by Item 402.[12] Item 402 also requires that the incremental value of repriced options (computed as of the repricing date and in accordance with ASC 718) should be included in the Summary Compensation Table and the Grants of Plan-Based Awards Tables, in each case, in respect of the year in which the repricing or exchange occurred.[13]

OVERALL FLEXIBILITY

Companies will need to continue to remain nimble and creative when faced with the expanding impacts of the Covid-19 pandemic. The common theme underlying each of the considerations summarized above and long-term and short-term incentive plan design during this turbulent time is the ability of the compensation committee to use its discretion to address novel issues that generally arise only during periods of market volatility. Companies should consult with their legal, tax, and accounting advisers and compensation consultants as they address these challenges.

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[10] 17 CFR §240.13e-4, §240.14e.

[11] Pub. L. No. 73-22.

[12] *See generally* 17 C.F.R. §229.402.

[13] 17 C.F.R. §229.402.

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