Milbank

Executive Compensation and Employee Benefits Group

Client Alert

Initial COVID-19 Compensation Adjustments and Related Considerations

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Contact

Manan (Mike) Shah, Partner
+1 212.530.5501
mdshah@milbank.com

Joel I. Krasnow, Partner
+1 212.530.5681
jkrasnow@milbank.com

Nicholas DeLuca, Associate
+1 212.530.5391
ndeluca@milbank.com

James Beebe, Associate
+1 212.530.5206
jbeebe@milbank.com

Kelly P. Bartley, Associate
+1 212.530.5012
kbartley@milbank.com

Christina Skaliks, Associate
+1 212.530.5282
cskaliks@milbank.com

Jon Sorger, Associate
+1 212.530.5677
jsorger@milbank.com

As discussed in our March 24, 2020 client alert "Compensation Considerations in Light of COVID-19", the fallout from the COVID-19 virus and nationwide quarantines continues to disrupt businesses throughout the country, and boards of directors and compensation committees are having to re-assess their compensation programs as the 2020 calendar year progresses. While each company will need to assess its own short-term and long-term priorities during this unprecedented period, the summary below provides a general overview of the types of adjustments to compensation programs that Milbank is seeing in the marketplace currently, as well as other potential alternatives for compensation adjustments.

Reductions in Base Salary

Several companies are reaching agreements with their executive officers or other employees to reduce base salary to help stabilize or preserve liquidity during this time. While some companies are opting for short-term or temporary reductions, other companies are implementing indefinite reductions. Most of these reductions do not impact the calculation of other benefits such as bonus targets or severance amounts. Some executives have even agreed to entirely forgo their base salary payments for six months to a year.

Key Considerations:

- Most executives have "good reason" termination protection as part of their employment agreements or other compensation arrangements. The definition of "good reason" almost always includes a trigger for reductions in base salary. In connection with implementing any reductions in base salary or other compensation, it would be prudent for boards of directors or compensation committees to seek waivers from the impacted employee(s) to ensure that these "good reason" provisions are not being triggered.

- To the extent there is any agreement that forgone compensation will be paid in a future year, consideration needs to be given to structuring such subsequent payment in compliance with the compensation deferral rules under Section 409A of the Internal Revenue Code.

- As with any change or modification to compensation arrangements, a publicly-held company will need to evaluate whether such changes or modifications trigger current reporting obligations under Form 8-K.

Providing Equity Compensation in Lieu of Cash Compensation

For many companies, equity-based compensation serves as just one aspect of total compensation, most-often used in the context of long-term incentives, whereas annual base salaries and short-term bonuses are typically delivered in the form of cash. Citing liquidity concerns, some companies are considering re-designing their compensation programs for 2020 to include a larger stock-based component by issuing equity-based awards in place of cash as part of the short-term compensation component. Some companies are also considering the feasibility of providing base salaries to certain employees in the form of stock, but this practice is not yet widespread.

Key Considerations:

- Any company considering this alternative must ensure that it has enough capacity under its equity compensation plan(s) in order to avoid exceeding its equity plan limits, both individual participant limits and limits on the total amount of equity reserved. For a company listed on the NYSE or NASDAQ, any increase in the number of shares reserved for issuance under such plan(s) must be approved by shareholders before any shares can be issued.

- While the increased use of equity will ease the cash outlay required to compensate employees, a company will need to consider the impacts of increased equity compensation on dilution, burn rates and other metrics that are focused on by shareholders and shareholder advisory firms.

- Companies that are making decisions with respect to changes to compensation programs will need to consult with their internal finance and accounting teams and external auditors to evaluate the accounting impacts of increasing the use of equity-based compensation.

- A privately-held company should review the availability of relevant securities law exemptions to the extent they are expanding the category of employees who will receive equity beyond the category of employees who have historically received equity compensation. A publicly-held company should confirm there is sufficient capacity under the applicable Form S-8 registration statement.

- A company will need to consider how employees will satisfy tax withholding obligations incurred in connection with stock-based compensation, bearing in mind that not all employees will be willing or able to remit cash to the company in order for the company to satisfy its tax withholding obligations.

- Consider the impact of filing requirements under Section 16(a) of the Securities Exchange Act of 1934 as a result of increased and/or varied types of equity-based compensation.

Adjustments to Length of Performance Periods and Types of Performance Goals

Most companies are facing two different timing issues with respect to managing their current performance-based award programs: (1) with respect to active performance periods for which goals or targets have already been established, deciding whether, and to what extent, the applicable performance goals should be modified or adjusted for the remaining period and (2) with respect to performance periods that commenced or were scheduled to commence in 2020 for which goals or targets have not yet been set, deciding what performance goals and length of performance period(s) will be appropriate going forward.

Key Considerations:

- In designing performance awards for 2020 and beyond, a company should consider implementing shorter performance periods in order to manage the long-term uncertainty of macro and micro conditions going forward. Alternatives to consider may include establishing quarterly performance periods for short-term programs that historically may have been based on a one-year period and/or establishing one-year performance goals for long-term programs that historically may have spanned two or more years.

- With respect to establishing performance goals for 2020 and beyond, a company should focus on performance factors that are not as closely tied to top-line metrics in order to give employees the opportunity to feel like they are working toward goals over which they have control and on which they can have a direct impact.

- For active performance periods, a company should evaluate whether the existing performance targets have become so unachievable that, but for an adjustment, such awards would lose their retentive value going forward. Alternatives to consider in this regard may include adjusting existing performance targets, revising how certain metrics are defined and calculated, and/or substituting existing goals for potentially more appropriate short-term goals.

- In connection with modifying any performance-goals for existing compensation programs, a company should evaluate whether the underlying program or award was intended to qualify for "grandfathering" status with respect to the pre-existing performance-based compensation exemption under Section 162(m) of the Internal Revenue Code.

Dealing with Underwater Stock Options

Given current market conditions, it is likely that employees are holding stock options that are "underwater" or "out-of-the-money". If the decline in equity values continues for a substantial period of time, a company should consider whether existing stock option awards provide sufficient retention value on a go-forward basis. This concern has re-opened the discussion on stock option re-pricing, which for several years has been a tool that many companies have avoided given the negative perception from shareholders and shareholder advisory firms. Given the unprecedented nature of the current market downturn, a company may want to consider all alternatives available to it in order to enhance the retentive value of its stock options going forward. However, a company considering this alternative should carefully weigh the pros and cons associated with option repricings.

Key Considerations:

- Both the NYSE and NASDAQ will consider any stock option repricing a material revision or amendment requiring shareholder approval, unless the applicable equity plan specifically permits repricing of stock options.

- Shareholder advisory firms such as ISS view option re-pricing negatively. Because ISS considers option repricing without shareholder approval a problematic pay practice, it is possible that ISS would issue a negative vote with respect to the company's say-on-pay vote for the applicable year.

- In general, stock options are not subject to Section 409A of the Internal Revenue Code, so long as the stock options meet certain conditions and are not subsequently "modified". A company seeking to re-price a stock option will need to ensure that it is maintaining the same conditions that were originally necessary to exempt the option from Section 409A, including that the new exercise price be at or above the fair market value of the underlying shares on the date of the repricing.

- Option repricings are generally reportable under Section 16(a) of the Securities Exchange Act of 1934.

- As with the other compensation adjustments discussed above, a public company will need to be mindful of the applicable disclosure obligations, and all companies will need to be mindful of the accounting implications associated with stock option repricings.

Overall, boards of directors and compensation committees have wide latitude with respect to how to adjust employee compensation programs in light of the COVID-19 crisis. In order to determine what adjustments, if any, are right for your organization, be sure to consider all of the relevant factors that are at play, including (i) how such adjustments may be perceived by employees, (ii) how such adjustments will be perceived by shareholders and shareholder advisory firms, (iii) the relevant tax and accounting implications, and (iv) any applicable disclosure requirements.

New York	55 Hudson Yards, New York, NY 10001-2163

Manan (Mike) Shah	mdshah@milbank.com	+1 212.530.5501
Joel I. Krasnow	jkrasnow@milbank.com	+1 212.530.5681
Nicholas DeLuca	ndeluca@milbank.com	+1 212.530.5391
James Beebe	jbeebe@milbank.com	+1 212.530.5206
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