Legal Update Article

COVID-19 Emergence Strategies for Companies' Executive Compensation Plans

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Employers that have experienced significant disruptions to their executive compensation programs as a result of the COVID-19 pandemic should consider our top 10 cost saving/incentivization strategies as they begin to reopen.

1. Expand the group of "executives" with whom you seek to "partner."

Policies, programs, and plans affecting "key" executives clearly merit attention, but companies can benefit by applying "skin in the game" and "performance reward" metrics to a broader class of executives and business leaders.

2. Is an employee stock purchase plan (ESPP) for you?

Many employees might want to buy their company's stock now "on the cheap" and may be willing to use a portion of their current salary for the opportunity to do so. The company may consider offering an ESPP, which permits an employee to purchase company stock at a discount of as much as 15 percent.

3. Shift the mix of compensation from mainly base salary to a blend of base salary and performance-based compensation.

The 2010 Dodd-Frank Act ushered in a series of changes in the executive compensation world for public company compensation committees to consider, including rules requiring pay to be aligned with performance. For instance, many public companies now use "TSR" (total shareholder return) over a specified performance period relative to companies in their peer group ("Relative TSR") as a key metric in their bonus and equity/equity-based awards.

Relative TSR would not apply to a private company. However, a private company could shift a portion of base salary to "milestone"-driven performance metrics (*e.g.,* an IPO, a round of private equity investment at a specified level, completion of a key project, or the receipt of a patent).

Milestone-driven performance metrics must be crafted with particular care in the non-profit sector. IRS rules prohibit a non-profit's revenues to be used for private inurement without jeopardizing the tax-favored status of the non-profit.

4. Don't forget the directors, especially non-employee directors of public companies.

Directors, particularly those of public companies, usually receive annual/annualized retainers and equity/equity-based compensation for board and committee membership. Under certain circumstances, non-employee directors can lose the benefit of the state law "business judgment rule," under which their decisions are generally upheld by courts, if they approve their own compensation.

Not being able to rely on the business judgment rule can expose non-employee directors of a public company to shareholder derivative suits alleging self-dealing. Such suits typically seek to have the compensatory payments evaluated, and sometimes clawed back, under the "entire fairness doctrine." This doctrine requires the directors to prove the compensatory payments they have approved for themselves are entirely fair to the shareholders.

Imposing annual/aggregate share limits in equity/equity-based compensation plans in which non-employee directors participate has become a relatively well-accepted strategy to mitigate the risk of losing the benefits of the business judgment rule. The key element of this strategy is obtaining *advance* shareholder approval of such limits, so that annual grants can be deemed made pursuant to shareholder approval.

Carefully evaluating share retention policies — under which public companies require non-employee directors (and executive officers) to have "skin in the game" by maintaining a level of share ownership during their tenure — is another option. Under this strategy, a public company seeks to strike an appropriate balance between the pro-company objective underlying its share retention policy and providing too great a benefit to directors.

5. If the company is publicly traded, reconsider adopting a Securities and Exchange Commission (SEC) Rule 10b-5 plan.

Bad publicity risks, not to mention SEC investigations, about executive officers and other "insiders" cashing their shares before a precipitous drop in stock price or buying large sums of stock before a precipitous increase in stock price can be real problems for public companies and their directors and compensation committees. One way a public company can address these concerns is to adopt an SEC Rule 10b-5 plan. Such a plan works by limiting buy and/or sell transactions by insiders to specified periods during the company's fiscal year.

6. Enlist compensation consultants.

Many companies have been experiencing cash flow issues in light of the COVID-19 pandemic. But a good compensation consultant can save more money and mitigate more litigation risks than might seem apparent at first.

For instance, a non-profit organization that does not have a compensation study done by a high quality (and sometimes costlier) compensation consulting firm can lose the rebuttable presumption that the compensation payable to the executive team is reasonable. Not being able to rebut the presumption would put the executives and the directors at risk of Internal Revenue Code penalties for the receipt and approval for payment, respectively, of "excessive" compensation.

7. Get tax advice from qualified tax counsel.

Every public company, private company, and non-profit organization should consider enlisting tax counsel for advice on the ever-shifting federal, employment, foreign, and state and local tax impacts of, among other decisions:

- Accelerating payments of deferred compensation.
- In LLCs taxed as partnerships, attempting to cash out deferred compensation payable to executives by providing them "guaranteed payments."
- Lowering stock option exercise prices to reflect option grants being underwater.
- Using dated 409A and other equity or equity-based compensation valuations.
- Deferring bonuses and other compensation.
- Changing performance metrics, particularly, making such metrics easier to achieve.
- Extending severance payments to employees who resign without "good reason."
- Selling incentive stock option shares before two years after grant and one year after exercise.
- Changing vesting provisions under Internal Revenue Code Section 457(b) and 457(f)

plans.

- Terminating executive, equity, or deferred compensation plans.

8. Go to the accountants.

Changes in deferred compensation and/or equity/equity-based compensation plans can produce unintended, and sometimes adverse, financial accounting consequences. Companies are well-advised to consult their accountants prior to implementing material changes to these plans.

9. Act now, if you can, then rinse and repeat.

Acting now is best, but these issues are not going away any time soon and typically will require a commitment to a short-term, medium-term, and long-term implementation strategy.

10. Take a deep breath.

Perspective, not panic, is the way to go. Even the seemingly most intractable executive compensation issues, issues that the COVID-19 pandemic has brought to the forefront, can be navigated well with proper planning.

Please contact a Jackson Lewis attorney if you have questions or need guidance with any of these issues.