# Addressing the Coronavirus Impact on Executive Compensation

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This article briefly summarizes the implications of the Coronavirus Aid, Relief, and Economic Security (CARES) Act (Pub. L. No. 116-136) on executive compensation and discusses in more detail certain alternatives available to companies addressing executive compensation decisions in light of the pandemic and the rapidly changing economic environment. The novel coronavirus (COVID-19) pandemic has inflicted significant economic harm and uncertainty for businesses around the world. That uncertainty has prompted many U.S. companies to quickly evaluate potential adjustments to their executive compensation programs in response to dramatically changed circumstances, including with respect to base salaries, annual cash incentive plans, and long-term incentive compensation. In addition, the CARES Act), signed into law on March 27, 2020, introduces additional complexity in the form of limitations on compensation and severance payments for companies that avail themselves of relief under the CARES Act.

## CARES Act Limits on Executive Compensation

The CARES Act is a broad-based, $2 trillion stimulus package that is intended to provide assistance to businesses and workers dealing with the economic effects of COVID-19. Two provisions of the CARES Act impose certain limits on executive compensation paid by businesses that receive loans, loan assistance, or other financial assistance under Title IV of the CARES Act, which provides $500 billion to the U.S. Treasury's Exchange Stabilization Fund. Note that these limits do not apply to companies seeking relief under the Paycheck Protection Program established by Title I of the CARES Act.

### *Eligible Businesses, Generally*

As a condition of receiving a loan or loan guarantee under the CARES Act, an eligible business must agree that it will comply with the following conditions for the period beginning on the date the loan or guarantee agreement is entered into and ending one year after the loan or guarantee is no longer outstanding (the covered period):

- No officer or employee of the business who received aggregate base salary, bonuses, awards of stock, and other financial benefits (total compensation) that exceeded $425,000 in calendar-year 2019 may receive:
    - Total compensation exceeding such calendar-year 2019 compensation over any consecutive 12 months of the covered period –or–
    - Severance benefits exceeding more than two times the individual's calendar-year 2019 total compensation –and–
- No officer or employee of the business who had calendar-year 2019 total compensation that exceeded $3 million may receive during any consecutive 12 months of the covered period total compensation that exceeds the sum of:
    - $3 million –plus–
    - 50% of the excess over $3 million of the individual's calendar-year 2019 total compensation

Pub. L. No. 116-136, § 4004.

***Specific Rule for Air Carriers or Contractors***

Air carriers or contractors receiving other financial relief under the air carrier worker support provisions of CARES Act Title IV, Subpart B, are subject to the same limitations described above, except that the covered period is the two-year period ending on March 24, 2022. Pub. L. No. 116-136, § 4116.

***Planning for CARES Act Limits***

Companies that anticipate seeking assistance under the CARES Act will need to quickly identify which of their employees are subject to the compensation limits in the CARES Act and then determine the aggregate 2019 compensation for each such employee to serve as the baseline. The CARES Act is silent as to whether the value of non-cash benefits like stock awards should be assessed for purposes of the limits at the time of grant or at the time of vesting, which, without additional guidance, may complicate that determination. In addition, the application of the limits is unclear with respect to employees who commenced employment following 2019 or received compensation for only a portion of 2019.

Going forward, these companies will need to implement procedures to track—and limit—compensation paid to covered employees. That process could be tricky in light of the need to apply the limit on a rolling 12-month basis during the covered period. Air carriers receiving both federal loans or loan guarantees and relief under Subpart B may be subject to the longer of the two covered periods. In addition, companies should review existing employment arrangements, which typically address compensation amounts and severance eligibility, in order to identify potential conflicts with the limitations imposed by the CARES Act. Those conflicts should be addressed in connection with seeking assistance under the CARES Act, which may involve amending the employment arrangements or seeking waivers from affected executives.

**Increasing Equity Plan Share Reserves**

Prior to the onset of the pandemic, many public companies were already contemplating not whether, but when, to seek shareholder approval to increase the share reserve under their long-term equity incentive plans. Putting aside concerns regarding favorable recommendations from advisory firms, this is an otherwise routine task. COVID-19 and the resulting economic shutdown has increased the reliance on equity-based compensation as companies move to conserve severely reduced cash flows. At the same time, substantially lower stock prices, brought about by extreme stock market volatility, are expected to further deplete share reserves as a higher number of shares will need to be allocated to make up the promised value of equity awards.

Accordingly, as a result of companies conserving cash and issuing a greater number of shares subject to equity awards, increasing equity plan share reserves will become a greater near-term priority. Companies that have yet to file proxy statements may want to consider adding proposals seeking more shares under equity plans, while companies that have already filed proxy statements should start thinking about the need to include such a proposal in next year's proxy statement.

**Determining Size of Equity Awards**

The recent volatility in the stock market should also prompt companies to revisit their methodologies for calculating the number of shares that will be subject to an equity award. Promises to grant equity awards are often denominated in a dollar value as opposed to a fixed share number, which is then typically converted to a number of shares using a specified price on the date of grant.

Many companies use the closing price, or the average of the high and low prices, of a share on the grant date to determine the number of shares subject to an equity award. However, when the market sees significant swings over a very short time period, a spot price on a given date may not be a reliable indicator of fair market value. In light of

the volatility, companies should consider whether it would be appropriate to shift to using, for example, a volume-weighted average closing price over a period of trading days (e.g., 30 to 90 days) prior to the grant date.

Other methodologies may also be appropriate, but no matter which methodology is chosen, it should be documented in the minutes or resolutions of the compensation committee and consistently applied to awards that are made at the same time to similarly situated employees. It is worth noting that the value of stock awards issued to named executive officers as reported in the summary compensation table of the proxy statement is typically calculated based on the closing price on the grant date and, accordingly, the reported grant-date fair value may vary from the intended grant-date fair value based on the selected methodology. Companies should consider including a clarifying footnote to the summary compensation table in order to address any discrepancy.

## Stock Option Repricing

Stock options that were granted prior to the onset of the pandemic and resulting economic turmoil may now be subject to a per-share exercise price that is substantially higher than the current fair market value (often referred to as underwater), and such options could remain underwater for an indefinite period of time in light of current market conditions.

Underwater options have little value as an incentive or retention tool and companies may wish to consider the feasibility of resetting the exercise price of stock options to current fair market value. Alternatively, companies may consider cancelling underwater options in exchange for new forms of equity awards. However, stock-option repricing programs are by no means straightforward and are subject to certain restrictions imposed by the stock exchanges. Repricing is also generally prohibited under the terms of public company equity plans, absent shareholder approval. Companies contemplating such an action should review and understand any such limitations.

## Performance Goals: Annual and Long-Term Incentives

The COVID-19 pandemic has also affected the ability to set performance goals for short- and long-term incentive programs and has called into question the viability of goals that were set at the beginning of the year, prior to the onset of the pandemic. In general, companies have been taking a wait-and-see approach rather than rushing to change (or set) performance goals in light of the current economic uncertainty.

### *Increased Flexibility Post-162(m)*

The repeal of the performance-based compensation exception to the limits on deductibility under I.R.C. § 162(m) has afforded companies greater flexibility in the goal-setting and payout-determination process. In general, performance goals are no longer required to be set within the first 90 days of a performance period, and companies may make in-cycle or post-cycle adjustments to performance goals and payouts without worrying about jeopardizing the deductibility of the compensation, since all compensation paid to a covered employee is now subject to a $1 million annual deductibility limit.

### *Considerations for Short-Term Incentive Programs*

Many companies that operate on a calendar-year fiscal year have already set, or were about to set when the pandemic began, their 2020 performance metrics and goals. In either case, companies should exercise caution in setting or adjusting any goals until there is better visibility into the longer-term impact of the pandemic on the economy and on particular industries or business segments. Waiting to set or adjust goals should also lessen the likelihood that multiple adjustments may be needed if the adjustment is done prematurely.

In addition, even if a company has set its 2020 annual incentive goals and ultimately makes no changes mid-cycle, the compensation committee typically would have the ability to make adjustments on the back end to exclude the estimated and unforeseen impact of COVID-19 as part of the payout-determination process. Companies should review their short-term incentive plans to understand the ability to make any necessary adjustments.

### *Considerations for Long-Term Incentive Programs*

For the same reasons mentioned above, companies should avoid premature changes to the metrics underlying multiyear performance-based awards that were granted prior to the COVID-19 pandemic. This is especially important for equity awards, which may see incremental increases in grant-date fair value for accounting purposes as a result of any adjustments that would then have to be reported in the proxy statement. While it is near certain that many companies will have to make adjustments, companies should consider delaying any such adjustments until the dust has settled and avoid making multiple rounds of adjustments before the performance period has run its course.

## Reducing Base Salaries

Many companies are considering, and some have already implemented, across-the-board, temporary base-salary reductions for top-level executives, particularly in industries that have been hardest hit by the economic shutdown as a result of COVID-19. In addition, a voluntary reduction in base salary applicable to a company's management team would demonstrate personal alignment with broader organizational pressures that may be causing employee furloughs, temporary or permanent layoffs, and diminished returns for investors.

How much flexibility companies have to make such salary adjustments depends on several factors, including the presence of contractual protections for their executives under employment agreements or severance arrangements, which typically provide for the ability to resign for "good reason" and receive severance in the event of material reductions to base salary. Companies considering such base-salary reductions should carefully review employment and severance arrangements with legal counsel to understand these implications. To the extent that a company has such an agreement in place with an executive, affirmative consent to the reduction should be obtained in advance, and the parameters of the reduction (amount and expected duration) should be clearly communicated to, and agreed to by, the executive.

## Related Content

### *Practice Notes*

- Coronavirus (COVID-19) Resource Kit
- Equity Compensation Plan Design for Public Companies
- Equity Compensation Plan Design for Private Companies
- Equity Incentive Plan Resource Kit
- Executive Employment Agreement Negotiation and Drafting (Pro-employer)
- Executive Employment Agreement Resource Kit
- Section 409A Fundamentals
- Section 409A Resource Kit

### *Articles*

- COVID-19 Executive Compensation Q&A: Focus on Incentive Plans and Nonqualified Deferred Compensation
- Adapting Executive Pay Decisions To COVID-19 Impact

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