Goodwin Alerts
April 15, 2020

Key Considerations for U.S. Public Company Compensation Committees in Light of COVID-19

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As the COVID-19 pandemic continues to unfold, U.S. public company compensation committees face unique challenges as they focus on retaining and appropriately incentivizing employees while evaluating the impact of the pandemic on the company. This client alert provides a high-level overview of some key issues that compensation committees should be focusing on in this environment.

1. PERFORMANCE METRICS FOR BONUS PLANS AND EQUITY GRANTS

Delaying Metric Setting

Given the uncertainty in the market as a result of the COVID-19 pandemic, many companies are reevaluating their operating plans and business projections. This can make it challenging for some companies to set reasonable performance metrics for compensation purposes.

Many calendar year-end companies have already set performance metrics and targets for 2020. For any companies that have not, compensation committees should consider whether it would be preferable to delay setting performance metrics until later in the year, or at least until after the company has determined the likely impact of the pandemic on the company's business. Some performance plans mandate that metrics be set within the first 90 days of a performance cycle – this is a provision that was required under legacy Internal Revenue Code ("Code") Section 162(m) rules that are no longer applicable in most cases. However, the 90-day requirement remains in many plans. If the performance plan does not have a 90-day requirement, or if there is an alternative way to award performance bonuses or equity grants, a delay would be more feasible.

If a compensation committee decides to delay setting performance metrics, we recommend setting the metrics before the end of the second quarter of the year, in order to ensure that the achievement of metrics is still substantially uncertain at the time they are set. Alternatively, if the company's bonus plan provides for the flexibility, compensation committees could consider setting a shorter performance period (*e.g.*, dividing the year into two six-month performance periods) in order to better determine rational metrics and targets.

Some compensation committees may want to consider restructuring incentive plans altogether to include new or different metrics that may be less impacted by the pandemic (such as relative, rather than absolute, metrics and non-financial metrics), to include more subjective performance metrics, or to include more discretion in the performance plans. In considering these alternatives, compensation committees should factor in the reaction of investors and proxy advisory firms and the future impact on the company's say on pay proposals.

Addressing Existing Performance Metrics

For companies that have already set 2020 performance metrics for bonus plans or performance equity grants, or for companies that have multi-year plans, the previously set metrics or targets may no longer seem relevant in light of the unforeseen pandemic and resulting economic impact. Compensation committees may have concerns about keeping a company's management team focused on the right goals in light of the irrelevance of previously set targets. Absent extenuating circumstances, we recommend compensation committees avoid resetting metrics at this time. The economic impact of the pandemic is still uncertain and most companies are not able to predict the impact on their business outlook. A better course of action may be to wait until the end of the performance period and make an informed decision at that time. In the meantime, compensation

committees should be discussing possible courses of action in the event that performance metrics are unattainable. For example, given the overall business performance, it could be the case that bonuses will not be paid and performance grants may be forfeited. In such event, the compensation committee should identify any retention risks. Alternatively, some compensation committees may determine it appropriate or necessary to pay discretionary bonuses or award retention equity grants. Any such decision should factor in the response of shareholders and proxy advisory firms as well as the potential impact of using discretion on grandfathered Code Section 162(m) performance awards.

On April 8, 2020, Institutional Shareholder Services ("ISS") published its *Impacts of the COVID-19 Pandemic Policy Guidance* ("ISS COVID-19 Guidance"). In this guidance, ISS encouraged companies who make adjustments to performance metrics to provide contemporaneous disclosure to shareholders explaining the rationale for such changes and reiterated that ISS is generally not supportive of mid-cycle changes in performance metrics applicable to multi-year long-term incentive awards but will evaluate such adjustments on a case-by-case basis to determine whether directors exercised appropriate discretion and provided adequate justification for the changes.

2. SUCCESSION PLANNING

Some compensation committees are responsible for executive succession planning, while sometimes this is within the domain of another committee. Compensation committees that are involved in succession planning should ensure that there is a clear plan in the event that the company's chief executive officer, or another senior executive, becomes severely ill or is otherwise unable to work. Compensation committees should deliberate with the chief executive officer to discuss succession planning for his or her direct reports. Once a succession plan is formulated, compensation committees should communicate with the full board. If part of the succession plan includes having a board member step into a management role, the compensation committee should understand the impact on that director's potential loss of independence status going forward if he or she actually takes on a management role.

3. STOCK OPTION REPRICING

Given recent market declines in response to the global pandemic, compensation committees may be considering repricing stock options. Absent other factors, we recommend that compensation committees wait to see how the COVID-19 situation develops and whether markets rebound before seriously considering moving forward with an option repricing program. The following considerations should be evaluated in determining whether to proceed and how any repricing will be structured:

- ***Shareholder Approval*** – The listing rules of the NYSE and Nasdaq require shareholder approval for any material amendment to an equity compensation program, including a stock option repricing, unless a company's option plan expressly permits repricing without shareholder approval.Shareholder approval is not required under NYSE or Nasdaq listing rules for a purchase of underwater stock options for cash.Nonetheless, many stock option plans prohibit the cancellation of underwater stock options in exchange for cash without shareholder approval because proxy advisory firms consider permitting such an exchange without shareholder approval to be a "problematic pay practice," which can result in "against" or "withhold" recommendations on compensation committee members (or the full board) and an "against" recommendation on the company's say on pay vote.

- ***Shareholder and Proxy Advisory Firm Support*** – Compensation committees should assess whether institutional shareholder and proxy advisory firm support is necessary to obtain shareholder approval of a repricing program. Institutional shareholders and proxy advisory firms such as ISS and Glass Lewis generally view stock option repricings negatively but may support a repricing proposal if it complies with strict guidelines, including that:

- It must occur only where the stock price decline was beyond management's control and only after a sustained stock price dip;
- It must be a value-for-value exchange (as discussed further below);
- Directors and executive officers must be excluded (as directed further below);
- Additional vesting terms must be imposed on replacement awards; and
- It must require that shares subject to reacquired options be retired and not be added to the option plan share reserve.

In the recently published ISS COVID-19 Guidance, ISS noted that it believes that its historical approach to repricings continues to be appropriate during the COVID-19 pandemic.

- ***Participating Option Holders*** – Institutional investors and proxy advisory firms generally will not support a repricing where directors and executive officers are eligible to participate. However, excluding directors and executive officer from participating in the repricing program may undermine the retention and motivation aims of the program.

- ***Repricing Method*** – Shareholders and proxy advisory firms will generally only support an option repricing program where the value of the replacement awards is equal to, or less than, the value of the underwater options being cancelled (*i.e.*, is value-neutral or value-creative for shareholders).

- ***Tender Offer Rules*** – Value-for-value exchanges generally require compliance with tender offer rules, including a minimum offering period and disclosure requirements (including filing a Schedule TO with the SEC).

- ***SEC Disclosures*** – Where shareholder approval is required, it must be sought at the annual meeting of shareholders, or at a special shareholder meeting.A proxy statement for the annual shareholder meeting must be filed with the SEC describing the program, including the terms of the repricing, disclosures relating to officers and directors (if eligible to participate), the reasons for undertaking the program and any alternatives considered.In addition, due to lack of clarity regarding whether a preliminary proxy statement is required for approval of a stock option repricing, we recommend filing a preliminary proxy statement, which must be filed at least 10 business days before the definitive proxy statement is sent or provided to shareholders. Disclosure may also be required in the annual meeting proxy statement filed the following year if directors and officers participate.

- ***Accounting and Tax Consequences*** – Repricing may result in an accounting charge.There may also be tax consequences under Code Sections 162(m) and 409A and incentive stock option rules that should be evaluated with the company’s legal, tax and accounting advisors.

- ***Inadvertent Option Repricings –*** Compensation committees should be mindful of situations that could give rise to an inadvertent option repricing in the event that an option holder forfeits underwater options, such as when a chief executive officers surrenders an underwater option in order to free up additional shares for employee equity grants.If a new equity award is made to the individual who forfeited the underwater option, even if not an overt quid pro quo, the arrangement could be deemed an option repricing for accounting and stock exchange listing rule purposes.This could expose the company to shareholder criticism, listing violations and disclosure implications.Compensation committees should consult with legal and accounting advisers if optionees are considering surrendering underwater options under any circumstances.

In sum, there are complex considerations that must be carefully evaluated before proceeding with an option repricing program.

4. COMPENSATION REDUCTIONS/RESTRUCTURINGS AND NONQUALIFIED DEFERRED COMPENSATION PLANS

Compensation committees may be considering taking measures to conserve cash, including salary reductions, awarding cash in lieu of equity and deferred compensation arrangements, and may need to be more creative and flexible in their approach to compensation as the impacts of the COVID-19 pandemic continue to come to light.

Base Salary Reductions

Compensation committees may consider reducing executive base salaries or implementing broad-based salary reduction programs, particularly where the company is also engaging in furloughs and layoffs, and in light of diminished returns for shareholders. Such a reduction may demonstrate personal alignment with broader organizational pressures and shareholders. Generally, an employer is not prohibited from reducing the base salary of an "at will" employee (as opposed to an employee who is party to an employment agreement, which is discussed further below). However, there are several considerations that must be taken into account.

There are implications of a pay reduction under most state wage laws. Please see our Client Alert entitled "Top 10 Compensation and Benefits Issues for Employers in Light of the COVID-19 Pandemic" for a description of some of these considerations. In addition, an employer should take into account the effect that a salary reduction will have on other compensation programs in which an employee participates, such as incentive or bonus arrangements, and on state unemployment insurance benefits.

For employees who are party to an employment or severance agreement with the company, the compensation committee should review such agreements with legal counsel to determine whether: (1) the terms of the agreement require the employee to consent to the salary reduction, (2) "good reason" termination conditions are triggered and (3) there is an impact on severance payments and benefits. For example, if the company maintains a severance plan with a formula tied to base salary, the compensation committee should consider how a reduction in base pay impacts the severance amount. Compensation committees may choose to revise the severance formula to provide a payout tied to the higher of a fixed amount (e.g., historic base salary) or current base pay.

Companies may consider deferring compensation and paying it out at a later date. However, unless properly structured (for example, through the implementation of a nonqualified deferred compensation plan as discussed below), deferred compensation arrangements will likely result in significant adverse tax consequences to the employee under Code Section 409A and the recognition of phantom income by the employee (resulting in tax liability prior to an employee's receipt of the compensation) under the constructive receipt doctrine. To avoid such tax consequences and issues under state wage laws, potentially resulting in enhanced damages and personal liability for individual officers of the employer, salary reductions should generally be structured as temporary or permanent reductions without any binding commitment to provide a make-whole payment at a future date.

Compensation committees may consider providing executives, either concurrently with or following a salary reduction, the opportunity to receive a cash bonus in connection with the occurrence of a future event or a company performance target. These arrangements should be structured with advice from legal counsel to be exempt from, or compliant with, Code Section 409A.

Shifting Cash Compensation to Equity Compensation

In order to conserve cash, compensation committees may consider awarding equity in lieu of cash compensation. Equity awards are often good retention tools following salary reductions. However, care should be taken to ensure that such awards are not deemed to replace any previously earned or unpaid base salary

amounts in order to avoid Code Section 409A tax penalties. If a company has a cash bonus plan in place, the compensation committee should review the plan to determine whether the plan provides flexibility to pay cash bonuses in equity and may want to consider modifying bonus plans to provide for such flexibility in the future. Finally, compensation committees should ensure that there is an adequate reserve in the company's equity compensation share pool to make such awards and consider the dilutive impact of issuing a substantial number of equity awards at significantly depressed values.

Nonqualified Deferred Compensation Plans

Compensation committees may consider implementing a nonqualified deferred compensation plan whereby employees may elect to defer payment of income earned in one calendar year until a later date. Such plans should be designed in consultation with legal counsel to be compliant with Code Section 409A. Nonqualified deferred compensation plans can provide the opportunity for the company to conserve cash since it is not being paid out currently; however, company assets may need to be set aside into a rabbi trust and will not be deductible to the company until actually paid. In addition, amounts set aside under in a rabbi trust must remain subject to the claims of the company's creditors, so could create an unforeseen risk for plan participants under certain circumstances.

Director Compensation

Compensation committees may consider shifting director compensation cash fee retainers to payments in equity grants. They may do so by requiring director compensation to be made in the form of equity or by offering directors the choice to receive their cash retainers in equity. Care should be taken to ensure that any such shift in the form of compensation will not result in adverse tax consequences under Code Section 409A or constructive receipt issues.

Small Business Administration Payroll Loan Qualifications

Under the Paycheck Protection Loan Program (the "PPL Program"), an emergency loan program created by the CARES Act, certain small businesses may be eligible to receive forgivable loans to help meet their payroll and day-to-day operating expenses. The Small Business Administration will forgive the portion of the loan used for qualifying expenses, provided that at least 75% of the loan proceeds are used for payroll costs. Payroll costs are capped at $100,000 on an annualized basis for each employee. Additionally, certain salary reductions could prevent the loan from ultimately being forgiven under the PPL Program unless restored by June 30, 2020. Please see our Client Alert entitled "Labor Cost Reduction Options for Employers in a Distressed Economy: The CARES Act and Other Considerations," for more details, including regarding the PPL Program.

5. DISCLOSURE IMPLICATIONS

Certain compensation changes will trigger disclosure and SEC filing requirements that need to be closely monitored to ensure compliance and provide clear communication to investors. As compensation decisions evolve, members of the compensation committee should keep the following key disclosure considerations at the forefront:

- ***Current Reports on Form 8-K*** – Material mid-year compensation modifications could trigger Item 5.02 current report disclosure on Form 8-K if either the discretion to make the modification or the modification itself have not been disclosed in previous filing. Modifications not expressly permitted by the terms of the plan or award may also trigger an Item 5.02 disclosure. Companies should work with legal counsel to assess whether a compensation adjustments will trigger Form 8-K disclosure. If Form 8-K disclosure is required, companies may want to consider the timing of such changes and should also consider recent guidance from ISS encouraging companies who make changes to performance metrics to provide

contemporaneous disclosure to shareholders.

- ***Following Year Proxy Disclosure*** – As compensation committees weigh whether and how to revise their executive compensation program, careful consideration should be applied to how these changes will impact required compensation tables and the compensation discussion and analysis section of next year's proxy statement. Modified or additional retention equity awards could result in substantial additional reported compensation for 2020. Shifting from a formulaic, performance-based cash bonus program to a discretionary cash bonus program will impact summary compensation table disclosure in a manner that ordinarily may be viewed unfavorably by investors and proxy advisory firms. Clear disclosure detailing any such changes, the reasons for them and how they conform to the standards enumerated in a company's compensation philosophy will be key. Compensation reduction programs (and any return to normal compensation levels) and any mid-year modifications or discretionary grants will need to be described. Companies should provide details on the following:

  - The economic impact of COVID-19 and how it necessitated a change to compensation, including base salary and incentive plans or awards;
  - Why any performance metrics were amended;
  - Why the new metrics are appropriate and demonstrate pay for performance; and
  - How the new metrics maintain a consistent level of difficulty in attainment of the new targets as compared to previous targets.

- ***Insider Filings*** – The global impact of COVID-19 on financial markets has ushered in a period of heightened SEC scrutiny on insider trading, which will invariably highlight insider filings. Companies should work closely with their legal counsel to ensure that any new grants are properly and timely reported on Form 4 and to determine whether amendments to awards will require new filings. More broadly, companies should be aware that even relatively routine trading activities by insiders relating to equity compensation, such as sales to fund tax withholding payments or the exercise of stock options, may result in heightened scrutiny due to the global impact of COVID-19 on financial markets. Companies should be thoughtful in planning and preparing for these activities, including through the use of instructions provided in advance in accordance with Rule 10b5-1 at a time when the company has recently disclosed all material non-public information to the public.

Goodwin serves as legal counsel to many public company compensation committees. We regularly partner with our clients to address challenges, including the unique uncertainties arising as a result of the COVID-19 pandemic. If you would like to discuss any of the topics covered by this Alert, please reach out to Alex Denniston, Lynda Galligan, or any other member of Goodwin's ERISA + Executive Compensation practice.

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Please visit Goodwin's Coronavirus Knowledge Center, where lawyers from across Goodwin are issuing new guidance and insights to help clients fully understand and assess the ramifications of COVID-19 and navigate the potential effects of the outbreak on their businesses.

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