Key Compensation Considerations for Public Companies in a Market Downturn

As a result of recent market trends, US public companies and their compensation committees face challenging decisions as they seek to maximize shareholder value while retaining and competitively incentivizing key employees. This insight highlights some of the key considerations that US-based public companies and their compensation committees should consider in this environment.

1. Impact on Performance-Based Compensation Arrangements

Compensation committees may have concerns about keeping a company's management team focused on the right goals where previously established performance targets are no longer relevant. Compensation committees should discuss possible courses of action in the event that performance metrics are unattainable, resulting in unpaid bonuses and forfeited performance grants. Consideration should be given to whether the terms of the existing compensation agreements provide flexibility to make adjustments and, if so, under what circumstances any such adjustments should be made. Note that whether an adjustment may be warranted also depends on the nature of the performance goals. Some metrics, such as share price or EBITDA, may be more obvious candidates for adjustment in contrast with comparative metrics, such as relative TSR, which may not need to be adjusted if peer group companies are being similarly affected.

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2. Discretion Considerations for Performance-Based Awards

Compensation committees may determine it appropriate or necessary to pay discretionary bonuses or award retention equity grants due to existing awards not achieving required performance goals. 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. When setting performance goals for new incentive compensation, companies should consider how the market downturn will affect the future achievement of such performance goals. Setting performance metrics with a view toward appropriate achievability in a variable economy may minimize the need for discretion in the future.

3. Stock Option Repricing

Companies that grant stock option awards to employees, particularly if such awards represent a significant portion of employees' total compensation, may consider an option repricing program. There are complex considerations that must be carefully evaluated before proceeding with an option repricing program. Please see our insight "Public Companies: Time to Consider Repricing Underwater Stock Options?" for a detailed discussion of such considerations.

4. Equity Plan Share Reserve and Denomination of Awards in Dollars or Shares

Consider how a drop in stock price could affect the share reserve in the company's equity plan, particularly if equity grants are denominated in dollars, and consider obtaining shareholder approval of a share reserve increase sooner rather than later as awards designated in dollars may require more shares to provide the same value. A drop in stock price raises similar considerations for the company's employee stock purchase plan, leading companies to consider implementing limits on the number of shares that can be purchased in the aggregate or on a per-participant basis in an offering period if it is anticipated that existing limits may result in an unacceptable level of dilution.

As proxy advisory firms have continued to focus on alignment between company performance and executive compensation, many public companies have moved toward providing a greater portion of their executives' compensation in the form of performance-based cash or equity awards. It is common for cash awards to be earned on an annual basis, while equity awards may be earned over a multi-year period. If any equity grants are denominated in shares instead of dollars (e.g., director grants), consider changing them to dollar amounts to retain the same value. Alternatively, awards designated in dollars may require significantly more shares to provide the same value and may result in an unacceptable level of dilution.

5. Compensation Reductions/ Restructurings and Nonqualified Deferred Compensation Plans

In light of diminished returns for shareholders, compensation committees may consider reducing executive base salaries or implementing broad-based salary reduction programs, particularly where the company is contemplating furloughs and layoffs. Such a reduction demonstrates alignment with broader organizational pressures and shareholder interests. 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 including implications of a pay reduction under most state wage laws, which should be discussed with the company's labor and employment counsel.

Companies may also consider deferring compensation and paying it out at a later date. However, unless properly structured, deferred compensation arrangements will likely result in significant adverse tax consequences to the employee under Section 409A of the Internal Revenue Code of 1986, as amended (Section 409A) and the recognition of phantom income by the employee (resulting in tax liability prior to an employee's receipt of such compensation). To avoid such tax consequences and issues under state wage laws, which would potentially result in enhanced damages and personal liability for individual officers of the company, 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 also consider implementing a nonqualified deferred compensation plan (NQDC plan) whereby employees 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 Section 409A. NQDC 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 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.

Additionally, any public companies that sponsor a NQDC plan while it or any member of its "controlled group" simultaneously sponsors a Title IV single employer defined benefit pension plan could be restricted when maintaining the NQDC plan. The company may not set aside monies into a rabbi trust or other funding arrangement to pay deferred compensation to certain applicable "covered employees" during a restricted period or the transfer will trigger a Section 409A violation (e.g., while the defined benefit plan is in "at-risk" status, while the employer is a debtor in a Chapter 11 bankruptcy, or during the 12-month period that begins six months before the termination of the defined benefit pension plan if that plan is not adequately funded for its liabilities upon plan termination). Such a violation would make the amounts immediately taxable to the applicable covered employees and subject to an additional 20% tax and penalties.

6. Compensation Reductions and Existing Employment and Severance Agreements

For an employee who is party to an employment agreement with the company, there are additional considerations and impacts of implementing a salary reduction arrangement. First, virtually all employment agreements require the employee to consent to a modification of the employment agreement, so a reduction may not be implemented unilaterally. Second, if an employment agreement has a "good reason" termination definition that includes salary reduction as a triggering event, then the employee may have a right to resign and receive severance pay unless the parties agree otherwise. The company should review existing employment and severance agreements to understand what the severance levels are, whether there is consistency among similarly situated employees, and how the "good reason" definitions would work in an economic downturn (e.g., in the event of an across-the-board reduction in salaries).

7. Key Disclosure Implications

Material compensation modifications could trigger reporting obligations, including reporting on Form 8-K and/or in the company's next proxy statement. Companies will want to consider the timing of such changes and how institutional investors might view any such modifications. 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.

8. Plan Fiduciary Considerations

Plan fiduciaries should review benefit plan investments and investment policies. Any decision-making should be documented by the plan committee, and fiduciaries should consider working with their plan investment advisors to determine whether any changes to the plan's investment line-up or investment policy should be implemented. Any changes that were in-process prior to the downturn may need to be revisited. Plan sponsors should also be monitoring recordkeepers and other service providers.

9. Other Benefit Implications

Companies may be considering changes to qualified benefit plans (e.g., whether to suspend or eliminate company matching or profit sharing contributions to defined contribution retirement plans) and benefits continuation issues during layoffs and other leaves of absence (e.g., Section 125 plan election changes, unintended full vesting of participant accounts due to partial plan termination). Please see our insight titled, "Benefit Plan Considerations for Employers in a Market Downturn" for a description of some of these considerations. Additionally, employers should consider the economic impact that the market downturn may have on the funded status of certain defined benefit pension plans.

Contact Us

If you would like to discuss any of the topics covered in this insight, please reach out to Crescent Chasteen Moran, Adrean S. Williams, or any other member of Goodwin's ERISA & Executive Compensation practice.

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