Client Alert

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Current Executive Compensation Considerations Resulting from Market Volatility and the Unknown

Today's economic environment has resulted in substantial loss of value to many shareholders and executives of publicly traded companies (i.e., the latter losing substantial value in their stock holdings and, too, losing prospective realizable pay as a result of unattainable performance goals within their outstanding performance-based awards). In most situations, the shareholders and the executives are aligned in such loss. But the problem is that substantial loss at the executive level could increase undesired poaching and turnover of key executives at a time when executives should be focused on navigating the company through a reopening of the United States economy. To overcome this problem, compensation committees of publicly traded companies (Compensation Committees) will likely need to consider adjustments to the company's compensation framework in order to continue to incent and retain executives. To that end, this article provides a list of thoughts on compensation issues for Compensation Committees to consider.

Consider Retention Packages to Address Depressed Realizable Pay Levels

Executives are likely suffering from depressed realizable pay levels since a higher percentage of total compensation is weighted towards annual cash-based performance awards and long-term equity compensation. And too, Compensation Committees will want to discourage poaching of their executives by other companies. As a result, Compensation Committees should consider the need for a retention package or entering into specially formulated performance bonuses for the remainder of 2020. Related thoughts include:

- Consider the time horizon for the retention bonus, including whether after the specified performance period the payment should be made in a lump sum or in installments.

- Consider using a broader range of performance measures and include more qualitative and individual criteria. And consider structuring goals that are relative to the company's peer group since it otherwise will be difficult to establish meaningful performance goals given the current environment.

Consider Addressing Outstanding Performance-Based Equity Awards

Many outstanding performance-based equity awards have currently unachievable performance goals. This issue is exacerbated because most long-term equity awards cover a three-year performance period (i.e., such outstanding awards were granted in 2017, 2018, 2019 and early 2020). Compensation Committees should consider whether it makes sense to amend such outstanding awards by replacing or revising ill-performing performance goals. Some of the alternatives that Compensation Committees could consider include (listed in no particular order):

- Approach No. 1 – Wait and See. Some Compensation Committees will wait until later in the fiscal year and determine at that time whether it makes sense to apply positive discretion to waive outstanding performance conditions. Whether this approach is sufficient to incentivize and retain

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the executives will depend on whether trust exists between the executives and the Compensation Committee. Risk exists where there is a lack of trust because, if the executive does not believe positive action will take place in the future, then the executive might leave for a better economic opportunity. And too, this approach is only permissible if the equity incentive plan and outstanding performance awards do not contain terms that would limit such future discretion by the Compensation Committee.[1]

- Approach No. 2 – Maintain the Outstanding Award and Grant a New Award. Many companies will have a problem adopting this Approach No. 2 because they have substantially constrained share reserves in their shareholder-approved equity incentive plan. For such companies, the Compensation Committee could partially adopt this Approach No. 2 by having it apply only with respect to outstanding awards that will soon expire, or alternatively, such companies could structure the new award to be settled in cash. And too, this Approach No. 2 could be adopted by those companies with a large available share reserve in their equity incentive plan.

- Approach No. 3 – Replace Performance Goals of Outstanding Awards. Outstanding performance awards could be amended by replacing ill-performing performance goals with new performance goals. The considerations to this Approach No. 3 include:

  - *Background.*

    - Accounting Considerations. This approach should not be implemented without first verifying the accounting consequences. As a gross over-simplification, the company will likely recognize incremental compensation expense based on the fair value of the modified award.

    - SEC Tender Offer Rules. Check with legal counsel on whether the contemplated amendment would trigger the SEC's tender offer rules (which are generally triggered whenever a holder of a security is being asked to make an "investment decision"). Important to this analysis is whether the terms of the outstanding award require the executive's consent before the Compensation Committee could effectuate the amendment (e.g., an investment decision is likely triggered if consent of the executive is required).

  - *Some of the Doable Alternatives within Approach No. 3*. Any of the following are doable alternatives that would not require an "investment decision" of, or consent from, the executive (listed in no particular order):

    - Eliminate Absolute Modifiers to Outstanding Relative TSR Awards. Eliminate absolute modifiers within outstanding relative total shareholder return (TSR) awards (i.e., awards that compare the stock price of the company to the stock price of its peer group). As background, past best practices would require a downward adjustment to a relative TSR award if the absolute return to the company's shareholders was negative over the performance period (a.k.a., an absolute modifier). The Compensation Committee could amend such an award to eliminate any absolute modifier and such amendment would typically not require

[1] The ability of the Compensation Committee to apply positive discretion is a relatively new concept. As background, prior to the Tax Cuts and Jobs Act that was approved by Congress on December 22, 2017, retaining positive discretion to adjust performance metrics was not permitted in instances where the award was designed to comply with the "performance-based exception" to the $1 million deduction limitation under Section 162(m) of the Internal Revenue Code of 1986, as amended (Section 162(m)). And too, a number of companies hard wired certain Section 162(m) governance provisions into their shareholder-approved equity incentive plan, including the prohibition on retaining positive discretion, for all equity awards regardless of whether the Section 162(m) deduction limitation was implicated. For these companies with hard-wired provisions, the Compensation Committee could be prohibited by the terms of the equity incentive plan from applying future positive discretion. For that reason, equity incentive plans and outstanding equity awards should be reviewed before adopting the wait-and-see concept in Approach No. 1.

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the executive's consent. But to provide a contrasting example, amending an absolute TSR return to become a relative TSR formula would likely require consent of the executive.

- Kick-the-Can Forward by Adding Another Year to the Performance Period. The Compensation Committee could amend the outstanding performance award by extending the performance period by another year (or months) to the extent that the performance goals are not achieved during the initial performance period, resulting in the executive's having more time within which to satisfy the performance goals (e.g., if the outstanding award has a performance period of three years and the performance goals are not met by the conclusion of such three-year period, the Compensation Committee could amend such award to have a performance period of four years). However, this alternative is more applicable to outstanding awards where the performance period will expire soon, because, for outstanding awards with two or three years remaining within the performance period, a wait-and-see approach is more shareholder friendly.

- Add a New Performance Goal to Outstanding Performance Goals and Provide Executive with the "Better of" the Two. The Compensation Committee could amend the outstanding performance award by adding a new performance goal to the preexisting performance goals, and provide in such amendment that the executive would receive a payout based on the "better of" the two performance goals. Typically, such amendment would not require consent of the executive.

Considerations with Respect to Upcoming Grants

The following are some thoughts for Compensation Committees to consider with respect to upcoming equity grants.

- Due to Low Stock Prices, Reconsider the Formula Associated with Grants of Equity that are Initially Denominated in Dollars. As background, it is common for Compensation Committees to first denominate equity awards as a dollar amount and then convert that dollar amount into shares (i.e., the company could have a practice or a contractual requirement that annual grants of equity awards be equal to 45 percent of the executive's base salary). Such is commonly referred to as a "value-based grant." Typically, a value-based grant requires a conversion from dollars to equity pursuant to a formula, with: (i) full-value awards being converted on a dollar-for-dollar basis with respect to the stock price on the date of grant; and (ii) stock options and performance-based awards being converted pursuant to a Black-Scholes formula or Monte Carlo simulation. For example:

  > Assume the company's stock price is trading at $1.00 per share, the executive has a base salary of $100, and a contractual requirement exists that the executive will receive an annual equity grant equal to 45% of his or her base salary. In this example, an award of restricted stock with a time-based vesting schedule would result with the executive receiving an award covering 45 shares. In comparison, a Monte Carlo simulation would be used to convert dollars into an RSU containing a relative TSR performance schedule, and the result is that the executive would receive an award covering more than 45 shares. And a Black-Scholes formula would be used to convert dollars into a stock option containing a time-based vesting schedule, resulting with the executive receiving a stock option covering more than 45 shares.

  Due to depressed stock prices in today's economy, there is a concern that value-based equity grant practices will result with executives' receiving too many shares, which could cause a

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windfall to the executive if the company's stock price were to increase as the economy rebounds. This type of assertion can be defended if the company has an annual grant policy (either a formal document or an operational practice of consistently effectuating equity grants at the same time each year). To combat such assertions, the Compensation Committee alternatives include (listed in no particular order):

- *Approach No. 1 – Delay Grants*. The Compensation Committee could delay the timing of the equity grants until a later time when more facts regarding the company's stock price become known. Before adopting this position, care should be taken to address any contractual requirements that equity grants occur within certain time periods (e.g., an executive has a provision in his or her employment agreement that requires equity grants to occur within the 10-day period immediately following the annual shareholder meeting).

- *Approach No. 2 – Convert Using a Trailing Average Stock Price*. Assuming no contractual requirement to the contrary, and in order to apply a smoothing effect to the recent drop in stock price, the Compensation Committee could effectuate the conversion of dollars into shares using a trailing average stock price (e.g., six months, twelve months). And use of a trailing average stock price would also be permitted with respect to converting dollars into stock options (though once the number of shares are known pursuant to the conversion, the exercise price cannot be based on more than a 30-day average).

- *Approach No. 3 – Convert Using Some Other Formula*. Assuming no contractual requirement to the contrary, any formula could be used by the Compensation Committee. The simple goal is to ensure that the chosen formula can be communicated to, and deemed fair by, the executives.

- Save Money, Time and Expense by Avoiding Future Underwater Stock Options. Underwater outstanding stock options (i.e., the exercise price is greater than the fair market value of the underlying stock) are a problem because they strain the share reserve of the equity incentive plan and provide minimal to no retention value to the optionee. And any repricing of underwater stock options to lower the exercise price, for example, to today's fair market value of the underlying stock is expensive (due to compliance with the SEC's tender offer rules), creates negative shareholder disclosure (i.e., why should optionees get a reset when the shareholders did not receive a reset) and requires shareholder approval in most instances.[2]

    - *Possible Solution to Consider*. To avoid future underwater stock options, any new grants could have an automatic forfeiture provision within the vesting schedule of the option award agreement. In concept, the automatic forfeiture provision would be structured such that, if the stock price ever falls by $X.00 or an amount based on a certain formula, then the stock option (both vested and unvested) is automatically forfeited. A benefit of this program applies to companies with equity incentive plans that contain liberal share counting because the forfeited shares revert to, and act to replenish, the equity plan's share reserve. And with the right communication strategy, employees should not be bothered with such a forfeiture because, from their perspective, the underwater stock options had no retention value.

    - *Risk to Vet*. The following risk should be vetted to ensure there is no "make whole" grant following forfeiture of the underwater stock option. As background, NYSE and NASDAQ

[2] Shareholder approval of any repricing is likely required because such is an express requirement within the shareholder-approved equity incentive plan. That said, for companies with a recent initial public offering, it is possible that the terms of the equity incentive plan that was approved by the shareholders prior to the effectiveness of the Form S-1 Registration Statement expressly state that shareholder approval is not required in order to implement a repricing. Therefore, the terms of such equity plans should be reviewed to determine whether shareholder approval is required (and if the equity plan is silent on the issue, then NYSE and NASDAQ listing rules take the position that shareholder approval is required).

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listing rules provide that a cancellation followed by a required regrant is deemed a repricing subject to vetting under the shareholder approval requirements. Therefore, if an option was forfeited due to a stock-price forfeiture provision and a make-whole grant was provided to the executive, then such make-whole grant could be deemed to be a repricing of the forfeited stock option. A simple operational solution to this issue is to avoid any new grants outside of the company's annual grant policy (whether such policy be formal or informal).

- Delay Performance-Based Equity Grants for Three to Six Months Until Performance Targets Can Be Assessed Accurately. If the company's equity incentive plan does not require performance-based equity awards to be granted within the first 90 days or so of the fiscal year, then the Compensation Committee could delay effectuating grants for three to six months until performance targets can be determined with more accuracy.[3]

- Use Relative Metrics Instead of Absolute Metrics. In order to lessen the negative impact of stock price return and instead focus the executives on competing against the company's peer group, consider using relative metrics instead of absolute metrics (e.g., use a relative TSR formula instead of an absolute TSR formula).

- Bolster Provisions to Allow for Positive Discretion. Consider adding or bolstering provisions that would provide the Compensation Committee with significant discretion to adjust performance metrics while the award is outstanding. The idea is to give the Compensation Committee more discretion than it would otherwise have had in prior years.

Consider Compensatory Changes to Increase Cash Flow

There are a number of ideas that the Compensation Committee could implement that could increase the company's cash flow and produce positive proxy disclosure. Such ideas include (listed in no particular order):

- Idea No. 1 – Temporarily Reduce Base Salary. The concept of reducing base salary is simple, but for companies with executives who have contractual rights to severance pay and/or change-in-control pay, it is likely that an amendment to such arrangements will be required for the following reasons (though the amendment could be a master amendment to multiple documents):

    - *Temporary Waiver of Good Reason Trigger*. If the executive has severance pay protection and one of the severance pay triggers is that the executive could quit for "good reason" (which most often includes a material diminution of the executive's base salary) and receive severance, then an amendment should be entered into that temporarily waives good reason with respect to the reduction in base salary.

    - *Address Other Forms of Compensation Based on Base Salary.* It is common for other forms of compensation, such as target annual and long-term incentive awards, to be expressed as a percentage of base salary. The amendment should address whether the reduction in base salary will flow through and reduce these forms of compensation or if such compensation will be calculated based on the unreduced base salary amount.

    - *Verify Base Salary Reduction Does Not Unintentionally Reduce Severance or Change-in-Control Pay*. As background, severance pay and change-in-control pay packages are

[3] As background, companies will want to review their equity incentive plan. Similar to Footnote 1, prior to the elimination of the performance-based exception to the $1 million deduction limit, some equity incentive plans had hard wired Section 162(m) operational requirements within the equity plan document (thus making them mandatory requirements). Some of these companies were hesitant to later seek shareholder approval to eliminate such provisions. As a result, some equity incentive plans require the Compensation Committee to effectuate performance-based equity grants within the first 90 days of the company's fiscal year.

often structured as a multiple of the executive's base salary and bonus. Therefore, an amendment will likely be needed to the applicable documents in order to avoid the executive's risking a reduction in pay should the company have a change-in-control transaction.

- *Address Stock Ownership Policy Denominated as a Percentage of Base Salary*. If compliance with the company's stock ownership policy is denominated as a percentage of base salary, then the executive should provide a waiver that any reduction in his or her base salary will not allow a reduction of his or her stock ownership.

- Idea No. 2 – Reduce Cash Compensation in Exchange for Grants of Equity. This idea is easy to implement. Any concern that the executive is receiving an unfair advantage due to the company's low stock price is defendable on the basis that the executive could have taken his or her cash compensation and bought stock in the open market. A data point to keep in mind is that the reduction of cash compensation in exchange for equity should be structured with respect to future services only, otherwise, constructive receipt and Section 409A issues, and equity classification issues under ASC Topic 718, will need to be navigated. Finally, this idea is not likely feasible for those companies with insufficient shares in their equity incentive plan.

- Idea No. 3 – Treasury Stock Purchase Program (a Solution to Idea No. 2 if the Equity Plan has an Insufficient Share Reserve). Under this concept the executive would elect to use his or her after-tax cash compensation to purchase treasury shares from the company (no shares from the equity incentive plan are used). As a result, the company's cash outlay associated with the compensation, minus the executive's income tax liability, is essentially returned to the company.[4] A plan document will be required, and this program will trigger a Form 8-K filing requirement. And too, a Form S-8 is often used to avoid Rule 144 resale restrictions. Some of the advantages of a treasury stock purchase program include:

  - Shareholder approval is not required under NYSE and NASDAQ listing rules provided the program is elective and the number of shares of common stock to be issued in the transaction does not exceed either 1 percent (in the case of NYSE-listed companies) or 20 percent (in the case of NASDAQ-listed companies) of the common stock or voting power outstanding before the issuance;

  - There is no draw from the share reserve of the company's equity incentive plan, as a result, such share reserve is preserved for other grants;

  - It encourages ownership in the company, thus serving the purpose of aligning the executive's interests with those of the company's shareholders;

  - It can help to facilitate stock ownership requirements/guidelines, which can act as a mitigating factor to negate "materiality" in the risk assessment process;

  - It is more efficient than open market purchases since all executives would be able to satisfy their ownership goals on the same day rather than over an extended period of time (the latter of which could otherwise result if there was low trading volume);

  - It is more equitable than executive purchases in the open market because all executives will pay the same price (whereas open market purchases could result in price disparity depending on the timing of purchases);

[4] This Idea No. 3 could also be used by a company's nonemployee directors.

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- Scheduling of purchases shortly after earnings release provides transparency and reduces risk of allegations that the executive used insider information; and

- Issuances of treasury stock add a small amount to the outstanding share count, which increases the company's market cap (thus helping the company satisfy ongoing listing requirements).

Revisit Stock Ownership Policy Requirements

Equity ownership goals within stock ownership policies are typically denominated in shares or dollars (the latter being a fixed dollar amount or a percentage of compensation). Dollar-denominated guidelines are the most common among publicly traded companies, and many of these guidelines are based upon a percentage of base salary. For those companies where compliance with their stock ownership guidelines is denominated in dollars, any significant drop in stock price is likely to cause the executive to fail the policy's requirements. In this instance, the Compensation Committee should consider a temporary waiver of the requirements, with the idea that the Compensation Committee will revisit the issue again in the fall of 2020. But in exchange for such waiver, the executive should be required to hold all shares currently subject to the policy so that such cannot be sold by the executive until the Compensation Committee revisits the issue in the fall of 2020.

Does It Make Sense to Consider a Secular Trust for Deferred Compensation

It is well-settled that the assets of nonqualified deferred compensation programs are subject to the claims of the company's general creditors. Due to the current market volatility with many companies struggling to survive, some executives will worry about decimation of their wealth build up in the nonqualified deferred compensation plan.

There is no magic solution. Moving forward, we might see a resurrection of the secular trust (where the assets are held outside and apart from the company and are not generally subject to the claims of the company's creditors). With a secular trust, taxation to the executive is generally triggered at the time the monies are transferred to the trust, though the timing of such taxation could be deferred if certain vesting schedules or clawback provisions are implemented as part of the initial secular trust design.

Modifying or Terminating a 10b5-1 Trading Plan

Many executives and directors will consider modifying their existing 10b5-1 trading plans because the minimum sale price scheduled therein is likely higher than the company's current stock price.

- Modifications. Verify compliance with the company's insider trading policy and preclearance procedures before modifying a 10b5-1 trading plan. Also, modifications should occur only during open windows and at a time when the executive does not possess material nonpublic information. A waiting period (at least 30 days) should be implemented before any trades could be reinstated.

- Terminations/Cancellations. Cancelling a 10b5-1 trading plan could be effectuated even if the executive is in possession of material nonpublic information. And given the circumstances associated with the market and the US economy, it is unlikely that any such cancellation would create a valid assertion that the 10b5-1 plan was not entered into in good faith (i.e., meaning that it is likely that any prior trades would remain covered by the affirmative defense to any allegations of insider trading).

Disclaimer: This article reviews high level considerations relating to compensatory issues, but does not address all of the related aspects or implications, including securities compliance and disclosure such as Form 8-K and Section 16 of the Securities Exchange Act of 1934 reporting, guidelines from shareholder advisory firms such as Institutional Shareholder Services, accounting impacts, and tax consequences, including with respect to Section 409A of the Internal Revenue Code of 1986, as amended.

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