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Executive Compensation Issues Amid the COVID-19 Crisis

Like qualified retirement plans and health and welfare arrangements, executive compensation arrangements are not immune from issues and challenges arising as the result of the COVID-19 crisis. In addition to employee relations, there may be tax and security law implications that warrant consideration. The following is a summary of some of the executive compensation considerations that may have to be addressed in the face of the COVID-19 crisis.

Annual or Long Term Incentive Plans. Companies may face challenges in establishing meaningful and appropriate performance targets and metrics. Companies that have yet to finalize their 2020 plans may find it prudent to delay their programs until later in the fiscal year or until impact of the COVID-19 crisis can be better assessed. Companies that want to proceed may want to consider shorter performance periods and relative performance measures.

Companies that have already announced their 2020 plans and are considering adjustments should review their plans to determine if adjustments can be made pursuant to discretionary adjustment provisions or for unforeseen events. If the plan contains those provisions, companies have the flexibility to take a wait and see approach to making adjustments. If the plan does not contain those provisions, then consideration can be given to amending the plan or agreement. Often times these types of amendments do not need shareholder approval. Another consideration is whether the arrangement permits participants to defer the payment of the incentive compensation. For Section 409A purposes, deferral elections can be made up to six months before the end of the performance period for "performance based compensation." In order to qualify as "performance based compensation," the performance goals must be established no later than 90 days after the commencement of the performance period. Changes to or adoption of performance goals after March 2020 for calendar year performance periods would preclude deferral elections for the same performance period. Deferral elections which were made before the beginning of the calendar year would still be valid.

For arrangements which are not considered "performance based compensation," participants may have had the opportunity to make elections to defer 2020 compensation by making irrevocable deferral elections by December 31, 2019. Even though the participant may now want to revoke that election, it would violate Section 409A deferral rules and trigger the adverse tax consequences associated with Section 409A.

Payment of 2019 bonuses. Companies with an annual payout of bonuses earned in a prior period and who have not made those payments may be looking to conserve cash or redirect the cash to pay for other benefits (e.g., leave). There are number of issues that should be considered before delaying bonus payments or changing the form of the payment, including: 1) contractual terms (e.g., will the delay cause a breach, impact other agreements or arrangements, employee relations); 2) compliance with wage and hour laws; and 3) compliance with Section 409A. Failure to comply with Section 409A can trigger significant adverse tax consequences for the employee (e.g., additional 20% tax). Often times these bonus arrangements are designed to be exempt from Section 409A by either requiring the payment of the bonus no later than 2½ months after the end of the year in which the right to the payment vests or requiring employment through the bonus payment date. If the bonus is not paid in accordance with the terms of the arrangement, the company may have to consider other curative measures, including whether a delayed payment would satisfy certain conditions that would allow the payment to continue to be treated as a short term deferral.

If the bonus arrangement is designed to be compliant with Section 409A, it may be possible to pay the bonus as late as December 31, 2020 without violating Section 409A. Other alternatives include consideration of whether the payment would jeopardize the ability of the company to continue as a going concern.

In addition to curtailing or deferring payment of prior period bonuses, companies may be looking to reduce current salary payments. While salary reductions in and of themselves should not violate Section 409A, substituting something else (e.g., equity grants) for deferred salary might raise Section 409A issues, depending on the structure.
Section 409A is complex and easily violated so it is advisable to consult with competent counsel before implementing a course of action or changing the time and form of payment.

Account Balance Arrangements. Account balance plans and other deferred compensation arrangements may contain a provision for early payment on account of an unforeseeable emergency. An unforeseeable emergency for this purpose is typically defined as a severe financial hardship to the participant resulting from an illness or accident of the participant or a covered dependent or other similar extraordinary and unforeseeable circumstance beyond the control of the participant. While a COVID-19 related employer shutdown is not likely to satisfy this requirement, the consequences of a shutdown might (e.g., the imminent foreclosure of or eviction from the participant's primary residence). The administrator of the arrangement should be concerned with substantiation of the facts and circumstances surrounding the claim and limiting the distribution to the amount which is reasonably necessary to satisfy the emergency need, taking into account any additional compensation that is available if the arrangement provides for cancellation of a deferral election upon a payment due to an unforeseeable emergency.

Plan Terminations. Some employers may consider termination and liquidation of their nonqualified deferred compensation arrangements as a means of providing liquidity to the participants. Unfortunately, Section 409A contains a strict limitations on the ability to terminate an arrangement and accelerate the payment of benefits. Generally, a plan termination cannot occur proximate to a downturn in the financial health of the employer and distributions, other than payments which would be made in the ordinary course, may only be paid during a 12 month window that opens 12 months after the arrangement is terminated. Section 409A would also prohibit the adoption of a similar plan for at least three years following the termination.

Equity Arrangements. With stock prices declining and the COVID-19 crisis occurring when employers were in the process of considering their 2020 equity grants, employers may want to delay issuing those grants until they have a better understanding of the impact of the COVID-19 crisis. If the equity grants were intended to be subject to performance targets and metrics, meaningful performance measures may be difficult to determine given the uncertainty. That uncertainty may warrant a delay in issuing the equity grants.
Other issues to consider would be the pool of available stock from which grants would be made. For instance, if the value of the stock has declined and the award is targeted to a specific dollar amount, it would take relatively more shares to achieve the result thereby depleting the pool of stock available for grant.

Underwater stock options may offer little incentives to the holders. As such, consideration might be given to cancelling the existing options and issuing new options, repricing the existing options or extending the exercise period. The terms of the arrangement under which the options were granted should be consulted to ensure that applicable procedures are followed (e.g., obtaining necessary approvals). Repricing or extending the exercise period may have unintended consequences (e.g., causing incentive stock options to lose their special tax status; building in an inherent financial windfall due to the current low price; violating Section 409A).

Even with the tremendous amount of uncertainty and disruption associated with the COVID-19 crisis, COVID-19 related issues associated with executive compensation arrangements can be mitigated with careful planning.

If you have questions, please contact Bodman attorney Dave Walters at (248) 743-6052 or dwalters@bodmanlaw.com or any of our Employee Benefit and Executive Compensation Attorneys.