

COVID-19 Executive Compensation Q&As: Focus on Incentive Plans and Nonqualified Deferred Compensation

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This article answers questions about incentive plan considerations and nonqualified deferred compensation issues arising from the economic downturn due to the novel coronavirus (COVID-19) pandemic. The massive market shake-up and economic upheaval triggered by the COVID-19 crisis echoes the sudden massive economic crisis that hit in the fall and winter of 2008. In the first quarter of 2009, many companies, still stinging from a crashing market, faced significant challenges in designing and operating their executive compensation programs. Many had to address the immense challenge of designing meaningful and appropriate annual and long-term incentive plans at a time of extreme economic uncertainty. Depressed stock values created problems for equity compensation plans. Much of what

we experienced during the 2008/2009 economic crisis can inform our actions now.

Can or should companies make adjustments to their annual and long-term incentive plans in light of COVID-19 business impacts?

As in 2008/2009, many companies now face the challenge of designing meaningful and appropriate annual and long-term incentive plans, programs and agreements at a time of extreme economic uncertainty. This time, though, the crisis is emerging during the first quarter, when many incentive plans (for companies with calendar year fiscal years) have just been designed or are in the process of being finalized. Companies may want to consider the following actions and issues in designing and implementing their 2020 annual and long-term incentive plans:

- **Shorten performance periods.** Companies may want to move towards incentive plan designs with shorter performance periods. In 2009, some companies had annual plans that used semi-annual performance periods. Subsequent performance periods then could be determined once financial markets settled. Long-term awards—typically in the form of performance share units (PSUs) or cash-based long-term incentive plans (LTIPs) with three-year performance periods—were sometimes redesigned to include multiple tranches, with some or all tranches relating to annual periods rather than the full three-year performance period (and with specific targets (not the criteria itself) to be established annually, rather than at the beginning of the three-year performance period). Relative performance goals (relative to the market or peer companies undergoing similar concerns), such as relative total stockholder return, also increased in popularity and can be useful during periods of widespread business uncertainty. For public companies, however, the proxy advisory firms (like ISS) and some institutional shareholders do not like shorter performance periods. Companies that move towards shorter performance measurement periods will need to be prepared to explain why these shorter periods serve shareholder interests.
- **Goal adjustment provisions.** Well-drafted incentive plans contemplate potential adjustments to the measurement of performance goals for unusual or unforeseen events. Companies that have already designed their 2020 incentive plans to include these adjustment provisions (or that are amended to include such provisions) likely will want to take a “wait and see” approach, and potentially

adjust the performance targets after the end of the performance period to factor out the negative business impact of the COVID-19 crisis. For public companies, any adjustments actually made will need to be described to shareholders in proxy statement disclosures and may draw criticism if not adequately explained. It is also unclear whether business impacts of COVID-19 will be easily quantifiable for purposes of making these adjustments.

- **Bonus pool adjustment provisions.** Some cash-based incentive plans also include elements of discretion that allow the board or compensation committee to adjust bonus pool accruals for a range of subjective factors. Again, companies with plans that include these discretionary features (or that are amended to include such provisions) may want to take a “wait and see” approach before making any adjustments. Typically, equity-based performance awards like PSUs generally will only permit the exercise of such discretion if such discretion is specifically reserved in the terms of the original awards, because the exercise of such discretion otherwise can result in additional financial accounting expenses associated with the award.
- **Revisit established 2020 goals.** Companies that adopted incentive plan designs earlier in the first quarter of 2020 likely will need to consider whether those designs should be revised in light of the rapidly changing business environment (although it is likely premature to do so at this time). For public companies, the later in the year changes are made, the greater will be the potential for institutional shareholder concerns absent an adequate explanation. The compensation arguably is no longer “performance-based” if the performance results are no longer substantially uncertain at the time the plan is redesigned.
- **Exercise caution in overriding performance results.** In 2008/2009, some companies decided to completely override the results of incentive plans that had low or no payments under the plan formula, and paid discretionary bonuses regardless of performance results (even after permitted performance adjustments). Proxy advisory firms and many institutional shareholders often will view such discretionary overrides of performance results with deep skepticism. Such actions should be taken only after careful consideration, with a strong rationale as to why payments benefit shareholders, and whether the payments should be approved in amounts below original target awards.
- **Consider Section 162(m) issues for grandfathered awards.** In 2008/2009, many public companies were also concerned about adjusting incentive plans because those

adjustments threatened the deductibility of awards under I.R.C. §162(m). Changes made to Section 162(m) under the 2017 Tax Cuts and Jobs Act (TCJA) eliminate this issue as a concern, except in unusual cases where pre-TCJA awards remain outstanding (e.g., 2017 awards that cover a four-year performance period).

- **Consider Section 409A issues for deferrals of performance-based compensation.** Also, some companies permit employees to elect to defer incentive compensation payments in compliance with performance-based deferral rules under I.R.C. § 409A. Section 409A permits those deferral elections to be made up to six months before the end of the performance period for compensation that qualifies as performance-based compensation under Section 409A. To qualify as performance-based compensation for this purpose, the relevant performance goals must be established no later than the 90th day of the performance period. For companies that permit deferral elections under Section 409A's performance-based compensation rule, a change to the performance goals after March 2020 (for a calendar-year performance period) may result in invalidating deferral elections made during the performance year under the performance-based election rules (i.e., deferral elections will only be effective if made before the beginning of the calendar year).

We were about to pay our 2019 annual bonuses but want to indefinitely delay payment given financial uncertainty caused by COVID-19. Will that delay cause any legal issues?

Companies with a calendar year fiscal year often pay annual bonuses during the first quarter of the following year (usually before March 15th). Some of those companies that have not yet paid their 2019 annual bonuses may be considering a delay in payment as a means to conserve cash in the uncertain short-term or in order to shift cash payments to other employee priorities like paid leave. Companies should carefully consider a number of potential legal issues before delaying bonus payments:

Contractual Terms

What does the bonus plan say as to timing of payment? A delay in payment beyond the time permitted by the plan could lead to employee breach of contract claims (in

additional to employee relations' issues). Where necessary, companies should seek the consent of adversely affected employees to alter the terms of the award or agreement.

State Wage and Hour Laws

Which state wage and hour laws apply? Some state laws have minimum time periods in which bonus payments must be made.

Section 409A Compliance

Will a payment delay cause the plan to violate Section 409A? Bonus plans need to be designed either to be exempt from, or comply with, Section 409A. A bonus plan that is subject to, but fails to comply with, Section 409A can trigger significant adverse tax consequences for the employees, including a 20% tax in addition to normal income taxes (and potentially additional state taxes).

Plans Designed to Be Exempt

Bonus plans are often designed to be exempt from 409A, usually under the short-term deferral exception. Plans may satisfy this exception by paying the bonus no later than two and one-half months after the end of the year in which the right to the payment becomes vested. Plans also may satisfy this exemption by requiring employment through the bonus payment date in order for the bonus to be considered earned and vested.

If the company delays payment, and the employee must be employed on the date of payment to earn the bonus, the company will need to consider if it will require continued employment through the delayed payment date to receive the bonus (and whether it can enforce such a requirement). If the continued employment requirement cannot be enforced, the company will want to ensure that payment is made no later than March 15, 2021 (the end of the short-term deferral period for compensation that first vests in 2020).

On the other hand, if the employee is vested in the bonus as of the end of the prior year, and the company has not already paid the bonus, there will be Section 409A concerns, and the company will need to consider corrective measures.

Plans Designed to Be Compliant

If the bonus was designed to be compliant with Section 409A by, for example, specifying the date of payment for the first quarter of 2020, then, Section 409A permits payment of the bonus as late as December 31, 2020 (although, as noted above, there may then be contractual and employee relations issues to address).

Special Rules for Late Payments

It may also be possible to invoke special rules under Section 409A that allows delayed payments (beyond the short-term deferral period or beyond the payment period under the plan)—for so long as the payment might reasonably threaten the ability of the company to continue as a going concern—but the IRS views this special rule as a narrow one. Other approaches for managing compliance with Section 409A may also be available.

Because the Section 409A rules are very complex and can trigger significant adverse tax results for employers and employees, these rules should be closely reviewed before a decision to delay payment is made.

The COVID-19 crisis has caused our stock price to drop dramatically. What impacts could this have on our equity compensation program?

Lower stock prices can have potentially significant impacts on equity plans and outstanding equity awards:

- **Plan share pools.** For companies that grant equity awards based on a target dollar value for the awards, a lower share price means more shares used to make the awards. As a result, this may more quickly deplete the equity plan share pool and require plan amendments to add shares. For public companies, adding new shares to the plan will require shareholder approval and will increase shareholder dilution.
- **Reduced incentives.** Lower share prices mean that outstanding equity awards will provide reduced retention value and may result in disgruntled employees. This can be particularly acute where executives are not able to sell shares in the market because of securities trading restrictions or stock ownership guidelines and must stand by as the value of the shares drops.
- **Underwater stock options.** The 2008/2009 crisis resulted in many stock options being deeply underwater — (i.e., having exercise prices greater than current stock prices) —and the term of the option was likely to expire before the stock prices recovered sufficiently to restore meaningful value to the option. Underwater stock options still must be expensed based on grant dates values, yet

they can have little or no incentive or retention value. Actions to reprice stock options or exchange underwater options for other forms of compensation may not be practical. For public companies, such actions typically require shareholder approval, which may not be easily obtained, and are likely to trigger additional financial accounting expenses. Short of seeking to reprice or replace underwater options, companies could consider providing extended post-employment exercise periods to give time for stock prices to recover for terminated employees with vested options, although this too may have financial accounting consequences. To avoid problems under Section 409A, any such extensions should be limited to options that are underwater on the date of the extension or should not go beyond the option's original expiration date (typically 10 years after the grant date).

Can we permit participants to cancel deferral elections and/or receive distributions from our nonqualified deferred compensation plans?

Generally, once the deadline for making the deferral election under a Section 409A plan has passed, the election becomes irrevocable. Any subsequent revocation or cancellation of the election would result in a violation of Section 409A and adverse tax consequences. However, the participant's deferral election may be canceled where the participant experiences an unforeseeable emergency under 409A or takes a hardship distribution from the company's 401(k) plan. In that event, the deferral election must be cancelled in full (not merely postponed or delayed). Any deferral election made after the cancellation will be subject to the normal provisions governing deferral elections for the period in question (no evergreen rules can apply).

In addition to cancellation of the participant's deferral election, the participant may be permitted to receive distributions from the participant's account under the deferred compensation plan upon an unforeseeable emergency. Whether the participant is faced with an unforeseeable emergency permitting distributions under Section 409A (and/or cancellation of a deferral election) is based on the facts and circumstances.

For an event to constitute an unforeseeable emergency, the event must arise from extraordinary and unforeseeable

circumstances beyond the control of the participant and cause the participant a severe financial hardship. A hardship will constitute a severe financial hardship under Section 409A only if it cannot be relieved through compensation or reimbursement received from insurance or otherwise, by liquidation of the participant's other assets (to the extent such liquidation does not itself cause a severe financial hardship), or by ceasing future deferrals of compensation under the plan.

Specific extraordinary and unforeseeable circumstances or events that could trigger an unforeseeable emergency include the following:

- The illness or accident of the participant or his/her spouse, beneficiary, or dependent
- The imminent foreclosure of or eviction from the participant's primary residence
- The need to pay medical expenses (including nonrefundable deductibles) or prescription drug medications
- The need to pay for funeral expenses of the participant's spouse, beneficiary, or dependent –and–
- Other similar extraordinary and unforeseeable circumstances arising out of events beyond the control of the participant.

Unlike a hardship distribution from a 401(k) plan, an unforeseeable emergency under Section 409A does not include payment of tuition and related expenses of post-secondary education for the participant or his or her spouse, children or dependents.

The amount of deferred compensation that can be distributed upon a qualifying unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include any amounts necessary to pay any income taxes or penalties reasonably anticipated to result from the distribution). In determining the amount necessary to satisfy the emergency need, the employer must consider the additional compensation that the participant could obtain by canceling future deferral elections under all qualified and

nonqualified deferred compensation plans. The employer is not required to consider any available distribution or loan from a qualified plan or from another nonqualified deferred compensation plan.

Whether an employee has experienced an unforeseeable emergency under Section 409A depends on the specific facts and circumstances. Not all hardships created by the COVID-19 crisis will necessarily rise to this level. Companies with unforeseeable emergency provisions in their Section 409A deferred compensation plans will want to establish a reasonable, documented administrative process to make unforeseeable emergency determinations on any specific set of facts. If the company's plan does not currently provide for distributions upon an unforeseeable emergency, that provision can be added at any time.

Lexis Practice Advisor Resources

Practice Notes

- [Bonus Agreements: Key Drafting Tips](#)
- [Equity Compensation Plan Design for Private Companies](#)
- [Equity Compensation Plan Design for Public Companies](#)
- [Equity Compensation Types and Tax Treatment](#)
- [Equity Incentive Plan Resource Kit](#)
- [Option Exchange Programs and Other Alternatives for Dealing with Underwater Options](#)
- [Section 409A Fundamentals](#)
- [Section 409A Resource Kit](#)

Checklists and Forms

- [Equity Award Drafting Checklist \(Section 409A Compliance\)](#)
 - [Equity Compensation Tax Treatment Chart](#)
 - [Equity Incentive Plan \(Private Company\)](#)
 - [Equity Incentive Plan \(Public Company\)](#)
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Lynda Crouse assists clients with the design, implementation and administration of all types of employee and director compensation and benefit arrangements, including employment agreements, incentive plans, equity plans, 401(k) plans, ESOPs, SERPs and other deferred compensation plans. Lynda also helps clients comply with securities laws applicable to these types of compensation and benefit arrangements. Lynda also routinely works with clients on complex corporate transactions and restructurings to address employee and benefit transition issues. Although Lynda represents all types of public and private companies, much of her practice is within highly regulated industries, including banking and financial services and energy.

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Jim advises clients on all aspects of the employment, compensation, benefits and severance of directors, executive officers and other senior managers. He has significant substantive experience with all forms of executive compensation and benefit plans, including the design and administration of stock plans, incentive plans, SERPs, nonqualified deferred compensation arrangements, perquisites (including executive aircraft), new hire packages and severance/retirement agreements. He helps clients to understand and comply with tax, securities, labor & employment, governance and other legal issues associated with these arrangements, including related disclosure issues for public companies.

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