

Compensation Arrangements in Light of the Coronavirus Pandemic

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As the coronavirus spreads throughout the United States and around the globe, companies are wondering what they can or should be doing to ensure the on-going effectiveness of their equity incentive and other compensation plans.

We have listed the key steps we believe companies should implement or consider implementing in light of the coronavirus pandemic, as well as additional considerations to keep in mind for the future.

1. **Ensure that there is company discretion to determine whether corporate or individual performance targets are met.** Companies may need to rely on, or build in more, discretion within their newly implemented bonus plans or performance-based equity awards to give them flexibility to address the impact of the coronavirus on the company's business, the financial markets and the economy. When building flexibility into bonus plan and performance-based equity awards, companies should involve their accounting advisors in order to avoid inadvertently creating adverse accounting consequences in connection with such flexibility.
2. **Consider using stock price averages to determine the number of shares subject to incentive equity awards.** The impact of recent stock price fluctuations and market volatility can be reduced by using a trailing average stock price when determining the economic value of the number of shares subject to an equity incentive award.
3. **Preserve company cash in connection with equity award income tax withholding obligations.** Consider discontinuing the use of net settlement or net exercise (i.e., the company delivering a net number of shares upon settlement or exercise) as a means of having participants satisfy applicable tax withholding obligations. Moving away from net settlement and net exercise of equity awards will improve the company's cash position.
4. **Preserve company cash in connection with bonuses.** Consider whether the company has the flexibility to settle bonuses in equity rather than cash. Companies should, however, be cautious before imposing such changes unilaterally in the absence of existing discretion.
5. **Consider whether recent events have impacted the company's 409A valuation.** Private companies should consider whether to rely on a 409A valuation issued within the past 12 months or to stop granting new stock options until the company can obtain a new 409A valuation that takes into account the potential impact of the coronavirus pandemic and market volatility on the company's valuation. It may be advantageous to the company and option award recipients to obtain a new 409A valuation once there's more clarity around the economic impact of the coronavirus pandemic. Companies should keep in mind that until a new 409A valuation is obtained, options must be granted with an exercise price at least equal to the current 409A valuation in order to comply with the safe harbor under Section 409A of the Internal Revenue Code.
6. **Avoid or address underwater stock options.** Granting full value awards (e.g., restricted stock units) instead of stock options will avoid underwater options (i.e., options with exercise prices above the current market value). Going forward, companies with options that are likely to be considerably underwater for a

prolonged period of time may need to consider implementing a repricing program or an exchange program to address the lost retention and incentive value of such options. Under a repricing program, the exercise price of an underwater option is reduced to the underlying stock's current market value. Participants in an exchange program, on the other hand, commonly receive a restricted stock unit award or a new option award in exchange for the cancellation of their underwater options. While stock option repricing and exchange programs can be powerful tools in the context of a prolonged market downturn, they should be carefully considered before implementation. Such programs must comply with the applicable equity incentive plan, exchange listing rules and securities and tax laws.

7. **Review employee stock purchase plan documents.** Employee stock purchase plan documents often contain provisions that either automatically or at the discretion of the plan administrator will cancel an offering period and start a new offering period if the stock price on the purchase date is lower than the stock price on the offering period commencement date. Employee stock purchase plan documents should be reviewed to determine whether they contain an automatic or permissive restart feature. Companies with plans that do not currently utilize an automatic or permissive restart feature should consider whether to include such a feature in future offerings under the company's employee stock purchase plan. Companies should also confirm the number of shares available under the employee stock purchase plan to ensure that sufficient shares remain available for purchase.
8. **Keep track of vesting and changes in employment status.** If the current economic uncertainty results in workforce reductions and large segments of the workforce, including HR personnel, working from home, companies should ensure that records of vested and unvested equity awards at the point of employment cessation are current, accurate and accessible remotely, which will minimize the likelihood of future disputes. It is also important to keep track of applicable provisions in equity awards and equity incentive plans that may be implicated when an equity award holder takes a leave of absence, transitions from full-time to part-time employment status or ceases employment entirely.
9. **Reduced services now may have a lasting impact.** Section 409A measures a "separation from service" by reference to the average level of services performed by an employee or other service provider over the 36-month period immediately preceding the purported termination of employment or services. Companies maintaining any deferred compensation arrangements subject to Section 409A (which commonly include equity awards granted in the form of restricted stock units) should keep detailed records of any reduced levels of services performed by employees or other service providers in response to the coronavirus pandemic in order to avoid potential issues in connection with determining whether a separation from service has occurred at a later date.

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