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Lessons From the Skies for Executive Compensation Programs

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As seasoned pilots know, a downward spiral often starts gradually, almost imperceptibly, unless you heed the early warning signs. If those signs are missed or ignored, trouble compounds. It's often tough to know whether you're really in a spiral until it starts to tighten, and at some point – sometimes seemingly suddenly – breaking free may no longer be possible.

So, you're thinking, what does that have to do with the design and administration of executive compensation programs? Although the nexus is perhaps not immediately obvious, the hard lessons from the sky have something to teach us.

Unfortunately, unlike pilots with instruments tailored to reveal an incipient spiral, those responsible for making decisions about executive compensation programs don't have specialized tools that can reliably identify external factors that could cause the program to misfire and fail to achieve its intended purpose. Most commonly those external factors relate to the broader macroeconomic climate – for instance, the 2008 financial crisis or, more recently, the COVID-19 pandemic. The volatility caused by financial or geopolitical shocks can easily disrupt compensation programs, leading them to a spiral toward dysfunction – for example, because of unanticipated swings in equity value or the depletion of cash reserves.

So is a spiral for compensation programs tightening? No one knows of course. The only thing that's certain is that **something** will happen, even if that something is simply not much of anything. That realization will cause its own reckoning.

The lesson for executive compensation programs is to be prepared for the uncertainty and whatever may (or may not) come out of it. The playbook for that preparation is becoming well-worn, but it's worth reviewing, particularly with the incentive award season in full swing.

As a refresher, some levers to keep at the ready are briefly described below along with some related considerations brought to the fore by volatility and its attendant uncertainty. Which levers to pull, if any, is a balancing act because compensation decision-makers (be that the board, compensation committee or a manager) must always remain focused on providing properly calibrated incentives with appropriate performance metrics and a reasonable assessment of performance against those metrics after taking volatility impacts into account among all other relevant factors. In a similar vein, compensation decision-makers need to be sensitive to how hard they pull on the levers to avoid overcorrection and ensure that the action is narrowly and otherwise appropriately tailored to the circumstances.

1. Consider the availability of 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 bonus plans or performance-based equity awards to provide flexibility to address volatility. Treatment of currently active compensation programs will differ from planning for programs that have not yet been established, because existing programs may have been established with limited flexibility in that regard. In any event, any actual use of discretion can risk adverse stockholder or proxy advisory firm reaction, particularly if the rationale for its use is not well articulated to stakeholders. It's worth bearing in mind that **when** to exercise discretion – during a performance period or upon its completion – can sometimes be just as important as **how** it's exercised.

2. Consider using stock price averages to determine the number of shares subject to incentive equity awards.

The impact of stock price fluctuations and market volatility can be reduced by using a trailing average stock price when determining the number of shares subject to an equity incentive award. For public companies, because the value shown for an award in the executive compensation table pursuant to Securities and Exchange Commission rules may differ from the award value communicated to executives based on the trailing average price, expectations may need to be managed. Stock price fluctuations can create especially acute problems when periodic share grants are denominated by a share number rather than dollar value, as is sometimes the case with director compensation programs – though of course a converse issue is that stock price declines can exhaust share reserves more quickly than anticipated where a target value is delivered.

3. Assess adequacy of share reserves.

Companies should confirm the number of shares available under their equity incentive compensation plans, including employee stock purchase plans (ESPPs), if applicable, to ensure that sufficient shares remain available, particularly if there has been a steep drop in price since the share pool was last assessed (or, in the case of an ESPP, since the commencement of the current offering period). Similarly, any individual or aggregate award limits under a plan based on share number may need to be revisited.

4. Preserve company cash if appropriate.

Uncertainty can often strain a company's cash resources or at least require prudent cash flow management. Companies should consider whether they have the flexibility to settle awards in equity rather than cash, being mindful that doing so can trigger significant securities law, accounting and disclosure consequences. In addition, companies can explore the feasibility of limiting net settlement for exercise price payment or tax withholding purposes, with public companies perhaps providing it only to individuals subject to Section 16 reporting requirements.

5. Consider whether recent events have impacted the company's 409A valuation.

Private companies should consider whether they may still rely on an Internal Revenue Code Section 409A valuation issued within the past 12 months. If a company's situation is rapidly changing, it may make sense for the company to briefly pause new stock option grants and obtain a new 409A valuation once there's more clarity around future developments.

6. Avoid or address underwater stock options.

If a company is concerned about a falling stock price, 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). Stock option repricing and exchange programs can be powerful tools in the context of a prolonged market downturn, but they should be carefully considered before implementation.

7. Keep track of vesting and changes in employment status.

Companies anticipating workforce reductions should ensure that records of vested and unvested equity awards at the time of termination are current and accurate. It is also important to keep track of applicable provisions in equity awards that may be implicated when an award holder takes a leave of absence, transitions from full-time to part-time employment status or ceases employment entirely.

8. Reduced services now may have a lasting impact.

Section 409A generally 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 service levels to avoid future disputes or IRS challenges.

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Sometimes the only thing scarier than what’s in the rearview mirror is what you don’t yet know about the road up ahead. Being prepared for whatever you might run into is key to a smoothly and appropriately functioning executive compensation program. Cooley’s compensation and benefits group is ready to help you navigate that road ahead – and safely help pull you out of any spiral along the way.

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Key Contacts

Alessandra Murata Palo Alto	amurata@cooley.com + 1 650 843 5696
Michael Bergmann Washington, DC	mbergmann@cooley.com +1 202 728 7008

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