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8 Executive Pay Considerations For An Economic Downturn

By **Mark Poerio and Dan Brandenburg** (January 14, 2020, 5:44 PM EST)

In the executive compensation world, there have been 10-plus years in which the rising economic tide has not only lifted pay but substantiated performance award decisions. Those who expect stormy seas in 2020 and beyond will need their A-game to get future compensation based on performance right.

Mark Poerio

Below are thoughts drawn from navigating the recession of the early 1990s, the economic bubble that burst a decade later, and the scare that came from Wall Street in 2007. Through those times, the best companies have been both forward-thinking in their positioning, and quick to adjust when disruption hits.

Dan Brandenburg

With an eye toward both, listed below are strategies that anyone interested in executive compensation will likely want to consider in order to best position for any economic volatility that may come in the new year. Note that, from an individual perspective, adverse changes generally require consent from affected individuals, and therefore need consideration (usually in the form of new awards or other compensation) in order to be binding.

1. Formula-Based Incentive Plans and Awards

From cash bonuses to equity awards, a best governance practice has become pay for performance. Whether applied on a short-term or a long-term basis, an objective formula often measures either the amount awarded, when and if vesting occurs or both. Results may be skewed by extraordinary events, including those associated with a recession, merger or acquisition.

In light of this, employers should review applicable performance goals, metrics or formulae — and consider an update for any that seem ambiguous, uncertain or unrealistic. Regardless, a key consideration is whether the incentive program has features that truly incentivize employees to perform in a way that is most beneficial to the company on a long-term basis, as well as if it enters a survival mode. One also needs to make sure that the program provides appropriate incentives when the company is successful and meeting goals, but cash is short.

2. Stock Options and Other Equity-Based Awards

Stock options are seductive in appreciating markets, because they inspire excitement as holders watch the value pf their in-the-money options escalate. A train wreck can happen in a downturn, in part because out-of-the-money (aka underwater) options have little perceived value.

They can nag as reminders of the employer’s declined stock value. They may even incline employees to seek fresh starts — with new at-market grants — from a new employer. Worse, it is often tricky and expensive to replace underwater stock options, due to the need for consent from the holders, and applicable securities laws.

For new equity awards, convert from stock options to restricted stock, because they have value in a downturn. It may also be beneficial to consider cash-settled deferred compensation for a long-term incentive that may reward performance based on financial measures other than stock price.

Also, secure the ability to unilaterally cancel or replace underwater options. In addition, in tight economic times or with startup companies, a payoff on stock may depend on partial or complete corporate buyouts or on liquidity events.

3. Severance as an ERISA Plan and Retention Strategies

An economic downturn invariably leads to job insecurity, and often prompts at-risk executives (and other employees) to seek greater security or compensation from a new employer. The most valuable employees tend to have the best alternatives, making them the most likely to abandon a stalled or sinking ship.

To address this issue, review current severance and retention plans and practices, especially as they relate to key employees. You may also want to consider establishing or enhancing a severance plan, which could be limited to changes in control if desired, in order not only to retain desired employees but also to minimize the risks of employment-related litigation if terminations occur.

Never underestimate the value, to an employer, of structuring a severance plan to fall within the coverage of the Employee Retirement Income Security Act.[1] Individual executives would be wise to weigh their negotiating power and seek enhanced protection (best done in times of solid performance). Companies also need to monitor the availability of cash to settle awards and to cover their severance obligations (with equity being one alternative to consider when cash is short).

4. Cash Flow Disruptions

A solid stock price does not always translate into a secure cash flow, especially when an economic downturn strikes a private company. In many cases, cash bonus and other cash-settled plans (including employee stock ownership plans) may create burdensome cash flow risks.

On this point, employers should assess the cash flow risks from current benefit plans, and initiate changes that limit those risks.

5. Clawbacks and Holdbacks

Stressed economic conditions have the potential to warp individual behavior, especially when significant pay-for-performance formula benefits depend on measures that can be manipulated. The departure of key employees can also backfire materially when key customers or other employees leave for a competitor.

- Clawback rights are most commonly imposed for bad behavior, but generally represent an extreme remedy — and one that is seldom used because it is costly and often problematic for an employer to seek to recover compensation that has already been paid.
- On the other hand, holdbacks of compensation are quite feasible because they can be accomplished through a combination of vesting and deferred payment provisions. Such holdbacks are possible for fraud or misconduct, as well as for an employee’s violation of noncompetition, nonsolicitation or trade secret obligations. These are referred to collectively below as protective covenants.

Employers should assure clawback rights not only address wrongful behavior, but also that they satisfy statutory requirements such as the Dodd–Frank Wall Street Reform and Consumer Protection Act. You may also want to establish, enhance or refine protective covenants to assure they are enforceable and that there are financial consequences to violations.

Finally, document fiduciary status for key employees in order to enhance the potential for injunctive relief or damages if protective covenants are breached.

6. M&A Transactions

Of course, a treatise is possible for the executive compensation issues arising from, or in anticipation of, business transactions such as mergers and acquisitions or initial public offerings. Through the lens of a downturn or other volatility, special attention is warranted to the disruption that could occur with respect to key employees.

There are myriad retention incentives available for business transactions. Significant flexibility exists for past awards and compensation, subject to special Internal Revenue Code Section 409A rules relating to accelerated or delayed benefit payments. New awards and employment-related agreements also need attention to assure key interests are addressed suitably.

To address this, identify key employees and encourage their retention through attention to past and future awards and compensation; establish or update protective covenants such that they work well on a post-closing basis; and consider other contractual protections and agreements that key employees would value if a downturn occurs.

7. Rabbi Trusts

Although rabbi trust assets must remain subject to general creditor claims in the event of an employer’s bankruptcy, the funding of a rabbi trust does provide significant protection for executives with respect to supplemental retirement benefits, deferred compensation and severance. At its core, an irrevocable rabbi trust offers change-of-heart protection against having an employer refuse to pay vested benefits to an executive.

A springing rabbi trust usually relates to a change in control, and is unfunded or minimally funded until the closing of a transaction springs a full funding obligation — thereby providing affected executives with protection with regard to the new party that survives as plan sponsor after a transaction.

On this point, evaluate the cost and benefit of a rabbi trust for various forms of executive compensation and severance benefits, and establish, revise and/or fund appropriate rabbi trust vehicles.[2]

8. Alternative Executive Compensation Structures

Although deferred compensation must remain subject to the claims of general creditors, all is not lost if an economic downturn occurs. For instance, Internal Revenue Code Section 409A permits plans to terminate and to pay out benefits as long as that is not done "proximate to a downturn in the [employer’s] financial health." Plan termination is also allowed in connection with change-in-control transactions.

Here are a few of many items that employers may find it desirable to establish or enhance in early 2020:

- The termination and cash-out of particular benefit plans and/or stock awards;
- Directors and officers insurance and indemnification rights, because personal liability risks accentuate in a downturn;
- Diversification strategies for employer stock that is subject to awards or credited under a deferred compensation or other plan;[3] and

- The establishment or refinement of employment agreements — especially regarding compensation, severance, protective covenants and changes in control.[4]

Conclusion

There is no predicting when and how hard market turbulence and disruption will strike. Given 10-plus years of tailwinds, however, employers and executives would be smart to start 2020 by evaluating their risks and taking precautions that will reflect smart positioning for any future storms.

Whether a company is public, private or tax-exempt, any changes should be readily justifiable when disclosed to stakeholders, and should be carefully weighed for their tax, financial, human resources and business consequences.

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[1] An ERISA-covered severance plan or program has the potential to significantly reduce an employer’s litigation risks (e.g., by requiring an exhaustion of plan-imposed claims procedures, judicial review under an arbitrary and capricious standard, and the assertion of claims within contractually-shortened limitations periods). For a more through discussion, see “Say Hello to Smart Good-byes” (Poerio et al, Legal Times, 2008).

[2] “Rabbi Trusts - When to ask. What to get” (Poerio, Wagner Law Alert, 2018).

[3] See “Too Much Employer Stock? Don't Ignore Diversification” (Poerio, Law360, 7/12/2018).

[4] See “Executive Employment Agreement Insights: From High Stakes to Competing Interests” (Poerio, LexisNexis, 11/2019).