ISS COVID-19 Compensation Guidance
More Flexibility (Maybe) For Public Companies, But More Tax Risk (Maybe) For NEOS

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The executive and equity compensation plans, agreements, policies and arrangements (collectively, the “Plans”) of publicly traded companies receive close scrutiny from various shareholder advocacy groups during the annual proxy season, which is well underway for 2020. These groups advise institutional shareholders whether to vote for, to abstain from voting on, or to vote against, such Plans and/or the boards of directors of the companies seeking to adopt or amend such Plans.

On April 8, 2020, Institutional Shareholder Services (“ISS”), one of the most influential shareholder advocacy groups, published a policy update addressing various issues of concern given the ongoing COVID-19 pandemic. The policy update, entitled “Impacts of the COVID-19 Pandemic,” includes two sections relating to executive and equity compensation.
As discussed below, these two sections may provide public companies with additional flexibility in modifying their Plans, but any such modifications should be done in the context of the potential triggering of adverse federal income tax consequences for the award recipient under Section 409A of the Internal Revenue Code (the “Code”). This Section of the Code, which governs the federal income tax treatment of nonqualified deferred compensation plans, operates as a strict liability statute: Any violation of Section 409A’s requirements, irrespective of materiality, exposes the award recipient to income inclusion at vesting, rather than at payment, a 20% penalty tax (in addition to regular taxes) and, if the federal income tax is not timely paid, premium interest liability for late payments of tax.

For this reason, many deferred compensation plans are designed in a manner intended to ensure exemption from the requirements of Section 409A of the Code. The most common exemption is the “short-term deferral exemption,” which provides that if payment is made within two and one-half months following the year of vesting (i.e., by March 15th of the following year in the case of a calendar year plan), Section 409A does not apply to the payment.

If Section 409A does apply to a payment, the payment must be made in accordance with a compliant payment event (i.e., a specified or fixed date, a separation from service, a change in control, an unforeseeable emergency, disability of the award recipient or death of the award recipient). Each event, other than death, has a specific definition under Section 409A.

Lest anyone think that we’re suggesting that the tax tail should wag the business dog, we’re not: We’re merely suggesting that the adverse tax consequences under Section 409A should be assessed as boards/compensation committees consider making COVID-19-related changes, as the very people likely to be affected the most will be members of the executive management team, particularly, the company’s named executive officers (“NEOs”).

1. Change in Metrics/Shift in Goals or Targets

In the section entitled “Change in Metrics/Shift in Goals or Targets,” ISS differentiates between short-term compensation plans (i.e., one-year performance plans) and long-term compensation plans (i.e., multiyear performance plans).

- **Short-Term Compensation Plans**

ISS acknowledges that many public company boards “are likely to announce plans to materially change the performance metrics, goals or targets used in [such] . . . plans” in response to the economic downturn and possible recession caused by COVID-19. For such plans, ISS – noting that changes to 2020 metrics, goals, and targets generally will be analyzed and addressed by shareholders at the 2021 annual, general meetings – encourages boards to contemporaneously disclose to shareholders of their reasons for making any such changes.

- **Long-Term Compensation Plans**

Material changes to long-term compensation plans will be reviewed with greater scrutiny. ISS writes that its “benchmark voting policies generally are not supportive
of changes to midstream or in-flight awards since they cover multi-year periods. Accordingly, we will look at any such in-flight changes made to long-term awards on a case-by-case basis to determine if directors exercised appropriate discretion . . . and provided adequate explanation to shareholders of the rationale for changes.”

- **Code Section 409A Issues (Delayed Payment and the Going Concern Exception)**

Without going into detail, suffice it to say that many short-term compensation plans are designed to be exempt from the requirements of Section 409A, typically under the short-term deferral exemption, whereas many long-term compensation plans are designed to be exempt from or compliant with such requirements. Any change in metrics, goals, or targets with the effect of delaying the date of payment of the compensation has the potential to vitiate the short-term deferral exemption and/or trigger an outright violation of Section 409A.

Delaying a payment will not have such an adverse effect if the sole reason is that making the payment would jeopardize the ability of the company to continue as a going concern. In such instance, the company must make the payment as soon as possible after doing so would no longer jeopardize its ability to continue as a going concern.

Any public company seeking to delay payments past the period of exemption (for calendar year plans, generally, March 15th of the immediately following year) or past the prescribed payment date necessary for compliance with Section 409A, as applicable, should document why making the payments would jeopardize its ability to continue as a going concern. Consideration should be given to obtaining an attorney-client privileged memorandum on the going concern issue as an alternative to a full vetting of such issue that finds its way into the board/compensation committee minutes.

2. **Option Repricing**

- **ISS Giveth and ISS Taketh Away**

In the section entitled “Option Repricing,” ISS acknowledges that, given the economic downturn and possible recession caused by COVID-19, some public companies may seek to “reprice (or replace/exchange/cancel and re-grant)” underwater stock options (i.e., options whose exercise price per share exceeds the current fair market value per share (typically, the current trading price per share). ISS advises boards that undertake option repricing actions to request shareholder approval or ratification of such actions promptly (by the 2020 annual general meetings); otherwise, the directors’ actions will be subject to scrutiny under ISS’ benchmark policy board accountability provisions, which, according to question 40 of its December 6, 2019 publication entitled “Equity Compensation Plans Frequently Asked Questions,” will cause a negative recommendation on the Plan.

If, in contrast, a board seeks shareholder approval/ratification of its option repricing actions at the company’s 2020 annual general meeting, ISS will apply its case-by-case policy approach in determining how to advise institutional shareholders. Under this policy, as applied, for example, to the U.S. market, ISS generally recommends
“opposing any repricing that occurs within one year of a precipitous drop in the company’s stock price.” ISS writes that, among other facts, it also will examine “whether (1) the design is shareholder value neutral (a value-for-value exchange), (2) surrendered options are not added back to the Plan reserve, (3) replacement awards do not vest immediately, and (4) NEOs and directors are excluded.”

ISS’ guidance on repricing underwater options, given COVID-19 may not be that helpful to most public companies. Not only will a proposed repricing within one year of a precipitous drop in stock price generally result in a recommended “no” vote on such repricing, but even a repricing within one year of a drop in stock price that is not precipitous frequently will benefit NEOs and directors disproportionately and surrendered shares frequently must be added back to the Plan reserve in order to effectuate a value-for-value exchange (lower option price means more option shares to produce the same value).

• Code Section 409A Issues (NQSOs)

From a Section 409A standpoint, a reduction in the exercise price of a nonqualified stock option (“NQSO”) is treated as the grant of a new option. For the new grant to be exempt from Section 409A, it would need to have an exercise price per share of no less than fair market value of an underlying share as of the grant date.

If the company were to cancel the option and grant compensation that could be payable after the expiration date of the option, the award recipient could face Section 409A exposure. For instance, if an NQSO is replaced with a restricted stock unit (“RSU”) – an unfunded, unsecured promise by the company to deliver a vested share of stock, or the cash equivalent thereof, in a future year – that vests after the option expiration date (e.g., the RSU vests after the remaining term of the option, let’s say five years of a 10-year option term, expires), the IRS could view the option as having provided for the deferral of compensation from the original grant date, thereby triggering Section 409A exposure for the award recipient.

Similarly, a public company should avoid a series of option repricings. The IRS could claim that the option lacked a fixed exercise price as of the original grant date, resulting in Section 409A exposure for the award recipient.

• ISO Issues

Substituting one incentive stock option (“ISO”) for another ISO creates even greater tax complexity. Although an ISO is not subject to Section 409A, its preferential tax treatment (unlike an NQSO, no tax upon exercise, unless the employee is subject to the alternative minimum tax) requires that the option shares be held for two years from the grant date and one year from the exercise date. The replacement ISO resets the two-year holding period.

In addition, only the first $100,000 in ISO value (grant date value) that becomes exercisable for the first time in any given year is treated as an ISO; the remainder is treated as an NQSO. For purposes of applying the $100,000 limit, any shares under the cancelled ISO that otherwise would have or actually did become exercisable and any shares that become exercisable under the replacement option, in each case during the year of cancellation, are counted. This rule makes the preservation of
vesting of the cancelled option more challenging.

3. **Concluding Thoughts**

ISS’ COVID-19 update to its compensation policy provides some flexibility to employers, particularly regarding re-setting short-term compensation plan metrics, goals, and targets. Flexibility on re-setting long-term compensation plan metrics, goals, and targets is minimal, and the one-year rule regarding “no” votes for option repricings following precipitous declines in stock value make such repricings significantly less palatable to boards/compensation committees.

Section 409A of the Code and the ISO rules make the ISS updates even more complicated to navigate. A delay in payment under a short-term compensation plan or a long-term compensation plan frequently will need to satisfy the “inability to continue as a going concern” exception to Section 409A exposure. Replacing an NQSO with an RSU that vests after the original term of the option or engaging in a series of repricings can trigger unwanted Section 409A exposure.

Repricing ISOS can get even more complicated. ISO shares, which are not subject to Section 409A, can be deemed NQSO shares, which may be subject to Section 409A, by virtue of the $100,000 rule, and replacing one ISO with another ISO resets the two-year holding period.

Navigating the interplay of the ISS updated policy and these tax issues requires thoughtful and practical legal and tax analysis.

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