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Frequently Asked Executive Compensation Questions for Private Companies in Light of the COVID-19 Pandemic

Insights
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These frequently asked questions are intended to provide a high level overview of questions we have been receiving from private company clients in light of the COVID-19 pandemic.

Question – Can I reduce employees' salaries?

Answer – In most cases, yes. An "at will" employee's salary can generally be reduced on a prospective basis, subject to any contractual severance rights that might be triggered (i.e., "good reason" resignations). Clients should be mindful of state wage laws that may require advance written notice, as well as applicable minimum wage laws and any higher amount necessary for exempt employees[1]. Clients with loans under the SBA's Paycheck Protection Program should also be aware that reducing the salaries of employees making less than $100,000 per year may impact the amount of loan forgiveness they are otherwise eligible for under that program.

Question – Can I ask employees to defer salary or to reduce their base salaries in exchange for a stock option?

Answer – Any deferral or exchange needs to be carefully structured to avoid adverse tax consequences for employees, especially under Internal Revenue Code Section 409A and the constructive receipt doctrine. Asking employees to accept a private company equity award implicates securities laws and can complicate a company's 409A valuation to the extent the formula for converting salary into equity implies a valuation other than the current fair market value. While asking employees to accept a new compensation arrangement may seem kinder than taking unilateral action it puts employees in a difficult position where they may feel compelled to accept the offer, which may lead to employment claims. Further there is no guarantee that a sufficient number of employees will accept the offer which may leave a company in the position of needing to take unilateral action after first asking for volunteers.

Question – Our 409A valuation has declined X%. What can we do?

If a company's valuation declines below the exercise price of outstanding options, the options may no longer serve their intended incentive and retention purpose. One way to address this is to reprice options (i.e., amend outstanding options to reduce the exercise price). Assuming no other changes are made to options in exchange for the reduced exercise price (e.g., a reduction in shares or additional vesting), a private company repricing is generally simple to implement. However before proceeding a company should consider securities law compliance. We also recommend that a client consider whether its valuation has reached bottom as multiple repricings create tax and accounting issues.

In the case of incentive stock options (also known as ISOs), a repricing will restart the 2-year holding period that runs from the grant of an option and that is necessary to obtain favorable tax treatment. In some cases a repricing can also limit the number of options eligible for ISO treatment.

If a company has, or has been considering, a private company restricted stock unit (or RSU) program, it could instead offer to replace underwater options (i.e., options with an exercise price per share greater than the current fair market value per share of the underlying stock) with RSUs. Since this would involve a new security with different terms and likely fewer shares, it is more complicated to implement as it will usually be necessary to structure the offer as an issuer tender offer for securities law purposes.

An option repricing or exchange will generally have accounting implications. While many private companies are relatively insensitive to non-cash accounting expense, the accounting treatment should be discussed in advance with a company's finance team and outside accountants.

Question – We are furloughing employees. What happens to their stock options or other equity awards?

Answer – A company's stock plan should be reviewed to evaluate the treatment of equity awards during a furlough. In particular the stock plan provisions governing leaves of absence may permit a company to suspend vesting for the duration of the furlough. Some companies also have formal leave policies that may apply.

To the extent a company has outstanding incentive stock options, a furlough may cause options to no longer be eligible for ISO treatment. Unless reemployment is guaranteed, if a furlough exceeds three months, a termination of employment will be deemed to have occurred for tax purposes and options will automatically become nonstatutory stock options (or NSOs) if not exercised within three months after the deemed termination.

The impact of a furlough on other benefits (health plans, 401(k) plans etc.) should also be assessed.

Question – We are laying people off. Can we extend the post-termination exercise period applicable to their options?

Answer – Yes. Many private company stock options provide employees with a three month post-termination exercise period in which to exercise vested options. This post-termination exercise period can generally be extended until up to the end of the option term (or, if sooner, 10 years from the date of grant of the option). This requires action by the plan administrator (in the case of private companies, often the board of directors or its compensation committee) and will immediately disqualify any in-the-money ISOs. It may also result in additional accounting expense.

One issue related to extending post-termination exercise periods is trying to preserve ISO treatment for any employees who are willing to exercise within the original post-termination exercise period. To avoid automatically disqualifying ISOs, any offer to extend a post-termination exercise period must be kept open for no more than 29 calendar days. However in the case of group terminations where laid off employees must be given 45 days to consider a release, an extended post-termination exercise period should either not be contingent on a release of claims or must be rejected before the release of claims would otherwise be due.

If the offer is made to more than a handful of employees, the advisability of complying with SEC rules for issuer tender offers should also be considered.

Question – My employee's 83(b) election is due, but the employee can't go to the post office. What can be done?

Answer – The IRS has issued relief for 83(b) elections that would otherwise be due on or after April 1, 2020 and before July 15, 2020. The filing deadline has automatically been extended to July 15, 2020. While this is useful relief, clients should encourage employees and other service providers to file as soon as they are able so that they do not overlook the July 15th deadline.

Question – The performance goals we set for our 2020 bonus program or other performance awards are no longer achievable. What can we do?

Answer – Many private venture-backed companies do not have formal bonus programs or performance awards, or, if they do, it is straightforward enough to adjust the goals mid-year. If a company is thinking about changing performance goals, it may be advisable to wait at least a few weeks in the hopes that the situation will stabilize and the company will have better visibility into what goals are reasonable in light of the changed environment. And, in light of the prospect of continued uncertainty, it may be advisable to establish new goals that are more subjective than the previously established goals.

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[1] For calendar year 2020, the minimum salary threshold for an exempt employee is: (i) $54,080 in California if the employer has 26 or more employees and $49,920 if the employer has less than 26 employees; (ii) $58,500 in New York City, $50,700 in Nassau Suffolk and Westchester Counties and $46,200 in all other counties in New York; and (iii) $35,568 in Massachusetts.

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