

COVID-19: Reductions in Executive Pay

May 6, 2020

The coronavirus (COVID-19) pandemic and the ensuing market uncertainty, as well as recently enacted legislation, have upended the compensation and benefit programs of many companies. This is the fifth memorandum in a series of client memoranda that we are preparing regarding how companies may wish to consider addressing their compensation programs in this context.¹

The recent market volatility has disrupted many companies' day-to-day operations resulting in economic hardship that has caused companies to consider or implement various measures to reduce personnel costs, including pay cuts, furloughs and/or layoffs. When implementing such personnel cost-cutting measures, a number of companies have reduced executive pay,² including reductions in base salary and bonus opportunities,³ and some have also reduced director retainers. This memorandum summarizes the actions that a number of companies have already taken and provides guidance for companies considering reductions in executive or director pay.⁴

1. Do reductions to executive pay need to be approved by the company's board of directors or compensation committee?

It depends. Reductions to base salary and bonus opportunities for executive officers are generally, although not always, required to be approved by the compensation committee of the board. Companies should review their corporate governance documents, in particular their compensation committee charter, in order to ensure that any such reductions do not require approval by the full board.⁵ The resolutions adopting a bonus program should also be reviewed as they may contain a delegation of authority to take

¹ Please see our previously published client memoranda:

- [COVID-19: Considerations for Companies That Have Not Yet Established Their 2020 Incentive Compensation Programs](#)
- [COVID-19: Considerations for Companies That Have Already Established Their 2020 Incentive Compensation Programs](#)
- [COVID-19: Addressing Underwater Options and Stock Appreciation Rights](#)
- [COVID-19: Impact on Nonqualified Deferred Compensation Plans](#)

² Throughout this memorandum, for purposes of public companies, we use the term "executive" to refer to the company's "executive officers," as defined by Rule 3b-7 under the Securities Exchange Act of 1934 (Rule 3b-7), but both public and private companies may be considering these actions for a broader group of senior management. Rule 3b-7 defines the term "executive officer" as a company's "president, any vice president of the [company] in charge of a principal business unit, division or function (such as sales, administration or finance)" or "any other person who performs similar policy making functions."

³ While reductions in annual bonus opportunities are not as common, some companies have already reduced or eliminated executive bonuses for the 2020 fiscal year.

⁴ Companies that receive financial assistance through certain programs established under the Coronavirus Aid, Relief, and Economic Security (CARES) Act are subject to limitations on employee compensation, which are discussed further in Question 3.

⁵ A compensation committee charter may only cover "executive officers" for purposes of Rule 3b-7. Companies that are considering a pay reduction for other members of the company's senior management team should review their policies to determine the required approvals, if any, for such reductions.

certain actions with respect to the program, including a delegation of administrative authority from the board to its compensation committee.

Companies should also consider whether to approve salary reductions for an indefinite period, or instead, to approve the reduction for a fixed period of time with the potential to later extend the time frame in which the reduction will apply. In either case, companies may want to consider whether the approval should include a requirement that the base salary being reduced will be reviewed and reassessed in the future (for example, at the end of each fiscal quarter of 2020).

2. Are there contractual issues for companies to consider when deciding whether to reduce executive pay?

Yes. There are a number of potential existing contractual issues that companies should consider prior to implementing a reduction to executive pay:

- *Good Reason Definitions.* For many companies, a reduction in base salary or a bonus opportunity may trigger an executive's right to resign his or her employment for "good reason" (or constructive termination) under an individual employment agreement, an executive severance plan or the company's severance, equity and other incentive compensation programs.
 - Good reason definitions sometimes include an exception for across-the-board reductions for similarly situated executives or the entire company.
 - To the extent that any good reason rights may be triggered, it will be more protective of the company to obtain a *written* waiver or acknowledgment (which can be via email) from its executives waiving their right to assert good reason as a result of the pay reduction.
- *Breach of Contract.* Reductions in pay to which executives are contractually entitled may give rise to potential breach of contract claims. For example, some employment agreements provide for an initial salary level with a provision that the executive's salary cannot be reduced below this level unless consent is obtained. In these instances, similar to when an executive may assert good reason, as noted above, companies should obtain the executive's *written* consent prior to any such reduction.
- *Incentive Plan Targets and Severance Benefits.* Because other components of executive compensation are often tied to base salary, reductions in base salary may have unintended or ancillary consequences. Accordingly, companies should review the executives' compensation arrangements and give careful consideration to the effects of a base salary reduction on various other components of compensation.
 - Target bonus is often tied to a percentage or a multiple of an executive's base salary amount. Companies that do not intend to also reduce an executive's bonus opportunity should be sure to clarify in any applicable resolutions and through any modifications to the executive's existing arrangements that those arrangements will continue to be based on the executive's pre-reduction salary.
 - Similar considerations should be given to the effect of any reductions (for both base salary and annual bonus purposes) on the executive's severance benefits.
- *Other Group Benefits.* Companies should also consider other employee benefit plans and programs that may be impacted by a reduction in an executive's base salary.
 - For example, because contributions under certain retirement plans, such as 401(k) plans, are calculated based on a percentage of base salary, the amount of such contributions would be proportionately decreased by a reduction in the executive's base salary. Employer matches under certain 401(k) plans may also be related to the percentage of

base salary that the executive chooses to defer under the plan and would be similarly affected by a reduction in the executive's base salary.

- Nonqualified retirement plans, such as excess 401(k) plans and defined benefit supplemental executive retirement plans, might be particularly affected by reductions in an executive's base salary. For example, some executives may have pension benefits that are calculated as a percentage of average salary over a period of time prior to termination.
- Companies should also be mindful of amounts that are customarily deducted from cash compensation, such as employee contributions to medical or other benefits.

3. What are some other considerations for companies to take into account when deciding whether to reduce executive pay?⁶

- *Federal and State Law.* Companies should carefully review federal, state and local labor laws, including minimum pay requirements, before implementing any reduction of executive pay.
 - The Fair Labor Standards Act (FLSA) requires the payment of a minimum wage and overtime premiums. Almost all executives are classified as "exempt" from the requirements of the FLSA; however, in order to be classified as exempt, an employee must receive a minimum "salary level" of \$684 per week (or \$35,568 per year) or the employee will no longer be exempt. Up to 10% of the salary level may be met with **nondiscretionary bonuses**, incentive payments and/or commissions if the employer pays them at least annually.
 - Most states also have minimum wage and overtime rules with minimum salary requirements, which apply separately from FLSA and should also be reviewed when a company is contemplating salary reductions.
 - New York: Under New York State law, in order to be classified as exempt, an employee must receive a minimum annual salary which varies based upon the location of the employer. For an employee in New York City, the minimum annual salary is at least \$1,125 per week (or \$58,500 per year).
 - California: Under California law, the current minimum salaries for exempt professional employees are \$4,160 per month (or \$49,920 per year) for employees working for an employer of 25 or fewer people and \$4,507 per month (or \$54,080 per year) for employees working for an employer of greater than 25 people.
 - In California, non-discretionary bonuses are treated as wages that must be paid to the extent they are earned. For executives located in California, companies should carefully consider whether any action in respect of the executive's bonus opportunity could serve to reduce a non-discretionary bonus that was already earned.
- *Stock Ownership Guidelines.* Stock ownership guidelines require executives to own a specified number of shares of company stock, which is often measured as a dollar value equal to a multiple of the executive's annual base salary. When implementing base salary reductions, companies should consider whether such reductions should factor into an executive's stock ownership

⁶ For other actions that companies have taken in respect of their 2020 incentive compensation programs in response to COVID-19, please see our previously published client memoranda: [COVID-19: Considerations for Companies That Have Already Established Their 2020 Incentive Compensation Programs](#).

requirements. It may be appropriate for companies to consider, at least temporarily, aligning stock ownership guidelines with the executive's reduced base salary, particularly in light of any recent drop in the company's stock price.

- *Golden Parachute Calculations.* A reduction to an executive's base salary and bonus opportunities could impact tax calculations under Section 280G and Section 4999 of the Internal Revenue Code (collectively, the Golden Parachute Rules) in the event of a future change in control. Under the formulaically specified Golden Parachute Rules, if an executive receives more than three times the executive's "base amount" in connection with a change in control, a company will lose the tax deduction to which it would normally be entitled in connection with executive pay, and the executive will be subject to a 20% excise tax for payments made in connection with a change in control that are above a certain threshold.⁷ This may be especially significant for public companies that are not permitted to take advantage of the golden parachute payment shareholder approval process permitted for private companies.
- *Payroll Deductions and Tax Withholding.* Companies should also keep in mind that payroll deductions and employer tax withholding will need to be done on the basis of the reduced pay. Affected executives should be given the opportunity to adjust their withholding elections by providing the company with an updated Form W-4.
- *CARES Act.* Under the CARES Act, companies that receive certain types of assistance – for example, an air carrier that receives funds under the payroll support grant program, or a business that receives a direct loan from the Treasury Department under the programs established for air carriers, businesses that are critical to national security and others – must impose limitations on executive pay. These limitations have also been imposed, as a policy matter, on the Federal Reserve's Main Street Lending Program.⁸
 - For any officer or employee (excluding union employees) whose 2019 "total compensation" exceeded \$425,000, total compensation for any 12-month period is capped at 2019 total compensation levels.
 - For any officer or employee whose total compensation exceeded \$3 million in 2019, total compensation for any 12-month period is capped at the sum of \$3 million *plus* 50% of the excess over \$3 million of 2019 total compensation.

⁷ An executive's base amount is three times the average amount of taxable compensation that the executive received over the five-year period immediately preceding the change in control. This means that a reduction in base salary will also reduce the executive's base amount, which could negatively impact the company and its executives by triggering the application of the Golden Parachute Rules or increasing the lost deductions and amount of excise tax owed.

We note that, for public companies, the loss of the tax deduction may be a lesser concern to the company because the recent changes to Section 162(m) of the Internal Revenue Code effectively make all compensation for a calendar year above \$1 million for its most senior executives non-deductible and significantly expand the scope of executives that are subject to this deduction limitation. However, the applicability of the excise tax on the executive was not affected by the Section 162(m) changes, so the reduction in the executive's base amount resulting from a salary reduction could be a real issue, especially for executives at companies that may be a likely takeover target.

⁸ For airlines receiving funds under the payroll support grant program, the limits apply until March 2022. For companies that receive a direct loan or guarantee from the Treasury Department or participate in the Main Street Lending Program, the limits apply until one year after the loan or guarantee ceases to be outstanding. For more information on the Main Street Lending Program, please see [our visual memo](#).

- For any officer or employee in either of the categories set forth above, severance payouts on a termination of employment are capped at two times the 2019 maximum total compensation.

4. How much of a reduction are companies typically approving?

It varies. Companies should consider their individual circumstances when determining whether and the amount by which to reduce their executive-level compensation.

- *Base Salaries.* Based on our review of public company filings that have disclosed base salary reductions, reductions tend to start at 20% of base salary on the lower end (though we have observed some companies implementing 10 – 15% reductions), with a handful of companies reducing salaries to \$0 at the top end. The majority of reductions range from 40% to 60% of base salary.⁹
- *Bonuses.* Based on our review of public filings that have disclosed bonus reductions, there does not appear to be a common trend in the amount of such reductions, with approaches varying from company to company.

5. Are public companies required to disclose reductions in executive pay?

It depends, and, in any case, the timing and the location of the disclosure may vary. We expect that regardless of technical disclosure requirements, many companies will want to make such reductions public, either for internal employee morale or investor relations purposes, to demonstrate that the executive team is sharing in the challenges being faced by its employees and shareholders.

- *Form 8-K.* Pursuant to Item 5.02(e) of Form 8-K, a public company is required to file a current report on Form 8-K within four business days following a material change in a named executive officer's compensation or a material modification to an existing compensation arrangement (e.g., severance arrangements).¹⁰ Whether a reduction in a named executive officer's compensation is material is determined by a facts-and-circumstances analysis, taking into account factors such as the amount of the reduction and its impact on any other compensation, as well as the company's overall financial health.
 - Companies that do not view the executive pay reduction as "material" but still want to disclose the reduction have the option of disclosing the reduction under Item 8.01 for "All Other Events" instead of under Item 5.02(e) (or another item as the facts may dictate).¹¹

⁹ Beginning in March 2020, we have tracked Securities and Exchange Commission filings that disclose company actions taken with respect to compensation as a result of the COVID-19 pandemic. Our findings are based on a review of those filings that have disclosed executive salary and director retainer reductions, which we discuss in Question 7.

¹⁰ Named executive officers, as defined by Item 402 of Regulation S-K, typically include any individual who served as the chief executive officer or the chief financial officer of the company in the last completed fiscal year and the next three most highly compensated executive officers who were serving as executive officers at the end of the last completed fiscal year. For companies that are smaller reporting companies or emerging growth companies, named executive officers include any individual who served as the chief executive officer during the last completed fiscal year and the next two most highly compensated executive officers who were serving as executive officers at the end of the last completed fiscal year.

¹¹ If an executive's employment agreement has been filed as an exhibit with the company's Form 10-Q or Form 10-K, then any amendment to that employment agreement in connection with the reduction in pay is required to be filed as an exhibit with the company's next Form 10-Q or Form 10-K.

- ISS issued [COVID-19 Guidance](#), which, among other things, encourages companies to provide “contemporaneous” disclosure for changes to executive compensation that come as a result of the COVID-19 pandemic and the rationale for such actions.¹²
- *Definitive Proxy Statement.* Companies will also be required to disclose their named executive officers’ salaries and bonus amounts in the Compensation Discussion and Analysis section¹³ and accompanying tables (including the Summary Compensation and Grants of Plan-Based Awards Tables) of their annual proxy statement that covers the fiscal year in which the reduction took place (for calendar year companies, this means the proxy filed in the spring of 2021). As part of this disclosure, companies will likely want to discuss the reasons for and the impact of any such salary or bonus reductions on other programs (e.g., if the company took action to provide that the salary reduction would not impact the calculation of bonuses or severance). The Compensation Discussion and Analysis section of the proxy statement gives companies the ability to provide a more detailed description of any reductions and related changes and to explain their executive compensation decisions in light of the COVID-19 pandemic.
- *Internal Company Communication.* Companies should also consider how to communicate any executive pay reductions to the company’s broader employee base. As this internal communication will give companies the opportunity to show the executives’ solidarity with the rank-and-file employees who may be feeling the impact of the COVID-19 pandemic most acutely, companies should pay careful consideration to how it presents this information.¹⁴ For public companies, if disclosing executive pay reductions to employees internally, consider whether similar disclosure should also be made to the public.

6. Can a current reduction in executive pay be exchanged for some other right to future compensation?

Yes, but be aware of tax considerations. Companies that are primarily concerned with reducing costs in the short term may wish to consider implementing base salary reductions now, in exchange for some other right to future compensation. Such later payment may be in the same form (*i.e.*, cash) and in an amount equal to the base salary reduction amount or in the form of other consideration, such as equity awards. For example, some companies have considered granting restricted stock units in place of the foregone salary. Such grants can only be made in place of prospective salary and not salary that has already been earned (even if unpaid).

Companies that choose to provide for any such make-up payments, specifically if the make-up payments will be paid after the 2020 calendar year, should do so with caution, because such an arrangement could constitute an impermissible deferral of base salary under Section 409A of the Internal Revenue Code (Section 409A). Generally, in order to be exempt from Section 409A under Section 409A’s short-term deferral rules, payments need to be made by March 15 of the year following the year in which the payments are no longer subject to a “substantial risk of forfeiture.” Although the rules under Section 409A

¹² For a more detailed overview of the ISS Guidance, please see this [blog post](#) published on the Davis Polk Corporate Governance blog.

¹³ Companies classified as smaller reporting companies and emerging growth companies are not required to include a Compensation Discussion and Analysis section in their proxy statement.

¹⁴ One item that companies may want to consider in their communication of executive pay reductions to rank-and-file employees is providing the appropriate amount of information and context so as to assuage any fears that the rank-and-file employees may have of an imminent reduction to their own salaries or other compensation, to the extent the company is not intending to, or does not want to reserve discretion to, reduce compensation for rank-and-file employees.

are not entirely clear, if the make-up payments are paid, and in the case of restricted stock units, if such units vest and settle, by March 15 of the year following the year in which the salary reduction occurred, the make-up payments will likely be exempt from the Section 409A requirements under the short-term deferral exception.¹⁵ If the make-up payments are not exempt from Section 409A, then any deferral of base salary would be required to comply with the specific timing rules that govern when deferral elections can be made.¹⁶

For deferrals of performance-based incentive compensation, including annual bonuses, there is more flexibility in the timing rules, because deferral elections can be made up to the date that is six months before the end of the applicable performance period, as long as the amount of the performance-based compensation is not readily ascertainable.¹⁷ Companies that have not yet set their annual incentive plans for 2020 may wish to consider the salary reductions in setting threshold, target and maximum performance levels and the amounts that may be earned at each level. However, as noted above, executives often have contractual rights to receive bonuses within a predetermined and pre-negotiated time period, so any deferral of such payments may require the consent of the executive.

7. Are companies taking action with respect to director compensation?

Yes, although a smaller number than those taking action with respect to executive pay. In connection with reductions in executive pay, a number of companies have reduced or have considered reducing annual director cash retainers and equity awards. While a decrease in director compensation is not required to be reported on Form 8-K, as Item 5.02(e) is not triggered by changes in director compensation, a number of companies have chosen to voluntarily disclose this information. So far, nearly 40% of the companies that we have observed disclosing reductions in executive pay have also disclosed reductions in director retainers.

Companies should review their governing documents to confirm whether there are any approval requirements for reductions in director retainers. Director compensation may be covered by the compensation committee charter or by the company's corporate governance guidelines and/or the nominating/corporate governance committee charter, depending on which body is responsible for director compensation. In the absence of committee authority, a reduction in director compensation could be approved by the full board.

Similar to reductions in executive pay, companies will also want to keep in mind that ISS recently adopted a **non-employee director "excessive compensation" policy** where ISS indicated that it will target companies with director pay in the top 2% of their ISS-determined peer group. We recommend that companies monitor whether their ISS-determined peers are reducing director pay in order to avoid inadvertently falling under the ISS director "excessive compensation" policy by virtue of not reducing their own directors' pay.

¹⁵ If the amount of the make-up payment is "materially greater" than the foregone salary and the executive is required to remain employed through the date of the make-up payment, then it is likely permissible for such make-up payments to be extended past March 15 of the year following the year in which the salary reduction occurred, but the guidance from the Internal Revenue Service on this point is not entirely clear. Treas. Reg. § 1.409A-1(d)(1). The Office of the Chief Counsel of the IRS has issued [advice](#) indicating that a 25% increase is "materially greater."

¹⁶ Treas. Reg. § 1.409A-2(a). Failure to comply with these specific timing rules can result in adverse tax consequences to the executive. If payments of nonqualified deferred compensation are made in violation of Section 409A, then the employee will be required to pay an additional 20% tax, on top of the ordinary income taxes on the noncompliant deferred compensation amount and underpayment penalties. For more information on deferral elections, please see our previously published client memoranda: [COVID-19: Impact on Nonqualified Deferred Compensation Plans](#).

¹⁷ Treas. Reg. § 1.409A-2(a)(8).

In Conclusion

Companies that are, or may be, considering reducing either executive or director compensation should consider the necessary approval and disclosure requirements and requirements under federal, state or local law, along with the implications such reductions may have for existing contractual arrangements and benefit programs and the impact on other related calculations such as stock ownership requirements and computations under the Golden Parachute Rules. Evaluating these direct and indirect impacts can facilitate companies acting in a proactive and thoughtful manner both with respect to the structure and rollout of any pay reduction program, and the manner in which such reductions in pay are communicated to executives and directors, other employees of the company and stakeholders generally.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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