Simpson Thacher

Memorandum

COVID-19 Considerations for Employee and Director Compensation Reductions

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As the coronavirus disease 2019 ("COVID-19") continues to impact consumer and business behavior and financial markets in unprecedented ways, many companies are facing difficult decisions on how to preserve cash, including with respect to employee costs. This memorandum discusses key issues employers should consider when contemplating compensation reductions for employees and non-employee directors during this challenging period.

Considerations for Employees

In the United States, employers generally are free to prospectively change an employee's terms and conditions of employment, subject to compliance with contractual obligations and, where applicable, collective-bargaining restrictions. These changes may include reductions to base salary and bonuses or a substitution of additional equity incentives in lieu of cash payments.[1] Below are areas an employer should consider before making any changes:

Scope of Changes. An employer must first decide what type of changes it intends to make. Many employers have simply announced reductions in wages and base salary, without specifying whether the foregone compensation will be paid in the future and/or whether the reductions will have an impact on annual bonus opportunities and/or long-term incentives. More holistic approaches could include:

- a clear statement that the employer will consider making employees whole for any lost wages or base salary later in the year through a discretionary bonus, if circumstances warrant (or even a formal commitment to do so, although this has not been a typical practice);
- clarifying that the value of annual bonus opportunities and long-term incentives will still be calculated based on the employee's wages or base salary in effect prior to the reduction;

[1] For employees outside the United States, guidance should be obtained from appropriate counsel. Many jurisdictions, particularly in Europe, provide employees with greater rights and protections.

- specifying that any severance paid as a result of a termination of employment during the period of reduced wages or base salary will still be calculated based on the employee's wages or base salary in effect prior to the reduction; and
- granting one-time equity incentives to make up for the reduced cash compensation levels.

Employers should keep in mind that reductions in compensation for executive officers and/or senior management may require approval from the board of directors and/or the compensation committee thereof. In particular, at public companies, the compensation committee of the board of directors, and, if required by the compensation committee charter, the full board of directors, should review and approve reductions to base salary and bonus opportunities for executive officers.

Contractual Obligations. Employers that are considering reducing employee compensation (including wages, base salary, annual bonus opportunities, and long-term incentive opportunities) should carefully review existing contractual arrangements with employees. It is common for employment agreements, equity incentive agreements, and severance arrangements, particularly those covering management- or executive-level employees, to have "constructive termination" or "good reason" protections that may be triggered by a reduction in compensation. The exact formulation of these provisions will vary, but, in the event the employer reduces pre-agreed elements of the employee's compensation, they generally permit an employee to resign from employment as a result of "good reason" or "constructive termination" and receive severance payments and/or accelerated vesting. Occasionally, a "good reason" definition may contain an exception for a reduction that is an across-the-board reduction affecting similarly-situated employees and/or that is not "material." The uniqueness of COVID-19-related reductions may present challenging interpretation issues. Even if an employment agreement does not contain a specific "constructive termination" or "good reason" protection, an employer's unilateral decrease in an employee's compensation levels could constitute a breach of contract (in which case the employee may have general damages claims) and/or violation of state wage laws (which may provide for significant liquidated damages).

If any doubt exists regarding whether a contractual provision could be implicated by a compensation reduction, employers contemplating a reduction should request that each affected employee executes a written (or electronic) consent agreeing to such reduction in advance of the reduction. By taking this preemptive step, an employer can obviate later disputes, including any claim for breach of contract. In our experience, senior and other key employees have been gracious in agreeing to changes in light of COVID-19 impacts, particularly to the extent cutbacks can reduce an employer's need to effect layoffs or furloughs.

A consent should expressly acknowledge the original and new compensation levels and specify when compensation will return to the original levels (if known) or that the reduction will continue indefinitely until further notice. The consent also should include a confirmation from the employee that he or she agrees that the reduction does not constitute "good reason" or a "constructive termination" (or term of similar meaning) under any agreement to which the employee is a party or any plan in which the employee participates, including any

equity arrangements. In addition, the consent should clarify whether the reduction will affect other compensation amounts that are based on percentages or multiples of base salary, such as 401(k) contributions by the employer or the calculation of annual bonuses and severance amounts.

Even if no contractual obligation exists, it is generally a best practice to inform employees in writing of any salary reduction prior to the date that the reduction becomes effective. Some states explicitly require that employees be informed of a new wage rate prior to performing any work during the applicable period during which the new wage rate is effective. Specifically, certain states require between one and 30 days' advance notice of such reduction, and in some cases states require that the notice be in writing.[2]

Deferred Compensation Considerations. Section 409A of the Internal Revenue Code ("Section 409A") sets forth a complex set of rules governing deferred compensation arrangements. While reductions in salary, wages, or cash retainers alone should not result in the deferral of compensation, employers should be aware that any commitment to repay the forgone compensation at a later date may be considered a deferred compensation arrangement under Section 409A. Employers contemplating these types of arrangements should ensure that employee communications related to any such payment programs are carefully drafted. Where possible, employers should be mindful of inadvertently creating any legal obligation to make such payments. A legal obligation can arise if an employer creates an expectation of payment that would rise to the level of a "reliance" claim, which may unintentionally create a deferred compensation arrangement subject to Section 409A. See here for Simpson Thacher's memorandum addressing other Section 409A issues presented by COVID-19 developments. To the extent an employer intends to make employees whole for prior compensation reductions as financial conditions improve, from a Section 409A compliance perspective, it would be better to do so on a discretionary basis in the form of a bonus or other compensation.

Severance, Life, Disability, and Retirement Benefits. In connection with wage or salary reductions, employers should consider whether other employee benefits may also be affected. Certain benefits, such as severance, life, disability, and retirement benefits, may be determined by an employee's annual base salary level, which could be impacted by even a temporary reduction. For example, a reduction in base salary may affect the aggregate amount of an employee's contributions to defined contribution retirement plans (*e.g.*, 401(k) plans). Employers should deliver appropriate communications to inform employees of the impact of a salary or wage reduction on other benefits and to allow employees to make changes to contribution elections at the next eligible date.

Reclassification, Overtime Claims, Constructive Discharge, and the WARN Act. Employers should be aware that reductions in salary or wage rate for exempt employees below the applicable state or federal minimum for exempt

[2] States that require advance notice of wage rate reductions include: Iowa (at least one pay period prior), Maryland (at least one pay period prior), Missouri (at least 30 days prior), Nevada (at least seven days prior), North Carolina (at least 24 hours prior), and South Carolina (at least seven days prior).

classification[3] will result in reclassification of those individuals as hourly employees who are entitled to overtime for hours worked in excess of 40 per week (or on a daily basis, if required locally). Reductions may also implicate other wage and hour-related obligations, such as a requirement to comply with applicable meal/rest period rules or additional recordkeeping requirements. In addition, reductions for any employees must continue to comply with applicable state, federal, or local minimum wage laws.

Courts have held that a significant wage or salary reduction that causes an employee to resign can be characterized as a "constructive termination." Moreover, such a "constructive termination,"[4] or any compensation reduction, can lead to individualized claims for discrimination and/or retaliation under federal or state labor and employment laws. Furthermore, courts have found that a significant compensation reduction may amount to a "constructive termination" for the purposes of the federal Worker Adjustment and Retraining Notification Act ("WARN Act").[5] Regulations under the WARN Act acknowledge that "constructive terminations" can qualify as employment losses, requiring 60 days' advance notice to be given to the affected employees (or payment in lieu thereof). Therefore, depending on the circumstances, widespread significant salary or wage reductions could arguably trigger notice or pay obligations under the WARN Act or similar state or local "mass layoff" or "plant closing" laws (although there may be COVID-19 exceptions available under certain circumstances). Additionally, employees subject to significant salary or wage reductions might argue that their "constructive terminations" should have required a WARN Act notice because the reduction occurred in connection with other cost-saving measures (such as mass layoffs) which were implemented around the same time and for which the affected employees did receive WARN Act notices.

Non-U.S. Employees and Collective Bargaining Arrangements. Changes to key terms and conditions of employment, including changes in compensation, generally are not permitted outside of the U.S. without employee consent (and typically require union or works council consultations if the employee is a member of one of these organizations). Similarly, such changes are not permitted within the U.S. if affected employees are covered by a collective bargaining agreement, unless bargaining with the applicable union prior to implementing such change. Labor counsel should be consulted before making any changes with respect to union employees.

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[3] The current federal salary threshold for most "white collar" exemptions is $35,568 per year. In New York State, the current threshold varies depending on location: $58,500 per year for employers in New York City; $50,700 per year in Nassau, Suffolk, and Westchester counties; and $46,020 per year for most of the rest of New York State.

[4] *See, e.g., Scott v. Harris Interactive, Inc.*, 512 Fed. Appx. 25 (2d Cir. 2013) (reversing summary judgment for employer, holding that reduction of at-will employee's salary from $220,000 to $150,000 is not insufficient as a matter of law to support a claim of constructive termination).

[5] *See* 29 C.F.R. §§ 639.3(f)(2), 639.5(b)(2); *Simonyan v. Countrywide Fin. Corp.*, 2011 WL 12611772 (C.D. Cal. Jan. 26, 2011) (denying a motion to dismiss WARN Act claims on the basis that reducing the plaintiff's hours to zero and denying him the ability to earn commissions, resulting in an 80% reduction in compensation, stated a claim for constructive termination under the WARN Act); *c.f. also Int. Oil v. Uno-Ven Co.*, (7th Cir. 1999) 170 F.3d 779, 784 (assuming without deciding that that the concept of constructive discharge would be applicable under the WARN Act for employees involved in a corporate change-in-control who were rehired by a successor "at a wage so much lower than their previous wage, or on conditions so much inferior as to rebut an inference of continuity of employment.").

SEC Disclosure. In light of selective disclosure concerns, public companies should consider whether to publicly disclose material compensation reductions by issuing a press release and/or by filing the information on a Form 8-K. In addition, any compensation reductions that impact a public company's "named executive officers" may need to be currently disclosed on a Form 8-K and will need to be disclosed and explained in the company's annual proxy statement (or Form 10-K for filers who do not submit proxy statements).

Anti-Discrimination Laws. When making compensation reductions, an employer must ensure that employees who are protected by federal and state anti-discrimination laws (*e.g*., the American Disabilities Act, Age Discrimination Act, and Title VII) are not disparately impacted. Any such reductions must be for justified business reasons.

Considerations for Non-Employee Directors

In addition to temporary reductions in employee wages and salaries, a company's board of directors may also consider whether compensation paid to its non-employee directors, including cash and equity retainers, should be temporarily reduced. Typically, director compensation is payable pursuant to a director compensation program approved by the board and can be modified by the board. To the extent a member of the board of directors has contractual entitlements to compensation, the company and the board will need to review such contractual arrangements and have any such director execute a consent letter agreeing to any reduction in advance to avoid later disputes, including breach of contract claims. In addition, public companies will need to disclose and explain any changes to director compensation in the company's annual proxy statement.

Conclusion

When making compensation decisions in this turbulent time, there are a number of factors that employers should consider. As with all compensation decisions, public companies must focus on SEC disclosure requirements, impact on say-on-pay voting, and input from proxy advisory firms and institutional investors, as well as take advice from experienced independent compensation consultants with appropriate industry experience. In addition, all employers should also consider employee messaging, including applicable state and local requirements for employee notices. Finally, employers should comprehensively analyze the legal, tax, and accounting implications when implementing or adjusting compensation programs for employees or non-employee directors, including compliance with collective bargaining agreements and applicable state and local laws.

Additional general guidance on matters related to COVID-19 can be found here.

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