

COVID-19 Impact on Executive Compensation – Salary/Wage Reductions

Tax Talks Blog on **March 27, 2020**

We continue our blog series on COVID-19 implications on executive compensation matters with a post that addresses salary or wage reductions on a company-wide or targeted basis.

Companies impacted by the COVID-19 pandemic, including the concomitant widespread shelter in place orders, may be considering pay cuts for some or all of their workforce, either in addition to or instead of furloughs and layoffs. In implementing salary or wage reductions, companies should be mindful of federal, state and local wage and hour and labor laws, consent and notice requirements under contractual agreements with individual employees or groups of employees, tax implications on subsequent “make-whole” or “make-up” payments, impact on employee benefit plan participation, governance considerations, and disclosure requirements for public companies.

Prior to implementing salary or wage reductions, companies should:

- **IDENTIFY** affected employees and applicable state or local law:
 - Who are the employees affected by potential salary or wage reductions? Are they exempt or non-exempt? Are they part-time or full-time? How many employees are affected at any single location? Will company executives be impacted?
 - Is the salary or wage reduction being undertaken in connection with a reduction in hours? If so, is the reduction proportionate?
 - What state or local law is applicable to the employee’s employment?
 - What are the state and local requirements for the notice, if any, that must be provided to employees prior to or following a wage reduction?
 - Would a reduction result in the employee’s wage falling below the threshold level for exempt classification (currently \$684 per week under federal law)?

- **REVIEW** the potential effects of a salary or wage reduction under applicable law, contract, agreements, offer letters, and employee benefit plans:
 - Is the employee a party to an employment agreement, offer letter, or other agreement or arrangement that sets base salary? If so, does it expressly provide that base salary cannot be reduced, such that it would need to be amended?
 - Is the employee covered by an agreement, offer letter, or plan with a “good reason” or similar definition that would trigger severance, equity award accelerated vesting, or other rights as a result of a salary reduction? Is there an exception for across-the-board salary reductions and, if so, whether a limit or such reduction applies?
 - Does the employee participate in employee benefit plans and programs (e.g., group health plans, retirement plans, 401(k) plans, severance benefits, and vacation programs) that may be impacted by a reduction in hours and/or salary or wage reduction? For example, salary reductions may reduce an employee’s severance entitlement, pension accrual or matching contribution.
 - Does the company’s employee handbook address salary or wages during a leave of absence or furlough?

- **ACT** to execute waivers, deliver notices, take action with respect to employee benefit plans and, for publicly traded companies, provide disclosure of the salary reduction where necessary:
 - Obtain consents to salary or wage reductions and waivers of “good reason” from employees as needed.
 - Provide advance notice in accordance with applicable state and local requirements.
 - Take any necessary actions under employee benefit plans and programs to continue or end coverage/participation, as applicable.
 - Prepare and file disclosure if/as required for public companies (e.g., Form 8-K, press release).
 - Consider creating a working group including representatives from HR, legal, and investor relations to coordinate actions and communications to internal and external interested parties.

Wage and Hour considerations; Notice considerations

A number of states and some cities require companies to provide employees with notice of salary or wage reductions and/or notice of hours reductions within a certain number of days in advance of the reduction or within a certain period following the company's decision to take such actions. Companies with operations in multiple states should confirm with labor/employment counsel whether state or local notice is required. If notice is required, the content of the notice should be reviewed by counsel to confirm that the messaging of the notice is consistent with the company's approach for labor, employment, employee benefit plan, contract, and tax purposes.

In considering whether to reduce salary or wages of employees classified as "exempt" under the federal Fair Labor Standards Act, companies should carefully analyze applicable federal and state law (for example, exempt employees who perform *any* work during a work week are generally entitled to full salary, subject to limited exceptions).

Companies should also analyze whether such a reduction would be reasonably likely to result in the employee's wage being reduced below the threshold level for exempt classification (\$684 per week under federal law and \$1,125 per week under New York law). If so, companies should consult labor/employment counsel with respect to the best approach with respect to such employees. Additionally, while outside the scope of this blog post, companies that have employees represented by a union or subject to a collective bargaining agreement, should review any limitations or prohibitions under those agreements.

Contractual agreements

Compensatory arrangements entered into by companies with their employees, particularly with respect to their executive teams, and other arrangements maintained by companies (e.g., severance plans, equity plans, incentive compensation plans) often include provisions that require a specified salary to be paid and/or allow the employee to terminate his or her employment for "good reason" as a result of a salary reduction.

A common provision in good reason definitions is a reduction in the employee's base salary and/or target bonus opportunity. Once an employee's good reason provision is triggered, and assuming that the wages are not reinstated within a short period of time or the employee does not consent to such reduction, the employee could terminate his or her employment and be entitled to severance, accelerated equity vesting, or other rights. Certain agreements contain exceptions to these provisions for company-wide reductions or similar reductions across the senior-executive team, sometimes up to an overall cap.

In addition, employment agreements or offer letters may expressly provide that an employee's base salary cannot be reduced below the stated level. If so, a reduction without the employee's consent could result in a contractual claim. Further, amendments to or terminations of certain broad-based plans providing for specified levels of compensation may be limited or delayed by the provisions of the plan or certain advance notice requirements under the Employee Retirement Income Security Act of 1974.

Companies considering broad-based salary or wage reductions should review their employment agreements, offer letters, and any other agreements that require payment of a specified salary or that contain good reason protections, and should discuss with executive compensation and benefits counsel whether reducing wages could trigger unintentional contractual or administrative claims or severance obligations.

Tax considerations

Companies considering providing for salary, wage, or other compensation reductions in connection with the opportunity of a later guaranteed or conditional (*i.e.*, merit or performance based) “make-whole” or “make-up” payment should be cautious, as such an arrangement could potentially result in an impermissible deferral of compensation under Internal Revenue Code Section 409A (“Section 409A”). Generally speaking, Section 409A, which governs non-qualified deferred compensation arrangements, requires elections to defer compensation to be made no later than December 31 of the calendar year before the calendar year in which the employee performs the services to which the compensation relates (there are certain exceptions with respect to performance-based compensation that may be applicable to bonuses, but a discussion of these exceptions is beyond the scope of this blog post). If an employee’s consent is required for the compensation reduction and if in connection with such reduction, the company commits to paying additional compensation to the employee in a future taxable year, this type of arrangement could result in adverse tax consequences to the employee (including a 20% additional income tax in addition to applicable income tax). Companies should consult executive compensation and benefits counsel before implementing any program that includes a “make-whole” or “make-up” payment that could be paid in a calendar year following the calendar year of the compensation reduction. Companies considering such programs should also consult executive compensation and benefits counsel to determine whether Congress, the Treasury Department, or the Internal Revenue Service have issued relief under Section 409A or other guidance in light of the COVID-19 pandemic and widespread salary/wage reductions.

Employee benefit plan considerations

Salary or wage reductions, especially when coupled with layoffs or furloughs, may impact employees’ participation in employee benefit plans. Companies should discuss the impact of a salary or wage reduction with their employee benefits counsel. In particular, companies should:

- (1) Review their group health plan and Affordable Care Act requirements to assess requirements for continued coverage, either as an active employee or through COBRA, and the cost for that coverage;
- (2) Monitor FSA and Dependent Care FSA contributions to be sure they are properly made depending on the facts; and

(3) Consider the effect of salary or wage reductions on 401(k) contributions and outstanding loans.

Governance considerations

In implementing salary or wage reductions, companies should confirm that such actions are approved at the appropriate level for corporate governance purposes. While decisions to reduce salary and wages for rank-and-file employees may in some cases be made by company management, salary and wage reductions for senior management and executive officers and director fee reductions should be approved by the Compensation Committee or the full Board, as applicable. Companies should consult executive compensation and benefits counsel to review governance documents (including Compensation Committee charter) and prepare the necessary approvals.

Public company disclosure considerations

For public companies, Form 8-K rules generally require disclosure of information that is important to security holders, including disclosure of information under Regulation FD and events material to corporate governance and management. Broad-based or selective salary or wage reduction programs may trigger disclosure on a Form-8-K (whether under Item 2.05 as steps taken in connection with exit or disposal activities, Item 5.02 as a material amendment of a material management contract or Item 7.01 / Item 8.01 as Regulation FD disclosure or voluntary disclosure) and filing requirements should be carefully reviewed and considered by public companies with counsel. Contracts entered into in connection with salary or wage reductions may be required to be filed with the company's next quarterly or annual report.

Our executive compensation lawyers are tracking the companies that have been implementing salary and wage reductions and are available to discuss the alternatives that other companies have been implementing.

Proskauer's cross-disciplinary, cross-jurisdictional Coronavirus Response Team is focused on supporting and addressing client concerns. Visit our [Coronavirus Resource Center](#) for guidance on risk management measures, practical steps businesses can take and resources to help manage ongoing operations.

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