STEVEN HALL & PARTNERS
EXECUTIVE COMPENSATION

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Managing the Impact of COVID-19 on Executive Compensation Plans

The COVID-19 pandemic has every company questioning the impact the virus will have on employee populations, supply chains, consumer demand and the global economy. With the short- and long-term ramifications of the virus unknown, companies have many issues to address, including their total rewards programs. Many companies just completed the process of setting annual and long-term incentive plan performance goals and making annual equity awards to senior executives prior to the impact of COVID-19 being felt. It is safe to say that most, if not all, of these goals will be unattainable by year end and outstanding equity holdings, including those granted just weeks ago, are far less valuable today.

Below we have outlined a few thoughts as we begin to assist our clients with their executive compensation plan concerns.

Restrictions to executive compensation under the CARES Act of 2020, the recently passed COVID-19 bailout package.

Companies seeking a loan or loan guarantee under the recently passed CARES Act should note the restrictions the Act places on compensation for any executive or employee making more than $425,000 in total compensation. Total compensation is defined as salary, bonuses, awards of stock, and other financial benefits provided by an eligible business to an officer or employee of the eligible business.

During the period that begins on the date the company enters into a loan or loan guarantee agreement with the U.S. Government and ends on the one-year anniversary of the agreement expiring:

- Executives and employees whose total compensation exceeded $425,000 in calendar year 2019 may not receive total compensation during any consecutive 12 month period exceeding the total compensation received in calendar year 2019
  - Severance pay or other termination benefits may not exceed twice the maximum total compensation received in calendar year 2019
- Executives and employees whose total compensation exceeded $3,000,000 in calendar year 2019 may not receive total compensation during any consecutive 12 month period exceeding
  - $3,000,000; and
  - 50% of the total compensation amount over $3,000,000 in calendar year 2019
  - Total compensation paid to an executive that received $10,000,000 in total compensation during 2019 would be limited to $6,500,000 ($3,000,000 + ½ * $7,000,000) during the limitation period
- These restrictions exclude compensation determined through an existing collective bargaining agreement entered into prior to March 1, 2020

Companies that have already set performance goals and made annual equity grants generally should consider delaying modifications rather than react in haste.

If your company has already gone through the process of setting annual performance goals and making annual equity awards to employees, consider waiting before making any modification. Given the current economic uncertainty and stock market volatility, it may be better to address executive retention issues after the economy has stabilized. Any action taken now may not have the intended consequences in the long run. As the saying goes: "Don't try to catch a falling knife."

Companies that have not set annual incentive performance goals may want to wait to set performance targets until business plans have been revised and the general economic outlook is clearer.

The elimination of the Section 162(m) performance compensation deduction under The Tax Cuts and Jobs Act of 2017 means companies are no longer required to set annual incentive plan targets within the first 90 days of the performance period (but check that your plan's language is flexible on the timing of goal setting). Additionally, the changes to 162(m) provide companies greater latitude regarding the use of positive discretion when determining payouts under performance-based incentive plans. This added flexibility may be useful in the current situation as companies continue to assess financial forecasts for the remainder of the year.

- **Consider setting quarterly or semi-annual performance goals in place of annual goals.** This provides flexibility as the facts on the ground continue to evolve.
- **Consider incorporating relative performance metrics in the annual incentive plan.** It may be difficult to forecast financial performance for the remainder of the current fiscal year. Setting relative performance metrics that reward executive teams for outperforming their industry peers once the economy has restarted can be considered as an alternative to setting absolute financial performance goals. If this option is considered, selecting an appropriate group of comparator companies will be just as important as selecting the right performance metrics to motivate the executive team.

Companies that have not made annual equity grants can consider delaying the annual grant process until stability returns to the economy and stock market.

Many companies were in the middle of determining and granting their annual equity awards to executives when COVID-19 began to effect the economy and stock prices. While some companies may decide to continue the annual award process due to precedent, others may look to delay granting equity to ensure they are providing the intended grant value. We do not believe there is one right answer; each company will need to review its individual circumstances to determine the best course of action.

Due to the increased volatility in the market, there are several alternatives to current equity grant practices companies can consider to deliver awards that will motivate and retain the executive talent necessary to oversee the turnaround, recovery and future growth of the company:

- **Break the annual award up into three or four smaller grants to be granted over the next 3 or 4 months.** This will help to lessen the effects of the current volatility without being perceived as trying to time the bottom of the market to benefit executives. This also helps mitigate the risk of a single grant losing value due to further declines in stock price.

- **Consider one-year change to equity mix.** We caution against knee-jerk reactions that will have long-term consequences for what is hoped to be a short-term situation however, companies should review their equity grant mix to ensure it continues to deliver on the goal of motivating and retaining the executive team given the uncertainties in the economy and stock market.
- **Review the effect on equity plan share utilization*.*** The recent drop in stock prices will mean companies will have to grant more shares now than they would have several weeks ago to provide the same target value to recipients. By using the moving average stock price approach below, a company can help to mitigate excessive share utilization.
- **Use a moving average stock price instead of the closing price on date of grant to determine grant size.** While it is common to see companies use short moving averages (10-day to 30-day) to determine the number of shares being awarded, longer averages, such as 45-day or 90-day averages, may be more appropriate at this time. This can help moderate any sudden increases or decreases in stock price. For stock options, this will not affect the strike price of the options, only the number of options granted. Such an approach may be appropriate if share usage is a concern, but may not be well received by participants.

Review current retention power of the executive team.

Companies should review the retention power that current outstanding equity awards provide on executives. Competitors may look to recruit away key executives as the cost of replacing an executive's outstanding equity awards with a new sign-on award has dropped in recent weeks. Executives would benefit from the move to a new company by replacing their outstanding awards with new awards made in the current environment that potentially have greater wealth-generating ability over the long term. This is especially true for stock options granted at a time when stock prices are depressed and existing options are underwater.

Addressing retention issues will be challenging in the current environment as companies review their need to participate in the CARES Act loan program and avoid actions that shareholders might view as enriching executives while shareholder value has plummeted. Below are several alternatives for companies to consider, but in all cases, the CARES Act compensation limits previously discussed should be considered for participating companies:

- **Grant special one-time retention awards.** If it is determined that special action must be taken to address retention issues, the next step is to determine the appropriate way to deliver the award to executives. Companies should review cash positions and number of shares available under the equity plan as well as the views of executives and major shareholders to determine the correct course of action. Consideration should be given to including a performance threshold that must be met for the awards to be earned in addition to continued service at the company. We advise that any performance goal set for the award should be perceived as achievable; otherwise the retention power the award provides will be diminished.
- **Accelerate the 2021 annual equity award into 2020.** In theory, this would stand to benefit executives by allowing them to participate in gains to the stock price as the economy returns to the new normal. This may be viewed more favorably by shareholders than making a special one-time retention award.

- **Reprice or exchange outstanding underwater stock options.** These alternatives are generally not viewed favorably by shareholder groups and corporate governance experts, but enacting one may be practical in cases of extreme retention power loss over key executives. Companies considering these alternatives should review their equity plan to determine if a shareholder vote is required to reprice or exchange outstanding underwater options. An approach that may be considered shareholder friendly is to limit exercisability of the new options until the stock price returns to pre-COVID levels.
- **Reset performance goals on outstanding long-term incentive plans.** The sudden and prolonged nature of the COVID-19 economic slowdown has undoubtedly left many long-term performance goals unattainable. Companies need to consider if this should be corrected at the end of the performance period with the use of board discretion or if it is appropriate to reset the goals for some or all of the outstanding performance awards. Resetting the performance goals may help with executive retention as well as provide focus and motivation for the executive team when the slowdown ends.

ISS and Glass Lewis reaction.

ISS released guidance on April 8, 2020 regarding the impacts of COVID-19. The compensation-related issues addressed include:

- **Adjustments to 2020 compensation programs will generally be analyzed and addressed next year.** ISS encourages boards to provide contemporaneous disclosure to shareholders of their rationales for making any current changes.
- **ISS will review any "midstream or in-flight" changes to long-term compensation plans on a case-by-case basis.** ISS voting policies generally are not supportive of changes to long-term compensation plans during the performance period. As part of their analysis, ISS will determine if directors exercised appropriate discretion and if shareholders were provided with an adequate rationale for changes made.
- **ISS will review 2020 stock option repricing approval/ratification requests on a case-by-case basis.** It should be noted that ISS will generally recommend opposing any repricing that occurs within one year of a precipitous drop in the company's stock price. ISS looks for the following provisions to be included in a repricing plan:
  - The repricing plan is shareholder value neutral (a value-for-value exchange)
  - Surrendered options are not added back to the plan reserve
  - Replacement awards do not vest immediately
  - Executive officers and directors are excluded

  Additionally, ISS noted that boards that undertake repricing actions without seeking shareholder approval/ratification will be subject to scrutiny under ISS' board accountability provisions.

Glass Lewis has not published additional guidance regarding COVID-related compensation changes as of date of this publication.

Consider how any changes being made will be communicated with executives and shareholders.

In this time of uncertainty, communication with executives and shareholders will be paramount. Fully describing any compensation plan changes being made and the rationale for those changes will be an important step in securing buy-in from these two groups. One exercise we find helpful when companies are considering compensation plan changes is to draft the relevant section of the future Compensation Discussion and Analysis report (CD&A) that will explain those revisions prior to board approval. This additional insight has proved useful in the past for both executives and directors to understand how the proposed changes will be communicated and viewed by the public.

Conclusion

We believe it is important for companies to take the steps they believe are necessary to motivate and retain the executive talent needed to lead the company through this crisis. At the same time, companies should continue to keep the long-term best interests of shareholders in mind when making any changes to the compensation program.