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executive law & regulatory group

managing incentives in uncertain times

How should companies address the impact of the coronavirus and the economic downturn on incentive compensation?

Against the backdrop of the global pandemic and economic downturn, compensation committees and management teams are meeting to make 2020 compensation decisions.

Recent stock price volatility is affecting equity plans, including the number of shares companies grant. And for annual incentives and performance-based long-term incentives, the current environment has made forecasting business conditions one to three years out nearly impossible.

Challenges were initially most acute for the travel, leisure, and consumer products industries, but we've reached the point where companies in all industries need to consider the potential implications of a possible recession on their incentive compensation programs.

Decisions should consider how the crisis is affecting all stakeholders, including employees and shareholders. They should balance the interests of executives with those of employees — who may be laid off or furloughed, or face pay cuts or large losses in their 401(k) plans — and investors who may experience significant financial losses.

2020 awards

Equity grants

With the recent stock market volatility, mechanical application of value-based grant guidelines could result in significantly more shares being awarded than anticipated. This would increase dilution and burn rates, and create potential compensation windfalls if stock prices recover quickly. On the other hand, delivering less value could raise retention risks and lower the morale of plan participants.

Companies that haven't yet made their equity grants should consider delaying grants (for example until May or June) in the hopes that the effects of the economic downturn and the impact on the broader workforce will be more fully known.

Several different approaches are available to companies that don't want to wait to determine 2020 grants:

Split the difference between estimated pre-stock price drop grant (or last year's grant) as a moderating approach

Example 1 — *value-based grant guideline*. Assume a value-based guideline of $30,000. If the company had made grants in January, when the grant-date stock price was $30, the company would have granted 1,000 shares. In March, the stock price drops to $20. With no adjustment in the formula, 1,500 shares would be granted to meet the $30,000 guideline. If the company instead averages the January and March calculated grants, it would award 1,250 shares worth $25,000. This is a savings of 250 shares and $5,000 over what the company would have granted using the unadjusted formula. The result: lower cost and lower dilution.

Example 2 - *fixed-share grant guideline*. Assume a share guideline of 1,000 shares. In January, when the grant-date stock price is $30, the 1,000-share grant would have been worth $30,000. In March, the stock price drops to $20; 1,000 shares would be worth only $20,000. If the company instead averages the value of the January and March calculated grants, it would award $25,000 in value, or 1,250 shares. This is an added cost of $5,000 and increase of 250 shares over what the company would have granted using the unadjusted formula. The result: higher cost and higher dilution.

Use a collar: Continue to base the number of shares on the stock price (value-based guideline) or number of shares (fixed-share guideline), but set a floor and maximum for the number of shares that can be awarded — for example, + or – 20% of the estimated pre-stock price drop (or prior year's) number of shares or share value

Example 3 - Using the facts from Example 1, a 20% collar around the number of shares granted under a value-based guideline would result in a grant of 1,200 shares (120% of 1,000 shares awarded last year) with a value of $24,000 at $20 per share.

Example 4 - Using the facts from Example 2, a 20% collar around the value of shares granted under a fixed-share guideline would yield a value of $24,000 (80% of $30,000), which translates to 1,200 shares at $20 per share.

For value-based grant guidelines, base the number of shares on an average stock price over a longer period of time (for example, the prior 90 days) to smooth out recent volatility. (This could also be done to assess compliance with stock ownership guidelines.)

For fixed-share grant guidelines, consider whether a temporary increase is warranted to keep compensation competitive with peers and retain executives.

When considering how to adjust the grant formula, companies may find it helpful to model potential award values for the next few years to estimate potential windfalls or shortfalls at various future share prices and determine how much share price appreciation is needed for equity grants to reach their target dollar value.

Goal setting

Companies that haven't yet set goals for 2020 annual and long-term incentive awards may want to consider the following actions:

For short- or long-term incentives:

As with determining the number of shares to grant under equity plans, **postpone** setting performance goals until the impact of the economic downturn on performance results is clearer.

Use **shorter performance periods** with additional service-based vesting requirements, since setting shorter-term goals is easier during times of uncertainty.

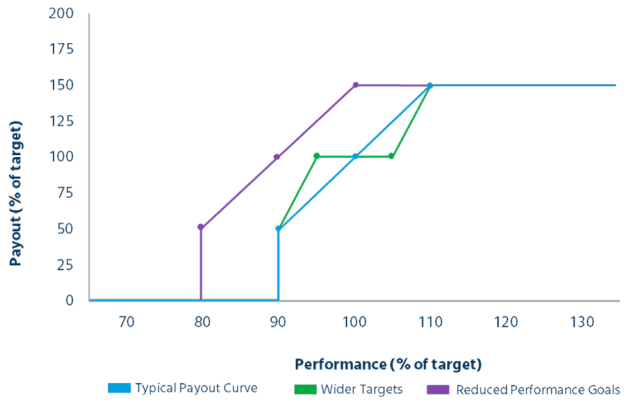
Build in **more discretion** to make adjustments to performance targets or award payouts (up or down), which is easier now that Code Section 162(m)'s performance-based pay prohibition on upward discretion no longer applies

Provide **less stringent plan leverage**, such as by:

Setting wider ranges for performance around target — e.g., +/– 5% of target performance yields target payout, which may mitigate goal setting challenges in volatile situations where predictions are difficult

Lowering or eliminating thresholds to help achieve a minimum payout (see illustration below) so awards where threshold performance wouldn't have been met can continue to motivate participants

Illustration. The blue line represents conventional leverage. The green line illustrates setting a wider range for performance around target (+/– 5%). The purple line illustrates lowering the performance threshold to help achieve a minimum payout, while also reducing performance levels needed to earn target and maximum payouts.



For example, if actual performance is at 95% of the original target:

- The typical payout curve **(blue)**, would pay 75% of target.
- The wider performance targets **(green)** would pay at target.
- The plan with reduced performance goals **(purple)** would pay 125% of target.

If actual performance falls below 90% of the original target, the plan with reduced performance goals (purple) would pay out, while the original plan would not.

For long-term incentives:

Use **relative metrics**, calibrated as a percentile rank against industry peers, rather than attempting to forecast internal financial metrics or using metrics relative to a broad index, such as the S&P 500 (this assumes the financial impact is likely to be similar for companies in the same industry).

Place more weight on **time-based awards**, which align participant interests with those of shareholders while also promoting retention.

In-progress LTI awards

The business impact of responding to the virus and a potential recession may also affect in-progress LTI awards where goals were set before the crisis began and awards may no longer be motivating to participants. It may be too early to adjust the goals for financial results. But to preserve the intended benefits of the plan, companies could communicate to participants that discretionary adjustments will be made at the end of the performance period.

Before taking any action, companies should consider the regulatory and governance considerations in the table below:

Regulatory and governance considerations	
Additional accounting expense	• For stock-based awards like performance shares, a modification to lower goals or exclude the negative impact of the virus could trigger additional accounting expense if these types of changes aren't required under the plan and are deemed discretionary • Standard plan language that excludes "unusual" or "infrequently occurring" items (accounting-defined terms) may not apply to the indirect impact of the virus or a recession (such as lost revenue), but direct costs (such as added expense of disinfecting facilities) might qualify as automatic exclusions (the determination for each company is subject to approval by its auditors)
More proxy disclosure	• Any incremental accounting expense arising from a discretionary adjustment to awards held by the named executive officers is reported in the proxy's Summary Compensation Table and Grants of Plan-based Awards Table • Adjustments should be accompanied by an explanation in the Compensation Discussion and Analysis
Negative investor and proxy adviser views	• Investors and proxy advisers favor clear connections between performance and incentive plan payouts — and typically take a dim view of short performance periods and discretionary adjustments that benefit executives — but would likely be open to alternatives in the current environment
Concerned employees	• Lack of specificity about items triggering adjustments may raise participant concerns about fairness

What to do now

Based on discussions with our clients, many are postponing long-term grant decisions. For in-progress awards, several expect to make discretionary adjustments at the end of the performance period when the effects of the economic downturn are more fully known.

But even companies in wait-and-see mode should take the following actions:

- Model potential award values for the next few years to estimate potential windfalls or shortfalls at various future share prices and determine how much share price appreciation is needed for equity grants to reach their target dollar value.
- For in-progress awards or prior to setting goals for 2020 awards, model potential goal achievement scenarios as more information becomes available. In coming months, more companies may be able to estimate the financial impact on their operations.
- Preview what your proxy disclosure might look like, particularly if decisions made might result in a windfall.
- Communicate decisions to plan participants and ensure your messaging around all human capital management decisions is consistent. Compensation decisions shouldn't be made in a vacuum. Granting executives more shares under grant guidelines or retention awards designed to make up for shortfalls in incentive plan payouts may not be appropriate if employees face layoffs, furloughs, pay cuts, and large losses in their 401(k) plans. Companies need to consider human capital management risks and corporate social responsibility, and balance the interests of all of their stakeholders.

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