Pay Governance®
Advisory Services to Compensation Committees

OPINION

# Viewpoint on Executive Compensation

## "Everything Should Be On The Table"

– JOHN D. ENGLAND AND JON WEINSTEIN

It's been said before in our business lifetimes – in 1987, 1990, 2000, 2001, and 2008 – that "urgent action needs to be taken to address the morale and continued motivation of executives and employees in a time of crisis." In each case, though with different recovery times, the economic shock and downturn ultimately abated, and most companies and their employees found themselves on solid ground again.

This one feels different. A black swan pandemic suddenly sweeping the globe, a financial market reaction so severe as to be described as "violent," and a looming recession triggered by strategies necessary to flatten the coronavirus curve have all combined to create a crisis unprecedented in modern times.

Hundreds of thousands of people have contracted COVID-19, and a significant number will die. We are acutely aware of the trillions of dollars evaporating and the worries of employees and retirees. We all know service workers and retailers who, along with millions of people in the energy, manufacturing, and travel industries, may soon be unemployed as businesses of all sizes struggle with lost revenue and liquidity issues. Whether we're executive compensation consultants, compensation committee members, senior executives, or human resources professionals, we all must consider these larger societal issues and support federal, state, and local government responses as we reexamine rewards program effectiveness and changes in this trying time.

Of course, Pay Governance's domain expertise is compensation consulting with a particular focus on executives and boards of directors. Concerning executive compensation, two things make this crisis different from those in the past: the timing of events and the rigidity of Say on Pay protocols.

**Timing**. This crisis has been no September or October surprise like several of the last economic shocks. In those instances, companies with calendar-fiscal years were able to adjust budgets, forecasts, and performance goals to economic uncertainties, and many assessed the optimal use of long-term incentive vehicles to be used in the following year. Indeed, some companies found it necessary to take drastic measures to control compensation expense, conserve shares, and ensure sufficient flexibility for awards in future years, but calendar-year companies generally had more lead time to develop reward strategies for a changed environment. Fast-forward to 2020: most calendar-year companies have been hit with this crisis *after* goal-based annual and long-term incentives (LTI) were approved and grants were made. Even companies that presented incentive plan targets and objectives for approval in mid-March tended to rely on Board-approved budgets ratified in January. As one CEO told their Compensation Committee on Friday morning, "there's no chance of our hitting these goals." Goals were nonetheless approved.

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**Say on Pay Protocols**. Say on Pay wasn't legislated in 2008, let alone the shift toward the homogenized incentive approaches that many companies have implemented to comply with the preferences of shareholder advisory firms and governance reviewers at large institutional shareholders. Goal-based, formulaic, and fully disclosed annual incentive plans and three-year performance share unit / performance cash plans now dominate executive reward systems at most companies. In fact, it's common for CEOs to have 70% or more of their total direct compensation tied to how well companies perform against pre-set goals that emanate from a budget or strategic plan. If discretion exists, its impact has generally been modest, either by design or in application — perhaps just 10-20% of an executive's annual incentive award. Some find the use of non-GAAP metrics and exceptions in determining awards to be suspicious. But, the rigor upon which today's incentive plans were built did not anticipate the extreme volatility of the current crisis.

**So, what should be done?**

In Pay Governance's view, everything should be on the table. But as with any well-set table, the dishes need not be handled immediately — with one exception. Every company should assess whether its compensation committee can exercise its business judgment to address current conditions should they continue. Some companies may take comfort in administrative powers that allow the compensation committee to unilaterally assess performance and determine incentive plan results. Others may wish to go further, adding into the meeting minutes or even including in a Compensation Discussion & Analysis (CD&A) disclosure that "the Committee may consider the effect of the global pandemic and other linked economic and environmental pressures that may negatively impact results." Consider the adage that people work harder during times of crisis, even if circumstances and shared sacrifice make it challenging to fully recognize those efforts through remuneration.

What else should we have on the table? Each company's circumstances will be different, but all should be cognizant that any executive reward solutions must be considered in the context of the pain being felt by shareholders, employees, customers, and society in general. At its essence, what remains on the table will be determined by how well the executive compensation programs that matured during the 11-year bull market can now endure evolving business priorities, transformed operating environments, reduced confidence in forward goal-setting, volatile stock market performance, and workforce demoralization.

Without being prescriptive, here are some initial considerations that Pay Governance Viewpoints, blog posts, and other communications will address in greater detail in the coming weeks.

1. **The Exercise of Discretion**. Certainly, any quantification of the global pandemic's effect should be compared to the financial and nonfinancial goals established before anyone knew COVID-19 would become the subject of daily headlines. Such an approach will be somewhat more feasible for non-calendar-year companies that found themselves well into their fiscal years before the pandemic occurred. Some compensation committees may wish to consider their management's 2020 actions to ensure business continuity and long-term sustainability in evaluating performance in a holistic manner. Committees would also be well-advised to consider human resources program changes and any employee actions taken in 2020 when deciding management pay. Acknowledging the effects on employees, customers, and those less fortunate in our communities has rarely been more important.

2. **Addressing Mid-Stream Incentive Plans**. Tax deductibility rules underlying 162(m) required goals to be set within 90 days of a plan cycle's inception, but these rules no longer apply. Below are a variety of options

for addressing in-process incentive plans, all of which have been used for years by companies in volatile and commodity-based industries:

- Consider shifting plan weightings away from financial goals and toward nonfinancial or operational goals that tie to business continuity, sustainability, efficiency, and customer focus.

- Consider changing individual performance objectives established at the beginning of the year. For companies that already devote a portion of annual incentives to individual objectives, there could be consideration given to amending the original personal performance indicators to include new initiatives and responsibilities that management is undertaking in light of the dramatically changed operating environment.

- Consider implementing a July – December incentive plan in lieu of, or in addition to, the plan approved at the beginning of the year; resetting current goals may be challenging given the lack of certainty in the current market. In times of crisis, each week may provide greater visibility, so revisiting goals later in the year may be a reasonable approach.

3. **Reassessing Equity Grants**. Given the current environment, historical equity grant practices may need to be reexamined. What made sense in a bull market may no longer be appropriate today:

- Consider deciding on a reasonable grant calibration price. When calibrating equity awards, it is sometimes forgotten that stock price is an assumption in any valuation model. For some companies that have not yet made this year's equity awards, the current stock price may not be feasible for calibrating grants if there are insufficient plan reserves or if the awards would create a higher-than-desirable burn rate. Further, the substantially greater number of shares needed to deliver targeted values today could produce unintended windfalls that may not fully align with the experience of many shareholders. Thus, it could be reasonable to calibrate using an averaging period (10 days, 30 days, 60 days, 90 days, etc.).

- For companies that traditionally grant equity in the second quarter, consider splitting grants between the second and fourth quarters of 2020. We were all taught about dollar-cost averaging as a prudent method for investing. Granting awards at two different times can help guard against peaks and troughs in a volatile time.

- Consider whether you are in the rare situation in which it might be viable to move some or all of 2021's grants into the third or fourth quarter of 2020, with clear communication to participants and in the CD&A that (1) such a strategy was not delivering additional incremental pay over the two-year period and that (2) no LTI awards will be made in the following year. This may be appropriate for companies facing the most serious concerns about employee morale and motivation.

4. **Re-think Long-Term Performance Periods**. During the Great Recession of 2008, it was difficult for most companies to set viable long-term goals. The concern was as much about overpayment as it was about underpayment based on the goals that would be set three years in advance. Many companies adopted a performance LTI design to change the award basis to the outcomes of three periods in which goals were annually set, measured, and averaged for an initial financial score. In this model, a three-year relative total shareholder return modifier was often used to increase or decrease the averaged financial score within a range, adding a longer-term performance condition to the award. We also saw variations on this theme as some companies adopted two-year performance cycles. As in the last recovery, shorter performance periods

may be a temporary solution, with companies reverting to full three-year plans as the environment becomes more predictable.

5. **Dealing with Out-of-The-Money Share Awards**. While nearly every company has been affected by the crisis, companies in certain industries have lost more than 75% of their value; energy companies have seen a multi-year bear market deteriorate further, and travel and retail companies are experiencing unprecedented challenges. Some potential actions for these organizations include the following:

    - Consider asking executives to surrender stock options that are deeply underwater; this might allow the company to manage dilution levels and provide additional flexibility to make share grants going forward.

    - Consider whether there are LTI award cycles that should be discarded. In these cases, awards could be canceled and new grants made to ensure that the rewards system supports the new objectives that the current environment demands. Given the potential backlash from some shareholders, however, "canceling and replacing" must be approached with care, investor outreach, and balance between employee motivation and the stockholder experience.

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Will this be a V-shaped downturn and recovery as it was in 1987, or are we truly experiencing a crisis unforeseen in modern times? No one knows, but all elements of society must do what they can to persevere.

As it relates to executive reward solutions, companies must ensure that compensation committees have the authority to use their business judgment, if they so choose, regarding the global pandemic and its repercussions. For the time being, everything else should be placed on the table — not to be immediately implemented but to be thoughtfully and deliberately considered over the following weeks and months. As solutions are evaluated, companies struggling for business continuity and long-term sustainability must be mindful of the current pain felt by their shareholders, employees, customers, and communities.

Pay Governance will return to these and other potential executive compensation strategies in subsequent Viewpoints, blog posts, and other communications. We will provide weekly updates on our website: paygovernance.com.