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OPINION
Viewpoint on Executive Compensation

Is a Replacement for Your Short-Term Incentive Plan Right for You?

– STEVE PAKELA AND BRIAN SCHEIRING

When it comes to 2020 incentive arrangements for calendar-year-end companies, COVID-19's arrival in the United States could not have come at a worse time. The vast majority of these incentive plans were approved by compensation committees in February, prior to many businesses being thrust into financial and public-market turmoil. When these plans were approved, it was generally business as usual for most companies, and shareholders were enjoying stock price peaks. Performance goals were based on company budgets established during the fourth quarter of 2019, back when the prospects for 2020 were much different than they are today. Within short-term incentive arrangements, performance metrics, and individual performance objectives reflected the desire to pursue business strategies that would bring the success of the past several years to new heights. Now, at the beginning of April, so much has changed in so many ways that *"everything should be put on the table"* concerning executive compensation design and practice.

Today, many annual incentive arrangements are "stranded" with performance goals that are no longer achievable and performance metrics that are no longer aligned with short-term objectives. We believe that providing responsible incentives during this time will be critically important for motivating and focusing employees through the crisis and uncertainty that we anticipate over the remainder of the calendar year. This Viewpoint provides discussion points and ideas for addressing short-term incentive arrangements that are no longer achievable or appropriately aligned. Future Viewpoints will address long-term incentive arrangements and other practices.

When considering bonus plans for 2020, the good news is that The Tax Cuts and Jobs Act approved in late 2017 essentially eliminated the performance-based exemption of IRC 162(m). The elimination of 162(m) provides compensation committees much more flexibility to make changes as appropriate beyond the first 90 days of the plan year, allowing companies to consider changing performance goals, metrics, or target opportunities without adverse tax consequences. While flexibility to make changes exists, compensation committees should continue to consider the various constituents who have a powerful voice in Say on Pay and a significant stake in the company's well-being: shareholders, proxy advisors, employees, customers, and communities.

The first question to be asked is, *"Are the current performance metrics and individual objectives appropriate to support the company for the remainder of the year?"* If the answer is currently "yes," and threshold-level performance goals are still achievable, we suggest preserving the plan. If there is some level of achievability under the current plan, either through a financial goal or individual performance, the plan should be maintained. This will clearly be a below-target payout year for most companies. However, if the plan is "stranded" and performance goals are no longer achievable, or the metrics are no longer appropriate,

PARTNERS

Aubrey Bout
John R. Ellerman
John D. England
R. David Fitt
Patrick Haggerty
Jeffrey W. Joyce
Ira T. Kay
Donald S. Kokoskie
Brian Lane
Joe Mallin
Jack Marsteller
Richard Meischeid
Sandra Pace
Steve Pakela
Jaime Pludo
Matt Quarles
Lane T. Ringlee
Brian Scheiring
John R. Sinkular
Christine O. Skizas
Bentham W. Stradley
Jon Weinstein

companies could consider the use of discretion or a replacement short-term incentive plan that focuses on the second half of the year (July through December).

Historically, compensation committees have used *negative* discretion to reduce the value of incentive awards. Now, with changes to 162(m), *positive* discretion could be considered; however, serious deliberation should occur if this discretion would override actual financial performance that is well below threshold goals. We do believe some compensation committees may use their discretion to either adjust awards, recognize individual performance during the crisis, or in a limited number of cases, partially adjust actual financial performance to factor out any measurable impact of COVID-19 on business results. Compensation committees should carefully consider the sentiment of investors, proxy advisors, and employees prior to using positive discretion.

When considering a replacement incentive plan, the term "replacement" is appropriate: we suggest that companies terminate their current full-year plan if a replacement plan is pursued. This clean-slate messaging would allow participants to focus on the new plan's metrics and goals. The following issues should be considered when determining whether a replacement plan is appropriate.

Assess the Current Situation

In typical downturns, employees often feel they work harder for lower compensation; however, companies must assess the current situation from multiple lenses:

- How unachievable are current plans? Are the current metrics still appropriate to lead the company through the crisis and into a potential recovery?
- Which outstanding incentives continue to promote employee morale and culture?
- Would a replacement bonus plan be a prudent use of limited financial resources?

Determine the Magnitude of Awards

Companies should cautiously consider each plan's magnitude and affordability. In other words, the replacement plan should not be viewed as a "make-whole" award; this is why companies should consider retaining the current plan if threshold goals are achievable.

- Companies should consider reduced payout opportunities (e.g., 25% to 50% of the current plan target opportunity): this addresses affordability and recognizes the challenging performance environment, yet still provides a meaningful level of incentive.

Determine Eligibility

A replacement plan's eligibility should be assessed in light of any actions impacting the overall workforce as well as other legal barriers:

- Consideration should be given to how employees would accept an executive-only plan while experiencing headcount reductions, salary reductions, or other actions negatively impacting morale; for this reason, we recommend including all remaining bonus-eligible participants in the plan.

- Regardless, companies who participate in governance assistance programs may be prohibited from increasing pay over prior year levels for executives or top management.

Determine Performance Metrics

Companies should determine whether current performance metrics continue to align with new priorities or whether changing metrics would be more beneficial.

- We believe there are several performance metrics that companies should consider in times of distress:
  - Measures of liquidity,
  - Operating cash flow or working capital as a percent of sales,
  - EBITDA (earnings before interest, taxes, depreciation, and amortization) margin or measures of cost reduction, and
  - Individual objectives such as customer preservation (solely or in addition to financial metrics).
- Similar to traditional bonus design, we believe companies should aim to limit the number of metrics to focus participants on those critical to success.

Consider All Stakeholders

Companies should be mindful of how a replacement incentive plan might be viewed by various stakeholders:

- Shareholders who have lost significant value in equity holdings,
- Proxy advisors who may view incentive payouts as misaligned with company performance,
- Terminated employees or current employees who have been negatively impacted by compensation or benefit reductions, and
- Customers and communities that have been adversely affected by the current economic environment.

Disclosure Implications

If company-named executive officers are included in the plan design, companies will be required to disclose the plan in both the Compensation Discussion & Analysis (CD&A) and the required tables.

- The CD&A description of the process, reasons for cancelling the annual plan, and approval of the new replacement plan, with significant emphasis on rationale, must be included.
- The Grants of Plan Based Awards table must disclose the grant value of both the cancelled annual plan and the replacement plan.
  - Additional narrative or footnotes will allow for clear and transparent disclosure.

Conclusion

During times of distress, company executives and employees are expected to work harder, smarter, and more strategically. As the "war for talent" has shifted to the "war for survival," it is important to remember that short-term incentive arrangements work to prioritize and focus participants on key objectives. Some current incentive plans remain achievable and their metrics remain appropriate — these plans should continue. However, if a company's current plan is unachievable, a replacement plan may be considered. Such a plan could span the second half of the year as performance expectations become clear. Much like positive discretion, a replacement plan may not be appropriate for some companies: the facts and circumstances surrounding the situation should be carefully considered.

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General questions about this Viewpoint can be directed to Steve Pakela at steve.pakela@paygovernance.com or Brian Scheiring at brian.scheiring@paygovernance.com.

This Viewpoint is one in a series of ongoing articles Pay Governance will be publishing regarding the impact of COVID-19 on compensation programs. All of our Viewpoints can be found on our website at www.paygovernance.com.