RESEARCH
Viewpoint on Executive Compensation

Evolving Compensation Responses to the Global Pandemic – Severely Harmed Companies

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In this Viewpoint, we focus on companies that have faced severe impairments due to the pandemic and are grappling with highly volatile stock prices resulting in substantial incentive plan design challenges. This continues our series of pay actions taken or considered among companies impacted by the pandemic.

Summary

- For many of the companies severely harmed by the global pandemic, immediate cost-cutting measures were necessary to protect the business including furloughs, layoffs, suspended 401(k) matching contributions, and base salary reductions for most/all of the workforce.
- Many of these companies approved their fiscal 2020 annual and long-term incentive (LTI) plans and prior LTI performance awards (i.e., 2018-2020 and 2019-2021 cycles) without any consideration for a global pandemic. These incentives often represent ≥50% of an executive's annual compensation (≥70% in the case of the CEO), and it is highly likely the performance-contingent incentives are tracking to a zero payout and time-vested restricted stock units (RSUs) have greatly diminished in value.
- The reduced value of realizable compensation directionally aligns with companies' pay-for-performance (P4P) philosophies; however, the reductions are largely based on an unprecedented shutdown of the global economy due to health concerns and a reshaping of how many companies will "do business" now and into the future.
- Severely harmed companies are assessing the near- and long-term implications of the downturn on all stakeholders and determining if changes to annual and long-term incentive programs are appropriate to balance the company's talent goals with its P4P philosophy.

Base Salary Reductions

Based on Securities and Exchange Commission filings and other public disclosures, ~600 companies implemented temporary base salary reductions or deferrals as of mid-2020—many of whom were severely harmed by the pandemic. Many companies stated or implied the reductions were for an undefined period and would be reevaluated during the year while others set specific end dates for the reductions.

Executive base salary reductions ranged from 10-100%, while salaried employees' base salary reductions typically ranged from 10-25%. Nearly 300 companies also disclosed that the Boards of Directors reduced their cash retainers from 25-100% to demonstrate their alignment with the salaried workforce in reducing expenses and cash outflows during these unprecedented times.

For those companies that committed to reducing executive base salaries for an undefined period, to date a few have announced the partial or full restoration of base salaries to pre-pandemic levels due to improved business performance. For those companies that continue to have a significant number of furloughed employees and/or expect additional layoffs, it may be difficult to fully or partially reinstate base salary levels for top executives without attracting criticism of leadership as being "tone-deaf." At some point, however, the compensation committees and leadership teams at these companies must weigh the risk of de-motivating or losing key talent needed to execute the path to recovery if these base salary reductions are extended too long.

Current-Year Annual Incentive

Severely harmed companies are forecasting payouts ranging from 0-50% of target based on pre-established financial goals approved before the pandemic. Many of these companies are taking a "wait and see" approach whether to exercise discretion at year end due to the ongoing uncertainty created by the pandemic and to fully assess the impact of the company's performance on all of its stakeholders (i.e., shareholders, employees, communities served, suppliers). As discussed in Pay Governance's recent Viewpoint, "Considering Resilience When Assessing FY 2020 Incentive Plan Performance," we believe the compensation committee and management should determine how best to apply discretion by assessing and documenting the actions that management has taken to help the company survive and emerge from the pandemic.

Based on publicly available information, some severely harmed companies have already implemented changes to the 2020 annual incentive plan that are intended to strike the right balance between rewarding and motivating employees while recognizing the experience of all stakeholders. These companies have taken various approaches that best fit their situation: setting revised annual goals, splitting the year into multiple measurement periods, adding new incentive plan metrics based on the achievement of critical financial and strategic measures (e.g., reduce expenses, improve balance sheet, open facilities safely, etc.), and more. Most companies applying these approaches are striving to maintain directional P4P alignment through below target incentive payouts and lower than expected financial results, which balances the severe financial impact to the company with the criticality of maximizing results through year end. In many cases, shareholders appear to have supported these changes based on the Say on Pay voting results reported so far. The chart below summarizes the most common approaches and rationale for each approach.

Approach	Rationale	Tradeoffs
1. Adjust for the pandemic at year end	• Allows the company to retain existing goals while adjusting for specific items related to the pandemic (higher costs due to PPE and other safety precautions, increased cost of freight/shipping, lost revenue due to forced shutdowns, etc.)	+ Avoids setting new goals during the performance cycle – May not restore the incentive effect unless communicated "now" to plan participants – Year-end adjustments to financial measures that exclude the impact of the pandemic on results may not align to

Approach	Rationale	Tradeoffs
	• Affords the compensation committee the opportunity to consider the pandemic's impact and management's response to mitigate its effects on all of the company's key stakeholders in determining if it should exercise discretion in adjusting incentive payouts using a resilience scorecard or other discretionary framework	other stakeholder experiences (unless a resilience scorecard is also used) – Potential criticism of the use of discretion absent a compelling rationale and fulsome disclosure
2. Set revised 12-month goals	• Retains 12-month focus based on revised forecast (e.g., combination of actual 8 months and forecasted 4 months)	+ Preserves the use of the normal 12-month performance cycle, with the focus on results from the time goals set through year end – Payouts highly dependent on the remainder of the performance cycle – Revised full-year goals may look "low" to investors – Setting revised goals may be difficult given continued uncertainty around the pandemic and its impact on business – Potential disclosure implications – May not be well received by shareholders if payout opportunities are not adjusted to reflect revised lower performance goals
3. Split into two 6-month performance periods and pro-rate target award for each period	• For many companies, isolates the worst effect of the pandemic and allows for the establishment of goals that include the recovery	+ Focuses on prospective results – Requires a new, partial year incentive plan – New partial-year goals may look "low" to investors – Same negative tradeoffs as above
4. Split into quarterly assessments / pro-rate target award for each period	• Allows companies facing extreme uncertainty to update performance metrics in order to establish goals based on the best available information	+ Focuses on prospective results with flexibility for setting reasonable goals for Q3 and Q4 – Requires a new, partial year incentive plan – May be perceived as "cherry picking" assessment periods and may include goals that look "low" to investors – Potential disclosure implications

Outstanding LTI Performance Share / Cash Awards

Severely harmed companies are also reviewing the status of outstanding LTI awards and evaluating potential approaches for performance shares / cash LTI plans (LTIPs), which, in many cases, are currently forecasted for low or no payments. We expect many companies to take a "wait and see" approach and decide the most appropriate action for outstanding performance awards at cycle end.

Modifying performance shares / cash LTIPs for the pandemic can be far more complex than adjusting the 2020 annual incentive plan. In addition to the LTI mix, plan design can have a significant impact on the types of adjustments that might be appropriate. For example, the company may be using a relative metric, in which case no adjustments may be needed as the use of a relative measure—in theory—adjusts for exogenous factors. Other companies use three 1-year performance periods, and only the 2020 portion of the award may be adversely impacted. Another plan design feature may measure the final year of the 3-year cycle to determine performance—in which case the plan ending in 2020 is likely to pay zero—whereas it may be too early to evaluate how performance cycles ending in 2021 and 2022 will be affected. The timing of when the cycle ends may also be a factor (e.g., March 31 compared to December 31).

Summarized below are three approaches companies may consider when determining if outstanding performance share / cash cycles should be adjusted after evaluating if other pay elements (unvested RSUs, next year's regular LTI awards) will be sufficient to achieve talent needs. In our experience, many companies are focused on the first approach (adjust for the pandemic) for the 2018-20 cycle; they will wait until the end of the 2019-2021 and 2020-2022 performance cycles to allow for a real-time assessment of performance (e.g., resilience in response to the pandemic, full 3-year financial and total shareholder return results, impact to shareholders, etc.) in determining if adjustments for the pandemic will be made and, if so, the appropriate amount. Similar to adjustments to annual incentives, shareholders appear to have supported well-reasoned changes based on the reported Say on Pay votes.

Approach	Rationale	Tradeoffs
1. Apply "normal" adjustments at cycle end	• Applies adjustments that are permissible under the original terms of the grant, as determined by accounting and legal, which may not trigger a modification of the award and the reporting of incremental compensation in the Summary Compensation Table (SCT) and Grants of Plan Based Awards Table (GOPBAT)	+ Follows the original terms of the plan, including allowable adjustments – May result in nominal payouts (<50% of target) – Could result in adverse shareholder response if payouts are not aligned with losses experienced by other stakeholders
2. Modify performance period or goals for pandemic	• Changes performance goals and/or performance periods to more properly reflect company performance during a difficult period and restore the incentive	+ Provides realistic incentive goals and award opportunities for outstanding cycles – Viewed negatively (potential "red flag" issue) by many investors and proxy

Approach	Rationale	Tradeoffs
	and retention impact of in-flight LTI cycles, while preserving much of the original design structure • Requires a strong case for making the modifications based on the impact to all stakeholders and being comfortable with reporting changes in the Compensation Discussion and Analysis as well as creating incremental compensation in the SCT and GOPBAT	advisory firms if misaligned with losses experienced by other stakeholders – Most likely to benefit only the highest paid executives (i.e., long-term performance awards are generally limited to a subset of the LTI-eligible population)
3. Provide special equity awards	• Provides new LTI award opportunities without modifying previously granted awards • Potentially easier to justify if outstanding awards are not modified (Approach #2) • Retains the executives that are most needed to execute the company's path to recovery	+ Provides flexibility to create a new grant mix and performance design as well as consider other relevant factors in structuring the award – Subject to intense investors' and proxy advisory firms' scrutiny (including an increase in compensation reported in the SCT, structure of the new award, and rationale for additional compensation)

Conclusion

In considering potential changes to outstanding incentive awards, it is critical to take a holistic perspective and review the accounting, legal, and proxy disclosure implications with the company's legal and accounting teams. Shareholder engagement—either prior to or after the changes are made—may also be necessary to understand and respond to shareholder concerns. Shareholder engagement is particularly critical during a year of lower financial results and volatile, generally lower, stock prices. Each company's situation is unique, and how to best balance the company's talent objectives, align executive pay with other company actions (dividend and stock buyback policies, base salary reductions, annual and long-term incentive plan treatment, special awards, and changes to /next year's incentive plans), manage external optics (including the societal impact of the pandemic, company performance on all of its stakeholders, and likely reactions of key investors and proxy advisory firms) must be decided on a case-by-case basis.

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