Adapting Executive Pay Decisions To COVID-19 Impact

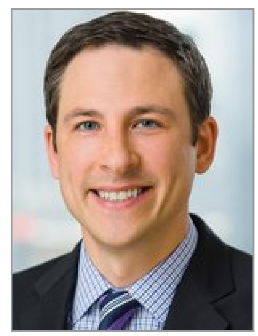
By **Regina Olshan, Joseph Penko, Erica Schohn and Joseph Yaffe** (March 30, 2020, 2:52 PM EDT)

COVID-19 is testing the oversight skills of boards of directors as companies come to terms with the new normal amid this global pandemic. Compensation committees are uniquely challenged by current circumstances.

Regina Olshan

Many companies are amid their annual compensation review and approval cycles, with compensation levels and performance targets being determined at the same time proxy disclosures are being prepared. In addition, previously granted awards already may have been severely impacted by market conditions.

On a very human level, employee and executive compensation is top of mind for many right now, as reasonable concerns about the individual impact of the crisis reverberate with executives and others in the work force. At the same time, compensation committees charged with implementing programs intended to incentivize and retain employees through alignment with company performance and strategic business objectives now find themselves with a very uncertain near-term future, and tasked with knowing the unknowable.



Joseph Penko

Below is a summary of some of the specific issues compensation committees should be considering in the context of current events.

Timing of Compensation Decisions

For many calendar-year companies, the February through April time period is one in which performance and compensation for the prior fiscal year is reviewed and approved. In addition, this is the time that many companies set performance targets under their short- and long-term incentive plans for the current fiscal year and approve new annual equity compensation awards.

Erica Schohn

Companies that have not yet made 2020 compensation decisions (including those relating to the prior and current fiscal years) may consider delaying their approvals until their stock price stabilizes and more is known about the impact of COVID-19 on the company. Companies that choose to delay compensation approvals should consider the impact a delay may have on employee morale and should clearly communicate and explain the reasoning behind any delay. Additional implications of delaying compensation decisions, or modifying existing compensation, are discussed in more detail below.

Bonus and Equity Award Performance Targets and Metrics

With the elimination of the performance-based compensation exception under Section 162(m) of the Internal Revenue Code, compensation committees now have greater flexibility in establishing performance goals for senior executives beyond the 90-day period from the beginning of the performance period.

In light of the uncertainty caused by current events, it may be prudent to wait until later in the fiscal year to establish performance targets applicable to the 2020 performance-based compensation. However, any delay in establishing performance targets should be weighed against the risk that the awards may not be viewed as performance-based compensation to the extent that the targets are substantially certain to be achieved when established.

Joseph Yaffe

For those companies who historically use absolute performance metrics such as absolute total shareholder return, consideration may be given to moving to relative metrics such as relative total shareholder return. The move to relative measures would reward management for performance compared to a peer or industry group and may lessen the risk of penalizing management for the impact of the COVID-19 pandemic when compared to company-centric measures.

To the extent that companies continue to use absolute measures, consideration should be given to setting performance targets that would not be viewed in hindsight by shareholders or proxy advisory firms as easy to attain when compared to pre-COVID-19 pandemic hurdles.

For awards that have not yet been granted, consideration should be given to including discretionary adjustment provisions in the awards that would allow for adjustments to performance targets to account for unexpected or irregular results of the COVID-19 pandemic, which is likewise permissible without negative tax ramifications, even for senior executives under current Section 162(m) rules.

To the extent that performance-based compensation for 2019 has not been paid or settled, companies may desire to change the form of payment or delay the payment or settlement. Any such changes may result in the imposition of penalty taxes under Section 409A of the Internal Revenue Code and otherwise have accounting impacts. Companies should consult with their legal and accounting advisers prior to changing the form of, or delaying, these payments.

Compensation Committee Discretion and Adjustment of Performance Targets

For awards that already have been granted, compensation committees may be able to exercise discretion to adjust performance targets through either preexisting discretionary adjustment provisions or adjustment provisions triggered by extraordinary or nonrecurring events. To the extent that existing awards do not already have these provisions, the plans or agreements generally may be amended without shareholder approval to provide the compensation committee with this authority.

While shareholders and shareholder advisory firms may initially prefer discretionary adjustment provisions that are narrow in focus, it may be prudent for compensation committees to have broad discretionary flexibility to address the impact of the COVID-19 pandemic. Proxy advisory firms such as Institutional Shareholder Services Inc. and Glass Lewis & Co. LLC will consider the application of compensation committee discretion to adjust performance targets or ultimate payments when conducting a qualitative review of pay for performance.

However, these advisory firms should carefully consider the company’s justification for the use of discretion and, assuming the as-adjusted targets are meaningful (i.e., the compensation retains its character as performance-based), then latitude should be provided given the unusual and widespread impacts of the COVID-19 pandemic.

To the extent that any applicable performance period commenced prior to November 2017, external advisers should be consulted to determine whether any adjustments would cause the award to lose grandfathered status for purposes of Section 162(m). In addition, discretionary adjustments may have negative accounting impacts.

Adjustments to performance targets generally will not be required to be disclosed in an Item 5.02 disclosure on a current report on Form 8-K but the adjustments will need to be addressed in the company’s compensation discussion and analysis in respect of the year in which the adjustments occurred.

Burn Rate and Pricing

For those companies that have a practice of valuing awards based on a target dollar value rather than a fixed number of shares, consideration should be given to revising this practice so as to mitigate the impact of an extraordinarily low stock price.

Valuing grants based on a target dollar value at a time when the company's stock price is depressed may result in a significant drain on the equity plan share reserve. This also may result in additional scrutiny from shareholders and proxy advisory firms if they perceive that the grants provide a windfall to management if stock price returns to prepandemic levels.

To the extent that grants are valued based on a target dollar value, compensation committees may wish to consider valuing the grants based on a trailing average stock price as opposed to a closing price on the day of grant or other spot price. A trailing average stock price approach to valuing the grants may smooth over pandemic-driven extremes in pricing that may arise from spot stock prices.

Longer trailing averages may be used for full-value awards such as restricted stock units. Note, however, for stock options and stock appreciation rights, Section 409A generally provides that fair market value may be determined by a trailing average stock price of no more than 30 days unless the options or stock appreciation rights are structured to comply with Section 409A, and the company will need to specifically identify the grantees and the number of shares underlying the award that each individual will be entitled to receive prior to the start of the measurement period.

Any adjustments to valuing grants should be made only after a review of the applicable plan terms as, for example, the plan may need to be amended to permit the use of a trailing average stock price. An amendment of this nature generally would not require shareholder approval.

Even where a company changes its valuation methodology for equity awards, it may be the case that companies need to seek shareholder approval for an increase in the number of shares available in the equity plan share reserve as a result of the decline in stock value and a corresponding increase in burn rate.

To the extent that the decline in stock price results in a company not being able to grant all or a portion of awards in the 2020 grant cycle, awards may be granted subject to shareholder approval of the shares underlying the awards or grant cash-settled awards (though it may have a negative accounting impact). Cash-settled awards will not require shareholder approval but they generally have less favorable accounting treatment than stock-settled awards.

Repricing

Given market volatility and broad declines in stock prices, stock options granted prior to the COVID-19 pandemic may be underwater and no longer provide the intended incentives for management. As a result, compensation committees may wish to explore repricing the underwater stock options to reset the options or exchange the options for different forms of equity compensation, such as restricted stock units or shares of restricted stock.

New York Stock Exchange and Nasdaq stock exchange listing rules require a company to obtain shareholder approval for a stock option repricing or exchange unless the applicable equity plan expressly provides that the company can reprice or exchange underwater options without shareholder consent.

In addition, repricing and exchanges generally are disfavored by institutional shareholders and proxy advisory firms. This is in part due to the fact that the last two significant waves of stock option repricing in 2001-2002 and 2009 were followed by rebounds in stock prices.

Repricing may be warranted but consideration should be given to a wait-and-see approach prior to requesting that shareholders approve repricing stock options.

Compensation Reductions/Waivers

In response to the COVID-19 pandemic, executives may desire to reduce their compensation or waive their rights to payment or settlement of awards. Companies and their legal counsel should consider the proxy disclosure of any waivers or reductions and also the impact on the determination of named executive officers.

In addition, several companies are affirmatively reducing management salaries in connection with other cost-saving measures to address the COVID-19 pandemic. Companies and their legal counsel should review any applicable employment and severance agreements to determine the impact, if any, of a company-directed reduction in base salary.

While compensation reductions or waivers generally should not necessitate an Item 5.02 disclosure on a current report on Form 8-K, companies may disclose the reductions or waivers on Item 7.01 of Form 8-K to the extent the company deems this information as material to shareholders or as required by Regulation FD. Companies that choose to disclose compensation reductions or waivers generally are doing so in connection with the disclosure of other cost-savings measures.

Overall Flexibility

Compensation committees will need to continue to remain nimble and creative when faced with the expanding impacts of the COVID-19 pandemic. The common theme underlying each of the considerations summarized above and long- and short-term incentive plan design during this turbulent time is the ability of the compensation committee to use its discretion to address novel issues that generally arise only during periods of market volatility.