COVID-19: Considerations for Companies That Have Already Established Their 2020 Incentive Compensation Programs

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The coronavirus (COVID-19) pandemic and the ensuing market uncertainty as well as recently enacted legislation, have upended the compensation and benefit programs of many companies. We are preparing a series of client memoranda regarding how companies may wish to consider their programs in this context.

Focusing on incentive-based compensation might not be at the top of the priority list for many companies as they focus on company-wide crisis leadership and workforce stabilization as a whole. When companies do turn to an assessment of their incentive-based compensation, there are a number of complexities and sensitivities in the current environment, and this memorandum discusses some ways that companies can address their short- and long-term incentive programs, particularly for companies that have already granted their incentive compensation awards for 2020.[1]

1. Should companies revise their performance criteria and/or goals now?

Maybe, but maybe not. It is still in the early days, and most companies are delaying affirmative adjustments to their performance goals to avoid adjustments that may result in inappropriate windfalls to executives or require further adjustments as the consequences of the COVID-19 crisis continue to unfold.

The following are some actions that companies may want to consider taking regardless of whether they have decided to make adjustments at this time:

- Tracking the specific impacts that COVID-19 has had, and will have, on their business (e.g., lost sales, supply chain disruption and cost of compliance with the CARES Act and similar legislation intended to promote worker relief and worker retention).
    - A number of companies, particularly those that are directly and acutely affected by COVID-19 (e.g., food service and brick-and-mortar retail establishments), have already begun tracking this information.
    - A number of companies have also begun to think about how their executives navigate the crisis from a qualitative perspective (e.g., workforce retention) as part of assessing the executives' performance.
- Assessing the potential reaction of rank-and-file employees, shareholders and proxy advisory firms (e.g., ISS and Glass Lewis) to any compensation adjustments.
    - As discussed in our recent blog post regarding **Glass Lewis' views on the COVID-19 crisis**, institutional shareholders and the proxy advisory firms are watching the steps that companies take regarding compensation to ensure that good governance practices are

[1] In a companion client memorandum, we discuss COVID-19 considerations for companies that have yet to finalize their 2020 incentive compensation programs **here**.

maintained and executives do not receive windfalls in the face of severe shareholder losses.

    - When disclosing any adjustments consider explaining how the company's interests will continue to be protected in spite of such adjustments (in addition to any other justifications).

- Assessing the impact of adjusting (or not adjusting) performance goals and criteria on the share capacity of any shareholder-approved equity incentive plans and the nature of any shareholder reaction to a request for approval to increase a plan's share reserve earlier than initially expected.
- Replacing absolute performance metrics with relative performance metrics in order to reward management for performance that compares positively to the company's competitors.
    - As part of this process, review comparator group(s) to determine whether there are companies that may be disproportionately affected by the COVID-19 crisis (positively or negatively) and consider whether they should therefore be excluded from the peer group.
- Denominating awards in dollar amounts with actual payouts tied to share price, but that are payable in cash or shares in the compensation committee's discretion.
    - Near-term share price volatility and uncertain share capacity may make this approach advisable for some companies.
    - Consider whether the interim mark-to-market accounting treatment would be an acceptable tradeoff for including this flexibility.
- Making adjustments before another fiscal quarter closes might help to confine the resulting expense accrual in the current quarter when poor or unusual results might already be expected, and for a calendar year company might help to spread the accrual over the three remaining quarters rather than simply the third and fourth quarter.
- If also adjusting long-term incentive award cycles, a company may want to particularly consider any long-term award cycle ending with 2020 and whether and how it might adjust that award. Given the circumstances, it will be challenging to predict and avoid conflicting performance criteria and actions, but companies might want to try to address these issues.
    - Similarly, when adjusting incentive goals for one tier of employees, a company will want to consider the incentive goals of other tiers, again to anticipate any pressure for consistency in approach.
- Companies that are considering whether to take advantage of any of the programs offered under the CARES Act, such as the permitted reduction or deferral of the employer portion of Social Security taxes that would otherwise be required to be paid between now and January 1, 2021, will want to keep the cash and accounting impacts of this on incentive compensation programs in mind when making decisions regarding adjustments to performance criteria.

2. For companies that do not adjust performance criteria and/or goals, what other actions can they consider taking now?

For companies that decide not to adjust performance criteria and/or goals now, below are some actions that can be considered now:

- Clearly communicating to employees the company's intent to continue to monitor the situation over the coming weeks and months and make any appropriate adjustments at an estimated "hold date" later in the year.

- Assessing whether the terms of current incentive compensation programs, plans and awards provide sufficient discretion for the compensation committee to adjust the performance metrics later in the year and whether a framework is needed for how discretion will be exercised, considering all relative performance metrics.
- Ensuring the compensation committee has sufficient discretion (including upward discretion) to adjust performance metrics.
  - If taking this action, consider including appropriate guardrails to reassure shareholders and other external stakeholders that management will not unfairly benefit from the exercise of such discretion.
  - Include discretion to further adjust awards throughout the performance period for unexpected changes related to COVID-19, but be cautious of making changes that could result in a high required payout amidst unsatisfactory annual results.

3. Are there alternatives to modifying the performance metrics to ensure that employees remain motivated and engaged?

Yes. If a company wishes to leave the current metrics in place for the time being, below are some actions that a company can consider taking to continue to motivate and incentivize its employees, including:

- Clearly communicating the intent to take the current-year hardships into account in making compensation decisions for future short-term and long-term incentive award cycles once there is more clarity.
  - For multi-year incentive grants, this could also include modifying performance goals or metrics in future years of the performance period. In some cases, it may be more beneficial to terminate existing long-term awards and replace these awards with new grants that have more realistic long-term targets.
- Granting time-based equity or cash awards in future years after assessing results under the existing plans.
  - Employees are likely looking for stability in the short term, so providing some degree of certainty regarding incentives may be worthwhile given the decline in share prices and potential decline in future payouts under existing incentive plans, particularly since the vast majority of companies are facing similar concerns.
  - This approach may be more appropriate for companies with employees who have talent that could be in demand, especially in the current market. As an alternative, also consider granting discrete and justified time-based retention awards now.
- Establishing a new short-term incentive plan.
  - Some companies have established or are considering establishing a plan with short-term goals (such as quarterly or biannual goals) and realistic targets, including goals relating to important strategic or recovery targets relating to COVID-19 response. These new plans often do not replace existing incentive plans, but would be a supplement to such plans in order to motivate executives to work towards important, but attainable, goals in the near term.
  - If a company takes this approach, the new plan should be structured so that the total payouts under the new and existing plans combined cannot exceed the maximum payout that could have been achieved under the existing plan alone.

  - Also consider the appropriateness and type of cap on payouts (e.g., at target if other objective measures such as shareholder return are flat or negative).

As noted above, regardless of the approach that is taken, companies should be cognizant that institutional shareholders and the **proxy advisory firms** will be paying close attention to changes made to executive compensation arrangements and should ensure that any changes would not come at inappropriate further expense to shareholders and rank-and-file employees.

4. Will an amendment to existing performance metrics and/or targets trigger a disclosure requirement?

Probably, but timing and location may vary. In deciding whether to amend existing performance metrics and/or targets, companies may want to consider the following:

- If a company is making changes to its short- or long-term 2020 incentive compensation program, it will want to consider whether those changes will need to be disclosed on a Form 8-K.
  - As a general matter, the terms of incentive compensation programs do not need to be disclosed unless they are material and are not within the terms of the company's previously disclosed plans and programs.
  - A company's historic disclosure practices often influence its ongoing disclosure decisions and should also be taken into account. Whether or not disclosure is made may also have a precedent-setting effect, which companies may wish to consider.
- Any adjustments will need to be disclosed in the company's Compensation Discussion and Analysis section of the proxy statement in respect of the year in which such adjustments occur, even if no Form 8-K is triggered. If an adjustment is made to an equity award and the adjustment constitutes a modification for accounting purposes, it may also require the reporting of an incremental amount in the Summary Compensation Table of the proxy statement for the year in which such changes occur.

5. Are there special considerations in light of the Tax Cuts and Jobs Act of 2017?

Possibly, yes. For companies that maintain compensation plans that were intended to comply with Section 162(m) of the Internal Revenue Code and have not been amended since the passage of the Tax Cuts and Jobs Act of 2017, the plan will likely include restrictions on the compensation committee's ability to increase payouts. Note that, depending on how the plan has been drafted, it may not be easy to amend or remove these restrictions without shareholder approval.

6. What are some other considerations for companies as they consider whether or not to make changes to their incentive compensation programs?

- There may be contractual limitations on any changes — for example, a change may constitute an event of "good reason" under an executive's employment agreement, such that it may be necessary or desirable to obtain that executive's consent to waive his or her "good reason" protection.
- Changes may require board approval, rather than just the approval of the compensation committee. Which body is required to approve a change in compensation is typically governed by the company's compensation committee charter and possibly also by the company's corporate governance guidelines.
- Companies will want to discuss or preview any changes to short- and long-term incentive compensation with the compensation committee's compensation consultants, both because they

will be well-positioned to advise companies in light of the company's particular circumstances and because their blessing can be especially helpful during times of difficult decision-making.

- In addition, as always, companies will want to discuss with their accountants whether any such changes will trigger accounting consequences, adverse or otherwise, and whether they could have an iterative effect on performance metrics.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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