COVID-19: Considerations for Companies That Have Not Yet 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 yet to finalize their short- and long-term incentive compensation programs for 2020.[1]

1. Should companies hold off on making 2020 short- and long-term incentive compensation grants until circumstances stabilize?

Probably, yes. In light of current uncertain conditions, it may not be realistic to make grants now or when historically granted, given the challenge of accurately predicting the economic impact of COVID-19 on the viability of achieving performance goals. Particularly for short-term incentives, this may quickly result in performance goals becoming unattainable or may present the risk of unintended windfalls to executives and other employees.

The following are some alternatives that companies may want to consider in respect of their 2020 short- and long-term incentive compensation programs:

- Adjusting the timing of 2020 incentive compensation grants, including a delay until there is slightly more visibility on how the second half of the year might play out.
- Introducing shorter than typical short-term performance periods (e.g., semi-annual).
- Communicating target grants to employees at the time that incentive compensation is typically awarded, with the intent to establish performance goals or criteria at a later date when the economic outlook is more clear (while, in the meantime, assuring employees that any service-vesting component would be tied to the date the grants are initially communicated).
- Revisiting the mix of performance stock units in equity compensation grants.
- Granting performance stock units or other awards in reference to a dollar target amount rather than a target number of shares (i.e., so that the number of shares issued on settlement is based on the earned dollar value), or by use of a weighted average share price over a period preceding the grant date.
- Giving the compensation committee the discretion to settle awards in shares or cash at the end of the performance period.

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

When granting awards, companies may also want to consider the potential impact of share price volatility in the near term 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.

See Question 5 below regarding ensuring your compensation committee will have sufficient discretion to adjust awards.

2. Are prior-year incentive compensation criteria appropriate in light of current circumstances?

Maybe, but maybe not. Performance criteria used in a prior year's long-term incentive compensation program may no longer achieve the desired incentive and retentive effects for employees over the remainder of the performance period.

Below are some points compensation committees may wish to consider in this regard:

- Adopting relative performance criteria, rather than GAAP or financial criteria used under prior years' programs (such as net income or EBITDA), to ensure that incentive compensation programs will achieve the program's desired incentive and retentive results.
    - 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.
- Adjusting the duration of the performance period relative to the forecasted duration of market volatility.
    - Performance criteria for short-term incentive compensation may require more robust adjustments than those used for long-term incentive compensation, with the expectation that market conditions should be more settled by the end of the longer performance period.

3. Are there any special considerations for companies that decide to take advantage of the CARES Act?

Yes. 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.

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 first three remaining quarters rather than simply the third and fourth quarter.

4. Are institutional shareholders and the proxy advisory firms (e.g., ISS and Glass Lewis) planning to scrutinize compensation decisions made by companies during the COVID-19 crisis?

Yes. We recommend using caution to ensure that any variance in historic performance criteria, goals or target payout amounts will not be viewed as trying to benefit the company's executives and senior management, or even to suggest that this is a "business as usual" year as it relates to compensation.

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

- One way to strike the appropriate balance for performance goals based on peer group comparison criteria may be capping payouts at target regardless of performance relative to peers if shareholder return is otherwise flat or negative during the applicable performance period.

5. Should companies consider building in discretion to make adjustments in light of current unpredictability? Are additional provisions needed?

Possibly, yes. While incentive compensation programs often include clearly defined performance criteria and goals, companies may wish to consider building in additional flexibility for the compensation committee in order to:

- Exercise discretion in adjusting performance criteria and goals as market conditions change over the course of the performance period; or
- Take a "wait and see" approach and exercise discretion when assessing achievement of the performance goals at the end of the performance period.

As part of including any flexibility, ensure that plan documents and individual award agreements provide compensation committees with the authority to act with fluidity as market and broader macroeconomic conditions continue to fluctuate.

Also consider, though, including appropriate guardrails to reassure shareholders and other external stakeholders that management will not unfairly benefit from the exercise of such discretion.

6. Are there any 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.

7. Are there any special disclosure requirements when granting awards in light of COVID-19 impacts?

Possibly, yes. If a company is making changes to its short-term or long-term 2020 incentive compensation program, the following considerations will be important in determining whether the changes will need to be disclosed on a Form 8-K:

- As a general matter, the terms of incentives 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 be taken into account. Whether or not disclosure is made may also have a precedent-setting effect, which companies may wish to consider.
- Companies will want to consider in advance whether additional disclosure would be required if discretion is exercised at the end of a performance period.
    - If performance targets are completely missed and a company uses its discretion to provide for significant payouts, a Form 8-K will likely need to be filed disclosing that discretion was exercised and the ultimate payout amount. [2]

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[2] **Form 8-K Compliance and Disclosure Interpretation 117.11**.

  - If only minor changes are made to the payout amounts, whether or not disclosure is required will be based on the particular facts and circumstances of the payout, including the company's historic Form 8-K filing practices.
- Any changes to short or long-term incentive compensation will need to be disclosed in the company's Compensation Discussion and Analysis section of the proxy statement for the year in which such changes occur.

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

- For some companies, 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.
- For some companies, changes will 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.

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