Executive Law & Regulatory Group

Addressing in-flight incentive awards

A holistic approach for comp committees

As the end of the year approaches, compensation committees are grappling with whether and how to address the impact of the pandemic on incentive awards.

Shareholder support for executive pay remained strong during the 2020 proxy season, with about 2% of companies failing to receive majority support for their pay programs and most companies receiving over 90% support. But this could change in 2021 if shareholders and proxy advisers object to companies' decisions to modify in-flight incentive awards where goals have become irrelevant and demotivating. Decisions need to balance fairness to plan participants, alignment with shareholder interests, and consistency with broader workforce actions. And in some cases, it may be more appropriate to let awards play out as originally designed despite the challenging circumstances. This article offers guiding principles and action steps for companies considering incentive plan changes such as modifying goals, exercising positive discretion, or granting special awards.

Holistic assessment

Decisions to adjust goals or payouts under annual and long-term awards shouldn't be made in isolation. They require a holistic assessment of all relevant factors.

Factors that may support consideration of positive adjustments include:

- The total rewards program, including the likelihood of payouts under all outstanding incentive awards, has minimal retentive and motivating impact. For example, the value of management's equity holdings has dropped significantly or there is a reasonable likelihood there will be no payouts for the next several years.
- Absolute performance goals were set and became unattainable as a direct result of the impact of the pandemic, and pre-COVID performance was strong. For example, revenues and profits that were on track for target or above performance fell because of decreased demand, disruptions in the supply chain, or increased COVID-related expenses — most of which was outside management's control.
- Management effectively responded to the crisis. For example, management implemented plans to keep employees safe, redeploy talent to pursue strategic initiatives, and/or manage costs.

Factors that may argue against positive adjustments include:

- The company took actions that had deleterious effects on the broader workforce such as pay cuts, furloughs and layoffs.
- The total rewards program, including the likelihood of payouts under all outstanding incentive awards, still has retentive and motivating impact. For example, all or a portion of outstanding incentives can be earned based on relative or strategic and qualitative goals. Or outstanding incentives included multiple shorter performance periods (e.g., semi-annual or quarterly for short-term incentives and annual for long-term incentives) and payments have been banked.
- The company's performance was poor relative to the performance of its peers and the broader industry.
- The company received government assistance.

When making positive adjustments for awards that would otherwise have a zero payout, strong consideration should be given to capping payments at or modestly above threshold. And where portions of a performance period are excluded (e.g., ring fencing 2020 for long-term incentives with multi-year performance goals), payout opportunities should be correspondingly reduced. For example, if 2020 performance is excluded from a long-term incentive award covering 2018-2020, then payout opportunities should be capped at 2/3 of amounts earned.

Finally, any adjustment should consider tax, accounting and disclosure implications.

Alternative approaches

There's no "one size fits all" solution for how to approach incentives within the context of a pandemic. The following tables can help companies and compensation committees tackle decisions in a consistent and transparent manner and effectively communicate the rationale for those decisions through shareholder engagement and proxy disclosure.

Annual and long-term incentive awards ending in 2020

Decisions around annual and long-term incentives with performance periods ending in 2020 require the most immediate attention. Given that only one quarter of the year remains for awards ending in 2020, we expect most companies will either use judgment at the end of the performance period or do nothing after conducting a holistic assessment. But companies can consider any the alternatives shown in the table below to address awards that aren't expected to pay out.

Alternatives	Most appropriate when one or more of the following are true…
Use judgment at end of performance period	• Performance period is almost over or economic climate isn't clear enough to reset goals • Plan participants managed crises effectively
Do nothing (let the award play out as originally designed)	• Other awards / pay elements have sufficient value to motivate and retain participants • At least threshold performance may be achieved • There is a qualitative component that might pay out • Goals are relative and peer companies were similarly affected by the pandemic • Pre-COVID business results were tracking below expectations
Adjust metrics for COVID-19	• Impact of pandemic can be isolated and excluded (e.g., direct costs such as cleaning and hazard pay)
Lower goals / eliminate threshold / reduce maximum / widen ranges for performance (e.g., +/– 5% of threshold performance yields threshold payout)	• Metrics are still relevant but goals are no longer achievable • Lower goal is viewed as attainable in the current economic climate • Payout / number of shares is reduced to align with lower goals
Exclude (ring fence), or assume target achievement for, the period impacted by COVID	• COVID primarily affected 1-3 quarters of the year • Pre-COVID periods were tracking above target • Payout / number of shares is reduced to reflect truncated period
Establish a new shorter performance period	• COVID primarily affected 1-3 quarters of the year • Economic climate is sufficiently clear to select appropriate metrics and set goals, and there is sufficient time left in the performance period for goals to be meaningful • Payout / number of shares is reduced to reflect truncated period
Extend the performance period	• Goal is viewed as attainable given longer time horizon

Incentive plans ending after 2020

A “wait and see” approach for outstanding long-term incentives awards with performance periods ending after 2020 may be the best strategy for now, particularly if there’s some likelihood that performance goals could be achieved at or above threshold or there’s enough retentive value in other awards. But if it’s clear that results on multiple cycles of awards will be below threshold and that performance is generally attributable to the pandemic (i.e., 2020 performance has wiped out three cycles and recovery is unlikely), more immediate action may be appropriate to ensure employees remain engaged. In that case, companies can explore the alternatives discussed in the table above and the following additional ones in the table below.

For the ring fence alternative, it might be challenging to wall off 2020 for performance periods running from 2019-2021, given 2020 falls in the middle. And for some of the alternatives, such as converting to time-based RSUs and granting special retention awards, it might be prudent to exclude proxy named executive officers (NEOs) as shareholders and proxy advisers are more likely to object to pay that isn’t performance-based.

Alternatives	Most appropriate when one or more of the following are true …
Change metrics and goals • Replace absolute metrics with relative metrics • Replace financial metrics with strategic or qualitative metrics such as sustainability • Replace multi-year goals with annual goals	• Metrics are no longer relevant • Economic climate is clear enough to reset financial goals, and / or relative or strategic goals support business strategy • Payout / number of shares is reduced if awards otherwise would not have paid out and / or performance period is truncated
Convert to time-based RSUs	• Outstanding awards have little or no value • High retention risk • Economic climate is not clear enough to set goals • Payout / number of shares is reduced to reflect elimination of goals
Grant a special retention award	• Outstanding awards have little or no value • High retention risk • Economic climate is not clear enough to set goals

Action steps

1. Take stock and evaluate the business case

Decisions should be made only after a holistic assessment of all relevant factors, including those discussed above. For awards that will extend beyond 2020, companies should model potential goal achievement scenarios and potential award values to estimate potential windfalls or shortfalls at various future share prices and determine how much share price appreciation is needed for equity grants to reach their target dollar value. This analysis should also take into account performance expectations for awards that will be granted in 2021.

2. Ensure messaging around all human capital management decisions is consistent

Compensation decisions shouldn’t be made in a vacuum and management shouldn’t be insulated from losses that shareholders and the broader workforce are facing. Exercising positive discretion or adjusting goals to make them easier to achieve may not be appropriate when employees face layoffs, furloughs, pay cuts, and large losses in their 401(k) plans. Adjusting in-flight awards may also raise concerns where a company received government assistance and where the communities where the company operates are struggling. Companies need to consider human capital management risks and corporate social responsibility, and balance the interests of all their stakeholders.

3. Understand regulatory implications

Before changing in-progress awards, companies should consider the following regulatory implications:

- **Plan documents.** Review plan documents and award agreements to see if they would cover a global pandemic as an event that would automatically trigger adjustments to goals, and whether there are any restrictions on discretionary modifications or replacements.
- **Accounting.** Modifying equity plan goals or exercising positive discretion can have accounting consequences, which differ for awards with nonmarket (e.g., EPS or sales targets) vs. market performance conditions (e.g., TSR). Automatic adjustments that are set out in the plan generally have no impact on compensation expense.
- **Proxy disclosure.** Proxy disclosure differs for cash and equity awards.
  - **Cash awards.** Discretionary cash awards must be disclosed in the Summary Compensation Table (SCT) "bonus" column (vs the non-equity incentive column).
  - **Equity awards.** Generally, the SCT presents equity awards using the accounting grant-date fair value. Any incremental accounting cost arising from a discretionary modification to, or cancellation and replacement of, awards held by NEOs is reported in the SCT and Grants of Plan-Based Awards Table. If the original grant and the modification occur in the same year, this will result in "double" disclosure because the grant date fair value of the original award must also be reported. (If the original award was granted in a prior year, the original grant date value would already have been reported.)

Any action taken should be explained in the Compensation Discussion and Analysis (CD&A) section of the proxy as discussed below.

- **Real-time securities filings.** If NEOs are affected by the award modification, companies should consider real-time disclosure on a Form 8-K filing even if the disclosure isn't required. ISS has specifically expressed a preference for real-time disclosure of changes made in response to the impact of COVID-19. Also, Section 16 Form 4 filings may be required for NEOs and other Section 16 officers for equity awards with goals based solely on achievement of an absolute (not relative) stock price goal.
- **Tax.** Where Code Section 162(m) covered employees are involved, if the original awards are grandfathered under the 2017 tax law changes, adjusting goals or exercising positive discretion might be a material modification that would void grandfather status and cause the awards to become nondeductible.

4. Anticipate proxy adviser reactions

Proxy advisers favor clear connections between performance and incentive plan payouts and generally take a dim view of making executives whole when goals aren't met. Recently, both Institutional Shareholder Services (ISS) and Glass Lewis recommended voting against the executive pay program at a company with a May fiscal year-end that awarded large discretionary bonuses to executives without sufficient explanation when payouts weren't earned under the 2020 short-term and 2018-2020 long-term incentive programs.

ISS. ISS generally doesn't support midstream changes to incentive awards. But, under COVID-19-related guidance released in April 2020, the proxy adviser has been reviewing changes case by case to determine if directors exercised appropriate discretion and companies provided adequate justification for inflight adjustments. The guidance urges real-time disclosure of the changes and supporting rationale.

In updating its voting policies for 2021, ISS will consider the results of its recent global policy survey. Responses to questions relevant to COVID-related executive pay decisions were as follows:

- **April guidance.** Investors and other stakeholders agreed ISS should continue using its flexible approach through at least the 2021 proxy season.
- **Short-term incentive adjustments.** Investors and other stakeholders agreed that the following approaches are reasonable with adequate justification:
  - Making mid-year changes to metrics, performance targets and/or measurement periods to reflect the changed economic realities
  - Suspending the incentive program and making one-time awards

- **Adjustments to executive pay and performance expectations.** Investors' and other stakeholders' answers diverged:
  - 70% of investors (vs 33% of other stakeholders) responded that the pandemic's impact on the economy, employees, customers and communities and the role of government-sponsored loans and other benefits must be considered by boards, incorporated into decisions, and clearly disclosed to shareholders
  - 53% of other stakeholders (vs. 10% of investors) said the pandemic is different from previous market downturns and boards and compensation committees should have flexibility to make decisions

Glass Lewis. In guidance issued in March, Glass Lewis warns it will oppose changes inconsistent with the challenges workers are experiencing and says it's most likely to support changes that "take a proportional approach to the impacts on shareholders and employees". The proxy adviser specifically cautions against "maintaining or even increasing executive compensation levels" and predicts that trying to make executives whole is a "certainty for proposals to be rejected and boards to get thrown out—and an open invitation for activists and lawsuits onto a company's back for years to come."

5. Have a game plan for engaging with shareholders

Companies will need to proactively engage with shareholders to explain the rationale for making in-flight adjustments and exercising positive discretion.

Companies should take the following steps well in advance of the proxy season:

- Identify and prioritize engagement with the company's top 20-25 shareholders
- Prioritize and schedule when and who the company is going to engage with well before the annual meeting, e.g., this fall for calendar year companies
- Review shareholders' say-on-pay voting history, including whether they tend to follow proxy adviser recommendations and whether they expressed concerns in prior years
- Establish talking points to ensure a consistent message

It's critical that company representatives who participate in the engagement are prepared to fully explain the rationale for 2020 pay decisions, and knowledgeable about and sensitive to the impact of those decisions on the broader workforce. If CEOs are involved in the engagement, they shouldn't discuss decisions about their own pay. If directors are involved, they should be fully vetted to be sure they understand the rationale for the pay decisions and can present a unified message.

6. Preview executive pay disclosures

Pay disclosure should be forthright and the proxy statement's CD&A should explain the context and rationale for 2020 pay decisions. Compensation committees should preview a draft of 2021 proxy disclosures at the time pay decisions are made to better understand the optics of the decisions in the larger context of the current environment and the amounts that will have to be disclosed in the SCT and Grants of Plan-Based Awards Table, as discussed above.

Boilerplate statements that awards were modified or upward discretion was exercised to motivate and retain executives are unlikely to be persuasive on their own but should include a demonstration of the retention and motivation risks and detail how the new performance conditions or awards promote business strategy. If discretionary awards are granted to executives because they were particularly adept at managing the crisis and minimizing the risk to the business, this should be fully described. For example, providing a detailed description of management's efforts to reduce expenses, maintain productivity, manage the supply chain, and protect employee and customer health and safety, will help shareholders and their advisers understand the rationale for the compensation committee's decisions to modify existing awards or grant special one-time awards.

Proxies should also describe shareholder engagement efforts, including steps taken to determine shareholder concerns and improve shareholder communication. Disclosure should include who the company engaged with, how often they engaged, what issues were discussed and any changes that were made in response to shareholder concerns.

Looking ahead

This past year may be viewed as an anomaly, with shareholders and proxy advisers giving significant latitude to decisions to ring fence 2020 or exercise discretion to adjust awards to ensure executive retention during the global crisis. But, shareholders and their advisers may not be willing to support pay decisions that they don't understand so communicating a sufficient rational basis for these decisions is critical.

Companies also need to find a way to move past the crisis and operate effectively in the new normal. This may require wholesale changes to incentive plan designs to be able to continue to motivate and retain key talent, while ensuring the interests of all stakeholders are represented.

If the economic climate is still too uncertain to set credible goals for 2021 awards, alternatives to consider are similar to those available to incentives with performance periods ending after 2020. They include:

- Using relative metrics
- Using strategic / qualitative metrics (e.g., sustainability metrics)
- Establishing shorter performance periods (quarterly or biannual for short-term incentives and annual for long-term incentives) with additional service-based vesting requirements
- Providing less stringent plan leverage, such as by setting wider ranges for performance around threshold and target performance
- Lowering or eliminating thresholds to help achieve a minimum payout
- Building in discretion to make adjustments to performance targets or award payouts (up or down)

Mercer resources

For a discussion of 2020 compensation decisions in response to COVID-19, see Just filed proxies offer closer look at how Compensation Committees are managing COVID-19's impact on annual and long-term incentive payouts.

Note: *Mercer is not engaged in the practice of law or accounting, and this article does not constitute and is not a substitute for legal, tax or accounting advice. Mercer recommends securing the advice of legal or tax counsel or accounting firms regarding any such matters related to this article.*

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