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COVID-19: What Compensation Committees Should Be Thinking About Today

The COVID-19 pandemic has in a matter of weeks upended life in America, including in American business. Public companies have witnessed dramatic decreases in market value and business challenges that were largely unexpected weeks ago. Executive compensation programs must adjust to the new reality and continue to motivate leadership and performance. While every company will face its own challenges, and no solution will be one-size-fits-all, certain common concerns are emerging. Sound responses will need to balance effective incentives with sensitivity to investor, public and political perception.

2020 Annual Incentive Programs. For many companies, the most immediate compensation issue presented by COVID-19 relates to 2020 annual incentive programs. Most companies had already approved, or were on the verge of finalizing, their 2020 incentive programs before the advent of the market turmoil. In many cases, the original 2020 projections are no longer realistic; what made sense in January is no longer appropriate. Companies should consider revising their metrics to attainable levels, or implementing additional metrics that are aligned with current priorities, to ensure that management is appropriately incentivized, while being sensitive to the pain being inflicted on shareholders by declining stock prices. An additional challenge is that the current level of uncertainty may make it premature to re-design business plans and incentive goals. For some companies, it may make sense to defer revising goals until there is more stability, or to rely upon discretion to create flexibility. In any event, reserving the right to make adjustments for unexpected events and expenses related to COVID-19 should be considered. The 2017 elimination of the performance-based exception to Section 162(m) of the Internal Revenue Code allows companies to modify plan design and to preserve flexibility without a tax penalty, although companies must be mindful of shareholder and proxy advisory firm reaction to, and public and political perception of, such actions.

2020 Equity Awards. Many companies grant equity compensation awards during the first quarter. Companies frequently determine the number of awards granted to employees by reference to a specified dollar value. For those that have not made grants, the reduction in market value will result in larger share numbers per grant; in general, the market volatility may erode confidence that a particular day's price reflects a true valuation. Some companies are using a more extended historical averaging period for purposes of pricing grants. For others, it may make sense to delay grants until there is greater stability, with a commitment that the vesting dates of awards that are ultimately made will be based on the customary grant schedule. For performance-based vesting awards, such a delay may allow companies to re-calibrate appropriate goals and business imperatives. A multiple goal approach may be appropriate, either for the whole award or allocated portions. Companies may want to consider limiting upside opportunity if they are implementing changes that provide some downside protection. To mitigate the impact of market volatility on award value, a portion of the annual long-term incentive award may be in a cash-denominated form. Granting some or all of the annual awards as time-vesting, at least below the key executive level, would be reasonable under the circumstances.

Outstanding Equity Awards. At companies that have experienced a significant stock price decline, outstanding awards have lost a great deal of value. If depressed values

continue for an extended period, companies will need to assess whether outstanding awards still serve their intended incentive and retentive purpose, particularly in the case of stock options that are underwater. An extended post-termination exercise period for stock options may be appropriate for certain employment terminations, but it seems unnecessary to take across-the-board action at this time. The great recession a decade ago witnessed many option repricings and exchange offers; however, for the vast majority of companies it would be premature to consider such programs, which would generally require shareholder approval and are disfavored by proxy advisory firms. For performance-vesting long-term incentive awards, companies will need at some point to examine whether the existing performance goals and targets remain sensible. Given the longer-term design of such awards, companies should be more hesitant to make changes for pre-2020 awards. To the extent that there is not a return to something close to normal in the months ahead, we expect some companies to re-evaluate these performance goals and adopt policies that take into account the impact of current events when measuring the level of achievement.

Beware of Equity Plan Limits. As noted, many companies determine the number of equity awards granted to employees based on a dollar value. If a company's stock price has declined precipitously, application of a formulaic award level can result in equity grants with respect to an unexpectedly large number of shares and can accelerate depletion of a plan's share reserve. Under these circumstances, companies may consider granting cash-settled awards outside of a shareholder approved plan in the form of phantom equity or stock appreciation rights; however, cash-settled awards will result in variable, or "mark-to-market," accounting. Companies seeking approval for new equity plans or new share reserves at their annual meetings may also need to re-calibrate the size of their requests to reflect the reduced value of shares. Companies should also be mindful of the constraints of per-individual share limits. While the changes to Section 162(m) eliminated the technical need for such limits, investor groups often welcome individual limits and many plans continue to contain them. Before making a large grant, companies should confirm that it will not exceed any applicable limit. Companies adopting or amending equity plans may wish to consider denominating future per-individual limits in terms of grant date value rather than a share amount.

Review Change-in-Control Protections. Depressed stock prices may in some cases lead to takeover activity. A potential transaction can disrupt a target's employees and damage the target's business whether or not a transaction ultimately materializes. Appropriate change-in-control termination protections help mitigate these concerns. Ideally, companies should establish suitable arrangements to ensure a stable and dedicated employee base in advance of a potential hostile bid or voluntary combination.

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The COVID-19 crisis poses many societal and business challenges. Companies that engage in careful planning and thoughtful evaluation of their workforce needs during a period of uncertain, fluctuating markets and business prospects will be best-positioned to preserve the human capital that is a prized asset of every successful company.

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