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The Impact of COVID-19 on Performance-Based Compensation Programs

As the coronavirus disease (COVID-19) pandemic continues and the economic consequences are becoming increasingly severe, this Client Memorandum examines its impact on public company compensation programs at this time of economic uncertainty and market volatility. In particular, we focus on the structure of performance-based compensation, in light of many companies adjusting their forecasts and announcing they will not meet first quarter guidance in light of the effects of COVID-19. This issue is particularly timely for companies whose Compensation Committees are in the process of being asked to approve executive compensation programs at regularly scheduled Board meetings or are in the process of mailing proxies for their annual shareholder meetings that describe such programs.¹

If companies have set 2020 performance targets for their compensation programs (even if very recently), it very well may be appropriate and necessary to adjust those targets, since the dramatic shift in the economic forecast has rendered those targets seemingly impossible to reach. Without making appropriate adjustments to incentive compensation programs to account for the impact of COVID-19, companies run a risk of not properly incentivizing and compensating their employees at a time that increased dedication is necessary to maintain company stability. This issue is compounded by the fact that stock prices have as a general matter declined by more than 20%, and most senior executives will likely have experienced a decrease in the value of their compensation due to the heavy weighting of executive compensation towards equity.

We recommend companies review their compensation programs more broadly to assess any other actions that need to be taken. For example, public companies should review their equity plans to assess if they have sufficient authorized share capacity to cover equity grant needs, and if it is necessary or desirable to amend their equity plans and request from shareholders an increase in the number of shares available in order to compensate executives and employees with equity awards. Stock price drops mean more shares will be needed to deliver the same value to employees who are paid in equity, and prior projections of burn rates may no longer be sufficient. Since such amendments require shareholder approval, careful consideration will need to be given prior to seeking such approval which will require an explanation of the reason for the requested increase as well as the potential impact (including dilution and burn rate). Companies may also want to consider whether this is an appropriate time to consider a shift to stock options, in light of market corrections, and whether any outstanding stock options should be repriced. Repricings require shareholder

¹ For additional guidance in navigating this crisis, visit our [Coronavirus \(COVID-19\) Resource Center](#).

approval under exchange listing rules, unless a company's plan explicitly authorizes them, and such plan provisions are disfavored by the proxy advisory firms and institutional investors.

Structuring Compensation Programs in Uncertain Times

Compensation packages at public companies are typically focused on maintaining alignment between performance and executive pay, and even broad-based bonus programs are often funded as a percentage of a cash flow metric such as EBITDA, subject to achieving hurdle targets. Since the imposition of mandatory say-on-pay votes in 2011, public companies are also increasingly focused on structuring their executive compensation programs to align with the voting policies of proxy advisory firms, such as ISS and Glass Lewis, and the guidelines of institutional investors.²

This has resulted in many public companies having a significant portion of executive compensation allocated to formulaic performance-driven programs, both for annual bonuses (usually paid in cash) and long-term incentive programs (most typically paid in equity). Although many bonus programs are still discretionary or determined by reference to various performance metrics that act as guideposts, with Board discretion as to their application, there has been a shift over the past ten years to more formulaic programs. For many public companies, a large portion of bonus payments to executives are now generally paid on pre-set performance metrics, and a significant portion of equity awards (in some cases, up to 100% for a CEO) are granted in performance stock units with rolling multi-year performance cycles (most typically three years). Metrics often tie to a combination of operational and financial metrics, and, according to a F.W. Cook 2019 survey of the largest 250 publicly traded companies, 65% of those companies in the United States use an absolute or relative total shareholder return ("TSR") metric in structuring their compensation programs.

Setting 2020 Performance Metrics

Many calendar year companies set performance goals in the first quarter of the year and have already set performance goals for annual bonuses for 2020 and equity grants with performance cycles beginning in 2020. We discuss how adjustments to these goals may be made below. However, a significant number of companies still have time to set these goals. Compensation Committees that are still determining the goals for their 2020 programs have the opportunity now to consider how to set performance targets that take into account any impact from the COVID-19 pandemic. For companies in this position, there are a number of options to consider:

² The assessment of "pay for performance" by the proxy advisory firm, ISS, is largely driven by a quantitative assessment of the relationship between the amount of reported compensation to a company's CEO and the company's stock price performance and returns to shareholders through dividends.

- “Wait and see”— set 2020 targets in the second quarter, or later for long-term programs

For companies that still have the flexibility to do so, we recommend considering a delay in setting performance goals, given current marketplace uncertainty and volatility and the limited bandwidth of Board members and management due to their necessary focus on core business and employee safety issues.

We see no meaningful obstacles to taking this approach. However, if setting goals is deferred beyond the end of the second quarter for calendar year companies, proxy advisory firms and investors may not view them as meaningful, but instead consider them as already “in the bag” for annual bonus program purposes.³

- Set target thresholds taking into account adjusted budgets and forecasts

For companies that have already adjusted 2020 budgets to take into account COVID-19 impacts, newly set performance targets should take into account the current and projected impact on revenue and stock price performance, to the extent known, but since there is so much uncertainty as to how 2020 will play out, this alternative may not be a feasible alternative for many companies.

- Draft broad performance-metric adjustment provisions

Typically, performance-based compensation programs include provisions that permit adjustments for extraordinary, non-recurring events, such as acquisitions, dispositions and changes in the accounting rules. Companies and Compensation Committees should consider drafting these adjustment provisions so as to provide authority to the Compensation Committee to adjust performance targets to take into account COVID-19 related impacts. The challenge in drafting such adjustment provisions will be to do so in a targeted way (e.g., adjustments for financial statement impacts due to displacement of workers or impacts on supply delivery) so that the proxy advisory firms and institutional investors will not view the programs as discretionary rather than performance based.

- Consider alternative metrics for 2020, such as qualitative performance measures, including successful implementation of measures to protect employees, or relative TSR instead of absolute TSR
- Set up programs that take into account performance in a less formulaic manner, with performance metrics as guideposts rather than formulas. Although these are not preferred by the proxy advisory firms, we think they make sense during a time of crisis in order to place the appropriate obligations on a Board to exercise its fiduciary duties to reward executives at the end of the performance cycles, rather

³ Under the pre-2018 Tax Reform regime, performance metrics had to be set within 90 days of the beginning of a performance period (March 30/31 for calendar year companies) to receive favorable tax treatment, but this requirement no longer applies.

than putting in place formulaic plans that cannot fully anticipate whether COVID-19 is a short- or long-term issue.

- Consider providing a range of performance targets based on the range of impact by COVID-19 (for instance, setting “high,” “medium” and “low” impact ranges), and/or build in a mechanism for a true-up within a certain time period to provide for adjustment based on impact
- Consider changing the equity mix and granting stock options, taking into account how the market correction has made these more attractive instruments from an employee incentive perspective

Should You Adjust Existing Performance Targets?

For companies that have already set 2020 targets for their incentive compensation programs, or have long-term incentive awards outstanding that have multi-year performance periods that are ongoing, their Compensation Committees should consider whether to adjust current performance targets to take into account the impact of COVID-19, or to wait and see whether and how to make adjustments until later in the performance period. Since companies are likely to be criticized for adjusting their targets multiple times, we think it is reasonable to take a wait and see approach.

If a Compensation Committee is inclined to make adjustments, the first question will be whether the existing program documents permit adjustments to targets for extraordinary non-recurring events that could be interpreted to permit an adjustment for COVID-19 related events. If so, the Compensation Committee’s position can be that the adjustment is hard-wired into the award.

If a company’s compensation programs do not include adjustment provisions that could permit a COVID-19 related performance adjustment, Compensation Committees generally still have the authority to do so, although, in that case, there is more likely to be accounting as well as disclosure implications, and related press and employee morale issues to navigate. Companies should consult with their accountants as to whether adjustments would trigger charges and whether any applicable charges will be impacted by the timing of making adjustments. If you have a performance period that started prior to November 2017, we recommend you consult with your tax attorneys to assess whether such an adjustment would cause payments under the program to lose grandfathered deductible tax treatment for qualified performance-based compensation that existed prior to Tax Reform.

In the case of performance-based equity incentive compensation, most equity plans provide the Board of Directors or Compensation Committee flexibility to amend outstanding equity awards without going to shareholders or the participants, unless doing so would materially adversely affect the participants. In the past, companies have availed themselves of this option to amend and/or terminate outstanding equity awards due to external factors that affect performance. For example, after Hurricane Katrina, many companies with facilities based in New Orleans either amended the performance targets for certain

performance-based equity awards, or terminated the awards altogether and replaced them with new equity awards that had revised performance targets.

Similarly, many cash-based bonus plans have broad adjustment and amendment provisions that companies can refer to when deciding whether to adjust performance targets.

How companies answer these questions and the timing of making adjustments will turn in large part on the nature of each company's business and operations. For instance, airlines that are affected by restrictions on travel, cruise lines that have suspended operations and companies whose manufacturing facilities have been impacted will likely have a more pressing need to revisit and adjust performance targets for this fiscal year to account for the impact of COVID-19. However, as the effects of COVID-19 on the economy are still uncertain at this time, it is likely that many companies will take a wait and see approach. It is also possible that some goals, particularly for bonus plans, may be restructured so that the goals are semi-annual or reflect a shorter performance period in order to keep the executive team motivated at a time it is under increased pressure.

Additional Considerations When Setting or Adjusting Performance Targets

When setting or adjusting performance targets, a company will need to take into account several additional factors, including SEC disclosure requirements, investor reactions, employee morale, impact on the next say-on-pay vote and accounting considerations.

The Board's assessment of how to set or adjust performance metrics is part of its overall executive compensation oversight function and exercise of its fiduciary duties, and its Compensation Committee will want to thoughtfully consider the impact of performance metric decisions on the overall target level of compensation for executive officers. The proxy advisory firms largely assess "pay for performance" based on how CEO compensation compares to TSR, and companies may feel pressure to recalibrate the amount of executive compensation if their TSRs are being significantly impacted. We would recommend that Compensation Committees avoid reaching this conclusion without a thoughtful analysis of what is necessary to incentivize and retain management teams at a time that their dedication is more important than ever to maintain business stability in the face of events entirely outside their control. If existing goals will not be adjusted, consider adding bonus programs that reward executives for maintaining the business and providing stability to employees and the overall economy.

If a public company adopts or modifies an incentive plan or award to set or adjust performance targets to account for the impact of COVID-19, it may be required to report such adoption or modification on a Form 8-K if certain executive officers are party to or are participants in the applicable plan or award, the adjustments are material and not pursuant to an existing adjustment provision. However, this does not apply to broad-based plans. Under Item 5.02(e) of Form 8-K, if a registrant enters into, adopts or otherwise commences a material compensatory plan, contract or arrangement (whether written or not written) as to

which the registrant’s principal executive officer, principal financial officer or a “named executive officer” (i.e., the chief executive officer, the chief financial officer and the three most highly compensated executive officers) participates or is a party, or such compensatory plan, contract or arrangement is materially amended or modified, then the registrant must provide a brief description of the terms and conditions of the plan, contract or arrangement and the amounts payable to the officer thereunder.

In addition, any changes to performance targets for incentive compensation of the “named executive officers” of a public company will also likely be disclosed in the company’s annual proxy statement. The company may need to consider disclosing the rationale behind setting and/or adjusting its performance targets, whether as part of the compensation discussion and analysis section or through footnotes to the compensation tables. Careful thought should also be given to shareholder and employee reactions to these changes and related disclosures.

As the situation with the COVID-19 pandemic is rapidly changing, we recommend that companies seek legal advice to stay abreast of additional developments. We will continue to monitor developments and keep clients apprised of pertinent information.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Scott A. Barshay

+1-212-373-3040

sbarshay@paulweiss.com

Brad S. Karp

+1-212-373-3316

bkarp@paulweiss.com

John C. Kennedy

+1-212-373-3025

jkennedy@paulweiss.com

Jean M. McLoughlin

+1-212-373-3135

jmcloughlin@paulweiss.com

Liza M. Velazquez

+1-212-373-3096

lvelazquez@paulweiss.com

Lawrence I. Witdorich

+1-212-373-3237

lwitdorich@paulweiss.com