

## **U.S. COMPANIES ASSESS RIPPLE IMPACT OF COVID-19 ON THEIR BUSINESS AND INCENTIVE PLAN METRICS**

Jun 19, 2020

As we near the end of second quarter 2020, companies are evaluating the ripple effect COVID-19 has had and will likely continue to have on their businesses as a result of worker layoffs, shelter-in-place orders, employee health and safety matters, supply chain and counterparty risk issues and decreased product demand, among other things.

One key area of focus for many companies and compensation committees will be assessing the impact of COVID-19 on incentive plan performance award targets, many of which were set in February before the pandemic hit the United States and may now be unattainable. Most companies will want to keep their executive and management teams striving for potentially new and adjusted goals that the new environment requires. How to go about reflecting and rewarding key employees for performance around these changes becomes challenging when awards for the performance period have already been granted.

Some companies have viewed their performance awards as long-term in nature and have maintained existing performance targets in spite of changed circumstances. Others see a need for changes. The approaches will depend on each company's particular compensation philosophy and structure, the amounts and types of awards that have been granted, the extent and manner in which the business and existing targets have been affected, and other motivating criteria at issue.

One approach that companies have considered in connection with their annual awards is to adjust the performance targets based on currently available information so as to reflect changing expectations. This approach is relatively straightforward. A more nuanced approach is splitting the original performance period into smaller periods so that appropriate goals can be established on a shorter term basis in the changing and unpredictable environment. For example, an annual award that pays out at target if target results are achieved at year-end might be split into two separate performance periods. Under this approach, targets would be reestablished for the first half of the year with one half of the original target payout based on those results, and new targets established halfway through the year for the second half of the year with one half of the original target payout based on those results.

Long-term awards with performance periods that span multiple years similarly present both opportunities and challenges. Changing targets for the entirety of the multi-year performance award at this time may be premature if the awards were recently granted. One approach may be to adjust the performance targets on a year-by-year approach. For cumulative multi-year targets, another approach may be to extend the performance period to provide an additional opportunity to achieve the multi-year target. An award that is midway through the performance cycle might also be amended to truncate the performance period, along with a potential adjustment in the payout if that better reflects the intended incentives at this time.

Any change in the performance measures or the amount or timing of payments under performance awards will need to be carefully considered in light of any contractual obligations under existing awards. Depending on the structure of the original awards and the changes contemplated, employee consent may be required before any changes can be adopted. In addition, companies will want to consider the effect that any changes may have on awards that may have been grandfathered under Section 162(m) of the Internal Revenue Code as well as any deferred compensation issues under Section 409A of the Internal Revenue Code. In addition, companies should consider potential accounting issues with their auditors.

In addition, certain proxy advisory services and institutional investors have issued statements expressing concern about changes to mid-cycle awards and warning that they will closely examine any changes to performance targets. For example, the May 2020 Vanguard Investment Stewardship Insights [commentary](#) states: "In general, we do not believe it is appropriate for compensation committees to adjust or create "easier" performance targets, especially now, despite the challenging environment. Simply stated, at-risk pay should remain at risk."

ISS took a similar position with respect to long-term incentive performance targets in its April 2020 updated COVID-19 policy guidance: "Regarding long-term compensation plans, our benchmark voting policies generally are not supportive of changes to midstream or in-flight awards since they cover multi-year periods. Accordingly, we will look at any such in-flight changes made to long-term awards on a case-by-case basis to determine if directors exercised appropriate discretion, and provided adequate explanation to shareholders of the rationale for changes."

ISS, however, did appear somewhat sympathetic to the possibility of changing short-term incentive performance targets in response to the market drop and recession in the wake of the pandemic, so long as boards make contemporaneous disclosure to shareholders explaining their rationales for making such changes. ISS noted that such real-time disclosures should provide shareholders with "greater insights now and next year into the board's rationale and circumstances when the changes are made."

Glass Lewis also provided updated [guidance](#) in May 2020 about its approach to governance during the COVID-19 pandemic. With respect to compensation programs, Glass Lewis noted that it has already seen a variety of approaches, some of which are [unlikely to get significant shareholder](#)

[support](#), while those that take a proportional approach to the impacts on shareholders and employees look more likely to be widely supported. Glass Lewis said it expects to see numerous amendments to existing plans and a marked increase in shareholder concerns on repricing, dilution, burn rates, hurdle adjustments, changes to vesting periods, caps and cuts on incentives, and the quality of disclosure concerning the limits and exercise of board discretion. "Companies with strong pay structures will be challenged to abide by them, and firms with less robust programs will be forced to choose between lying in the bed they've made or changing arrangements and all but guaranteeing shareholder ire."

Against the backdrop of COVID-19 and world-wide political protests, companies may face unprecedented scrutiny over their proposed changes to incentive compensation plans, especially in situations where there does not appear to be shared sacrifice among executives and rank-and-file employees. Next steps: Companies considering changes will want to take inventory of all compensation arrangements to determine whether, in the aggregate, they reflect the intended incentives. Where they fall short, consider whether the shortfall is appropriate given performance to date and the effect any changes may have on shareholder value and employee morale. If changes are warranted, careful thought should be given to the approach that is right for the types of awards that have been granted and where those awards are in their performance cycles. Companies will need to carefully analyze all accounting, tax and legal aspects of changes with their advisors. ISS recently published some illustrative [examples](#) for adjusting annual targets in light of the COVID-19 pandemic. Finally, companies will need to consider how they will be judged in the court of public opinion, when the amendment to the incentive plan is disclosed on Form 8-K and described in the 2021 proxy statement.

For more information on COVID-19 compensation considerations, see our [Benefits blog post](#).

## MEET THE TEAM



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