Compensation Planning in the Wake of the COVID-19 Pandemic

To our clients and friends:

We are going through what may turn out to be one of the most significant health and economic events of our lifetime – the global COVID-19 pandemic. As we adjust to the new realities of everyday life, Compensia remains committed to supporting the broader community.

We recognize that for many of our clients this may be a busy time on the compensation calendar, as bonuses are determined and next year's incentive compensation plans and equity budgets are implemented. We continue to operate at full capacity and stand ready to meet your needs in this new and evolving environment. In the weeks ahead, we will use our website as a means for sharing pertinent information on the latest compensation developments related to the COVID-19 outbreak and our experiences helping companies address their executive and equity compensation programs in this rapidly evolving environment.

As your trusted advisor, we want to assure you that we remain committed to serving your needs in every way possible. Should you need any assistance, or simply want to know how others are responding to the challenges that lie ahead, do not hesitate to reach out to your engagement manager. Most importantly, please stay safe in the days ahead.

The Compensia Team

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Preliminary Thoughts

Our position as the most prominent advisor in the technology and life sciences sectors gives us deep real-time insight into market practices and trends. Combined with our expertise on the policies and guidelines of major institutional shareholders and their advisors, we are in a position to help companies better understand and evaluate what compensation strategies, and their associated risks, may be advisable to address issues they are facing with their executive and broader cash and equity compensation programs.

While many of these issues – and possible responses – are evolving in real time, we have already seen companies consider and, in some cases, implement a number of practices in response to specific issues. How companies address issues will depend in large part on the nature of each company's business and operations, and how those are likely to be affected by the impact of the pandemic on the economy. Context will be critical and the appropriate course of action for each company will necessarily vary. For now, adopting a "wait-and-see" approach may be the most prudent response for some companies.

We note, also, that many of the alternatives outlined below involve the exercise of some level of discretion, which can have material regulatory consequences, raise concerns with institutional shareholders and their advisors, and trigger legal and accounting implications. However, this may be a year in which we see significantly more discretion exercised than normal. We have found in these situations that it may be beneficial for companies to consider the principles they will apply to such exercises of discretion. For example, will discretion be applied consistently for executives and employees? Will payments be limited to target levels where discretion is being applied? Will there be an agreed range for performance beyond which adjustments will not be made? What percentage of incremental profits (where applicable) is it fair to deliver to employees versus shareholders?

A company's potential course of action may be impacted by many factors, such as public or private company status, prior investor feedback and/or Say-on-Pay support levels, the need to balance its risk tolerance with its retention objectives, ownership structure, financial and total shareholder return ("TSR") performance (actual and projected), existing cash balance/constraints, compensation program design, and equity plan funding and pressure on future dilution levels.

As always, we recommend that companies engage directly with their legal and accounting advisors in connection with implementing any chosen strategy, as there may be complex and/or unforeseen consequences.

Finally, the discussion that follows is quite lengthy, but we wanted to share with all of you, our clients, what we are seeing considered and implemented. Feel free to skim for sections most relevant to you. We have organized the discussion by program type (e.g., STI, LTI, etc.) and by approval timing (e.g., pre- or post-pandemic) to make it easier to find topics of interest.

Short-Term Incentive ("STI") Plan Issues

The onset of the pandemic has coincided with the approval of current year STI plans for many companies. Some public companies have already established the performance measures and related target levels for their STI plans and are now faced with metrics that may no longer be attainable. Still other companies are preparing to go through that process shortly. Here are some of the actions that companies have taken or are considering in view of the uncertainty in the marketplace.

Plan Already Approved Pre-Pandemic

Companies have implemented or are considering one or more of the following alternatives:

Approaches Already Implemented:

- ***Maintain Current Plan*** – Maintain the plan under its approved terms and conditions, even though there is a significant risk of a low or no payout at the end of the year. Coupled with an openness to exercising discretion at the end of the performance period, this is currently the most common approach taken by our clients.
- ***Exercise Discretion at Year End*** – Once performance results are known, exercise reasonable discretion to adjust the plan payout to reflect a modified set of objectives and/or a reasonable, but subjective, assessment of corporate and individual performance under the circumstances.

Other Potential Approaches:

- ***Exercise Discretion Now*** – We have not yet seen clients take this approach, as it presupposes that the Compensation Committee is comfortable resetting the performance metrics and/or scaling (threshold, target, maximum) in a still highly uncertain economic climate.
- ***Truncate the Performance Period and Establish a New Performance Period*** – For similar reasons to exercising discretion now, clients have not (yet) taken this approach. However, we may see more companies take this approach at the mid-year mark if there is better ability to forecast.

Plan Still Pending Approval

Where the design of the STI plan is still being reviewed by the Compensation Committee, companies are considering the following alternatives:

Approaches Already Implemented:

- ***Adjust Performance Goals/Payout Curves Now*** – We have had a number of clients, recognizing the pandemic is likely to impact 2020 performance, make their plans more durable – and the associated performance outcomes less volatile – by reducing targets and/or widening the performance scaling, especially on the downside. However, we note that executive bonus payouts in the face of significant cost-cutting actions can be controversial, so a realistic evaluation of other actions that may be necessary to address the impact of the pandemic should be carefully evaluated.
- ***Delay Approval of Performance Objectives*** – In view of the elimination of the exemption for performance-based compensation under Section 162(m) of the Code, it is no longer necessary to set performance objectives within the first 90 days of the performance year. Rather, it may be prudent to wait until the uncertainty generated by the pandemic has subsided some before setting goals for the year.
- ***Use Two Six-Month Performance Periods*** – If permitted under the terms of the plan, use multiple performance periods for the year, with performance metrics and/or related target levels being reset for the second half of the year when presumably there will be greater visibility into the economic environment.

Other Potential Approaches:

- ***Increase Weighting of Non-Financial/Individual Performance Metrics*** – Since most STI plans use multiple performance metrics and many include an individual performance component, it may be prudent to select one or more non-financial performance metrics for the year (such as operational and/or strategic metrics) and/or place greater emphasis on individual performance. Again, keep in mind the potential optics of paying your executives on these metrics while also pursuing cost-cutting efforts.
- ***Use Discretionary Bonuses*** – Rather than setting formulaic performance objectives for the year, establish less formal performance guidelines for the plan (both corporate and individual) and allow the Compensation Committee to exercise its discretion to pay bonuses at year-end after evaluating performance in light of the resulting economic climate. A minimum level of corporate performance may be established for bonus availability.
- ***Grant Full-Value Awards Instead of Cash Bonus Opportunity*** – Rather than attempt to set performance objectives in a volatile climate, grant full value equity awards in an equivalent amount to the target STI opportunity that vest 12 months after the date of grant.

Compensation Planning in the Wake of the COVID-19 Pandemic (continued)

Long-Term Incentive ("LTI") Plan Issues

Many public companies grant performance-based LTI awards, which present their own set of complexities in the current environment.

Awards Granted Pre-Pandemic

Companies have implemented or are considering one or more of the following alternatives:

Approaches Already Implemented:

- ***Maintain Current Plan*** – Similar to annual bonus plans as discussed above, except that many LTI plans have longer performance periods than their bonus plan counterparts, which may make any adjustments even more premature. As with annual bonus plans, staying the course (coupled with an openness to exercising discretion at the end of the performance period or adjusting goals at a later date) is the approach most of our clients are currently taking.

Other Potential Approaches:

- ***Exercise Discretion at End of Performance Period*** – Similar to annual bonus plans as discussed above. We also recommend that companies review the terms of their LTI plans with legal counsel to confirm flexibility in this regard and with their auditors to confirm the potential financial accounting impact.
- ***Exercise Discretion Now/Adjust Goals During Performance Period*** – Similar to annual bonus plans as discussed above, with similar challenges. One alternative that could minimize the risk associated with setting goals in the current environment is to move to a relative TSR metric. Another alternative would be to exercise discretion to terminate the current performance period and establish a new performance period using adjusted performance metrics and/or targets.
- ***Replace or Supplement the Plan with Time-Based Full-Value Awards*** – Rather than attempt to reset performance objectives in a volatile climate, grant time-based RSUs in an amount equivalent to the target performance-based award. We recommend reviewing with legal counsel whether to terminate the performance-based awards and replace with RSUs or just grant additional RSUs.

Awards Still Pending Approval

Where the LTI awards have yet to be granted by the Compensation Committee, companies are considering the following alternatives:

Approaches Already Implemented:

- ***Delay Approval of Awards*** – As with annual bonus plans, both due to goal-setting difficulties and highly volatile stock prices, it may be more favorable to wait until the uncertainty generated by the pandemic has subsided some before making LTI awards. We have seen a number of clients take this approach. See the separate discussion below under "Broader Equity Award Considerations" for how clients are addressing the extreme stock price volatility we are experiencing in their annual LTI award cycles.
- ***Provide Wider Performance Curve*** – Similar to annual bonus plans as discussed above.
- ***Reduce PSU Values*** – Since most companies use a "portfolio" approach to their long-term incentive compensation awards, it may be relatively simple to reweight the annual award mix towards performance awards that are not dependent on specific operational performance metrics (for example, relative TSR) or towards time-based awards. On this front, we have seen a number of companies move from a 50%/50% weighting of PSUs and RSUs to a heavier weighting of RSUs (for example, 60% to 75% of the total annual equity mix).

Other Potential Approaches:

- ***Use Multiple Annual Performance Periods*** – Rather than using a single three-year performance period, isolate the current period by switching to three consecutive one-year performance periods. Under this approach, the company can postpone setting performance objectives and related target levels for the second and third periods until the beginning of each period.
- ***Use Relative TSR as a Performance Measure*** – Rather than using absolute financial and/or operational performance measures with the attendant uncertainty that they bring in the current environment, introduce relative TSR as the sole or secondary performance measure for the current set of awards. Many clients already have taken this approach in their LTI plans and may be better positioned to ride out the current uncertainty than those with more focus on financial performance metrics.
- ***Re-Introduce Stock Options into Equity Mix*** – Although not immediately retentive, the leveraged and relatively long-term orientation of stock options, coupled with a perceived bottoming of a company's stock price, may lead some to view options as an attractive and shareholder-aligned alternative for their executives even though most advisors to the institutional shareholder community do not view options as sufficiently performance-based.

Compensation Planning in the Wake of the COVID-19 Pandemic (continued)

Broader Equity Award Considerations

With many companies experiencing sharp declines in their stock price, funding targeted grant values for annual equity awards may be challenging. Many companies are finding that they need to grant more shares than they anticipated to deliver intended LTI values to employees. Some companies may not have sufficient shares available in their equity plans to grant planned values. Others may run the risk of exhausting their pool sooner than anticipated, or otherwise face an annual equity "spend" (burn rate) that is outside market norms or investor preferences.

Awards Granted Pre-Pandemic

Where companies have already made their annual equity award grants for the year, some have decided to take no action to address the decline in the intended target value, taking the position that the awards are long-term in nature and their ultimate realizable value will align with shareholder interests. Other companies continue to monitor the situation with the potential for targeted retention awards at a later time to high performers or to address value shortfalls.

Awards Still to be Granted

Companies that have yet to grant their annual "refresh" awards are considering a range of alternatives, including:

- ***Delay Equity "Refresh" Cycle*** – Postponing what for many companies is one of their largest compensation expenditures may be prudent until there is better market visibility. It may allow awards to be granted after the company's stock price has stabilized and at a time where the most critical retentions risks have been identified. A number of clients have taken this approach and will be evaluating the rest of the alternatives below over the next several months.
- ***Maintain Status Quo*** – Make no change to the intended target value of awards or the related value-to-share conversion methodology. Depending on the length of the share conversion price averaging period, this may result in delivering a number of shares that reflect an actual grant date market value significantly below the intended target value.
- ***Change Share Conversion Methodology*** – Some companies that use an average share price over a specific period of days or weeks (rather than a "spot" price) to convert intended grant values into shares have increased or decreased the conversion price averaging period to deliver an award that is closer to the intended target value. For example, we have seen some companies shift from a 30-60 day averaging period to a shorter period such as the closing price at grant or a 10-day average.
- ***Maintain Share Conversion Methodology but Increase Target Award Values*** – Rather than adjust the value-to-share conversion methodology or delay awards, some companies are simply increasing their target award values to help offset higher conversion prices and resulting lower actual, delivered grant values. We have most commonly seen a "compromise approach" where the intended grant value is increased by less than the full amount of the related decrease in the company's stock price.
- ***Use Share Pool More Selectively*** – Companies with limited share pools or concerns about their burn rates may reserve the bulk (if not all) of their pool for key employee retention awards and/or to single out high performers for awards. This can either be done now or by reserving a portion of the planned spend for later in the year.
- ***Consider Stock Option Exchange Program*** – Companies with a material number of outstanding "underwater" stock options may also wish to consider implementing an option exchange or "repricing" program. These programs are complicated, may require shareholder approval, and can be expensive to implement. Similar to the 2008–2009 downturn, waiting to ensure a bottom has occurred in a company's stock price before implementing such a program has been the consensus opinion so far. We recommend that companies review the costs, advantages and disadvantages, and potential issues of any contemplated exchange or repricing program with Compensia, legal counsel, and their audit firm.

Cash Conservation and Liquidity Considerations

Another area that companies may consider in go-forward compensation planning is their near- and medium-term cash position and compensation actions to help conserve cash. Some items to consider include the following:

- ***Delaying/Foregoing Salary Increases*** – Delaying or foregoing planned base salary increases.
- ***Voluntary Salary Reductions*** – Instituting a voluntary salary reduction program for some or all executives.
- ***Paying Bonuses in Stock*** – Considering paying annual bonuses in shares of company stock rather than cash. We recommend reviewing with legal counsel whether this would be permissible under the governing plan.
- ***Suspend "Net Settlement" Programs*** – Suspending or discontinuing any "net settlement" program associated with the vesting of RSU awards and/or exercise of vested stock options This will reduce company cash outflows to satisfy tax withholding obligations associated with equity programs.
- ***Suspend Section 401(k) Matching Contributions*** – Delay or suspend employer matching contributions to the company's 401(k) plan.
- ***Enhance Employee Stock Purchase Plan*** – Enact employee-favorable amendments to the company employee stock purchase plan (for example, increase the level of permissible employee payroll contributions, lengthen the "lookback" period, etc.).

Final Thoughts

We believe Compensation Committees should closely monitor developments in these areas on an ongoing basis, so as to retain and properly motivate executives and key employees and ensure appropriate shareholder alignment. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance assessing your specific situation, please contact your Compensia engagement manager.■

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