Performance in a Pandemic

10 governance and shareholder considerations for performance-based compensation

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The uncertainty and disruption caused by the pandemic has created a challenging situation for compensation committees that need to address the impact of the pandemic on their companies' performance-based compensation programs. Compensation committees must face the daunting task of balancing the desire to align executive pay with performance with the need to retain their top talent in an environment where there are still few answers as to where things are headed. Read our 10 tips to help committees navigate these murky waters.

1. Consider All Stakeholders. Committees need to be mindful that there are many constituencies watching what they do. Shareholders and proxy advisors want compensation to be performance-based and may have little sympathy for "rewarding" executives when the stock price is depressed. Executives on the other hand, may be willing to share the pain to some degree but still expect to be rewarded for likely working harder than ever in difficult conditions. External forces such as the media will look for opportunities to highlight any perceived disconnect between company performance and executive pay.

2. Don't Be Tone Deaf. It is important that committees look holistically at the organization to understand how the compensation decisions they make fit in with the overall picture of conditions at the company. Have workers been furloughed? Laid off? Taken salary cuts? Has the company cut or suspended its dividend? What has happened to the company's stock price? Committees need to consider how payouts to executives will be perceived in the face of these headwinds and be prepared to answer hard questions as to fundamental fairness.

3. Don't Work in a Vacuum. It is more important now than ever for committees to understand what is happening outside the four (virtual) walls of the company. Committees need to hear from their outside advisors to keep them apprised of how compensation decisions are being handled at other companies, particularly in their peer group and industry at large. They also need to be kept up to date on the positions being taken by proxy advisors with respect to changes to compensation programs. In addition, committees

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need management to keep them informed as to internal human resource and retention challenges. Minutes should reflect that the committee received advice from external advisors and that it developed a framework used for the ensuing decision-making.

4. Be Prepared to Pivot. Flexibility and an ability to adapt quickly are critical. What may have seemed like a sensible plan last week or last month may seem completely wrong or out of context a short time later. In considering compensation decisions, committees should build in flexibility to adjust programs as circumstances evolve and change.

5. Metrics. Committees may be considering whether the metrics they traditionally have used to measure performance should be adjusted, or replaced, in the current environment. This question may be more easily answered for an annual plan than a long-term plan where it may be harder to explain throwing out the window metrics that were perceived as good indicators of long-term company performance. To date, proxy advisors have indicated that they will be more open to accepting changes to annual plans than long-term plans.

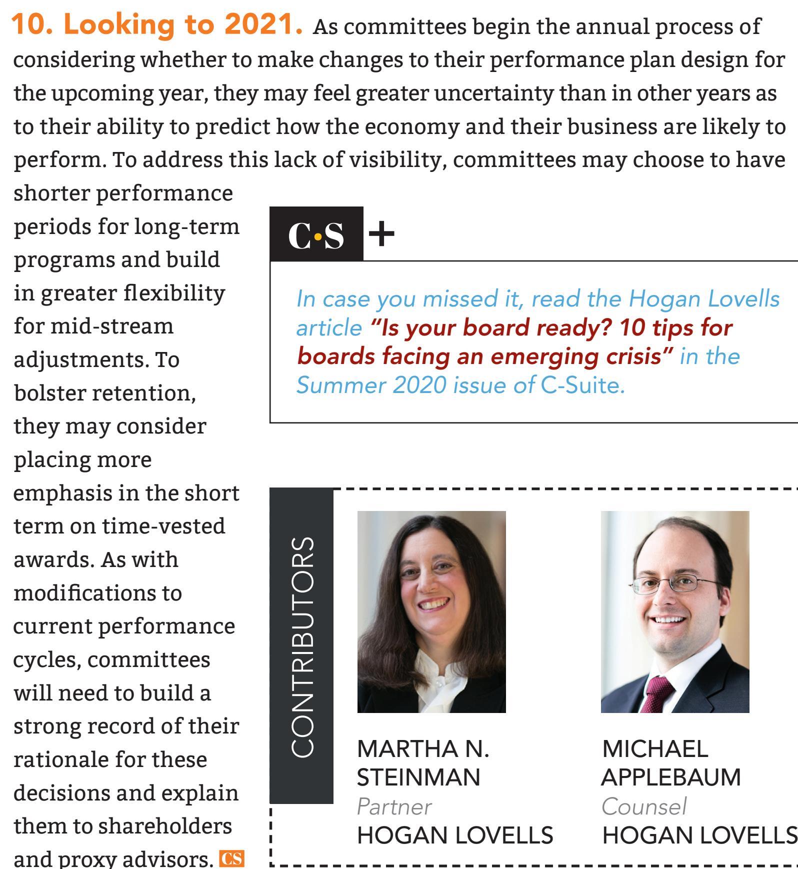
6. Beware of Guessing Wrong. Committees need to be mindful of the fact that it will not be a good "story" to present to shareholders if they modify programs and then need to change course again, so they should be wary of rushing to make a decision. For annual plans, this is less of a concern as it is now in the latter part of the year. However, for long-term plans, this concern remains real, and for cycles not ending this year, directors may wish to adopt more of a wait-and-see approach for now.

7. Discretion. While, from a committee's perspective, the ability to use discretion provides flexibility to modify performance goals and/or payouts based on unforeseen circumstances not taken into account at the time goals or payout levels were established, shareholders and proxy advisors tend to see things through a different lens. To them, discretion may mean the ability to pay someone without performance, and thus they may assert that the use of discretion causes pay not to be performance-based. This concern (as well as prior concerns about tax deductibility prior to the changes to 162(m) enacted in 2017) has traditionally made committees reluctant to use discretion absent a compelling case. A global pandemic may present that case. With no ability to see it coming and limited ability to see its ultimate impact on a business and the broader economy, directors may wish to use discretion to determine appropriate payouts based on the information available at the end of a performance cycle rather than making a mid-cycle guess as to how to modify targets. Committees choosing this path, however, must recognize that while the proxy advisors may have some sympathy to the use of discretion in this situation, they will remain skeptical, so robust disclosure of the rationale for the decisions will be required.

8. Shareholder Engagement. Shareholder engagement will be especially important this year to explain modifications to a performance program or the use of discretion to mitigate the impact of the pandemic on executive compensation. Having gone through a careful and deliberative process to make decisions about the appropriate way to modify programs, companies need to engage with key shareholders and proxy advisors to make sure that they understand the process followed prior to making those decisions and the rationale for what was done.

9. The Pandemic's Impact Has Varied by Industry. Committees must recognize that while the pandemic has negatively impacted most industries, some industries have suffered disproportionately and some industries have in fact benefited (from an economic standpoint). Committees should strive to right size changes to performance programs, taking into consideration the relative impact of the pandemic on the company.

10. Looking to 2021. As committees begin the annual process of considering whether to make changes to their performance plan design for the upcoming year, they may feel greater uncertainty than in other years as to their ability to predict how the economy and their business are likely to perform. To address this lack of visibility, committees may choose to have shorter performance periods for long-term programs and build in greater flexibility for mid-stream adjustments. To bolster retention, they may consider placing more emphasis in the short term on time-vested awards. As with modifications to current performance cycles, committees will need to build a strong record of their rationale for these decisions and explain them to shareholders and proxy advisors. CS



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In case you missed it, read the Hogan Lovells article ***"Is your board ready? 10 tips for boards facing an emerging crisis"*** *in the Summer 2020 issue of C-Suite.*

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