EXECUTIVE PAY

COMPENSATION AND THE COVID-19 CRISIS

Revisiting pay practices to adjust to a new, post-pandemic reality.

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THIS SPRING, with some notable exceptions, vast swaths of the business community saw share prices plummet as social distancing shutdowns, declining revenues, supply chain upheavals and other coronavirus-related disruptions derailed performance prospects. Still reeling from the impact of Covid-19, companies across industries and around the globe are now bracing for a lengthy stretch of leaner times all around.

What that will mean for compensation programs continues to unfold. Early on, dire circumstances prompted a number of companies in the most severely hit industries to announce reductions in executive pay. "As of May 10, about 15 percent of companies in the Russell 3000 and 20 percent of the S&P 500 had announced pay cuts," says Ted Simmons, principal at FW Cook. Those early actions fueled speculation about whether companies less impacted by the crisis would follow suit.

PANDEMIC PAY CONCESSIONS

"Beyond facing cash-flow crunches, liquidity concerns and expressing a sense of shared sacrifice with a furloughed workforce, there are other factors that might lead companies to announce pay cuts," says Dan Ryterband, CEO of FW Cook. "These include things like pressure from the perception that other companies are doing this or the sentiment that executives should share the pain being felt by shareholders."

However, aligning shareholders' lost value with executive pay is generally baked into long-term incentive pay programs. "Variable incentives account for between 80 percent and 90 percent of C-Suite pay among the largest companies, with the predominance tied to performance-vested, equity-based incentives, the value of which have already depreciated," notes Ryterband. "So, not only do executives have the probability of earning less than the target shares [due to performance], with few exceptions the value of shares they may earn is reduced."

How these performance rewards are likely to pay out at year-end is a pressing challenge for companies that set goals and designed incentive pay programs for 2020 that have since been effectively rendered moot by a black swan event. Barring adjustments, executives may now be "rewarded" with zero bonuses for 2020, underwater stock options or performance-based restricted stock likely to vest substantially below the target opportunity and on a substantially diminished stock price—if it vests at all.

Yet, companies should be wary of rushing in with remedies to potential performance pay shortfalls. "It's really important to think about these things in a holistic, coordinated fashion rather than individually or piecemeal," warns Ryterband. "While companies may tend to consider pay concessions, resetting goals and applying discretion to pay when performance targets weren't met as isolated issues, investors and proxy advisory firms will consider everything in tandem and do so with the benefit of hindsight in the next say-on-pay vote."

RIGHT IS BETTER THAN FAST

Amid wide acknowledgement that unforeseen circumstances rather than poor performance by executives is to blame for missed performance targets, it can be tempting to move quickly to adjust goalposts. But given the difficulty of setting targets with so much uncertainty ahead, letting the original goals play out and exercising judgement at the end of the year may be a better strategy.

"If you're going to reset, wait until there is a reasonable amount of precision in your future forecasting opportunity," advises Ryterband, who points out that erring in either direction will have far-reaching ramifications. "Guessing will lead to either a windfall or another compensation deficit. Then, at the end of the year, you may need to take down a payment that is too high or adjust the payment upward."

A multistep process triggers the need to disclose the application of discretion on multiple bases—which, in turn, will be viewed with suspicion by investors. The same will be true in a case where pay concessions were made in the name of sharing the pain of investors and furloughed employees, then followed at year-end by discretionary pay adjustments that diminish the materiality of the pay concessions.

"It implies that you simply wanted to pay the management team so you continued to revisit the situation until you were able to justify it," says Ryterband. "It's important for companies to avoid that kind of perception because it connotes an entitlement-oriented, as opposed to a performance-oriented, culture. When making decisions around executive compensation, consider them in the context of, 'How can we explain them to investors, and how is a rational investor likely to react?'"

At the same time, circumstances that demand a reshuffling of priorities are a reality for the vast majority of companies today. While it can be tempting to change the performance metrics to align with newly pressing priorities, less formal ways of redirecting focus to maximizing cash flow, operating more efficiently and containing costs may be preferable.

"As the situation evolves, a company could communicate changes in direction with regard to focus on cash versus revenue and profit by communicating with the team on a consistent and recurring basis the expectations around performance," says Ryterband. "That kind of communication can occur with or without a formal change to the metrics or targets in the incentive plan. Companies that would, in ordinary course, have used the incentive plan to communicate goals may need to do that through other mechanisms—consistent and evolving communication from the CEO, the CFO and the business unit presidents."

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THE ISSUE OF RETENTION

Looking ahead, the Covid-19 crisis is likely to reshape conversations about 2021 compensation programs. "For companies that had to implement broad pay cuts or suspend 401k plans, there will be conversations about the right way to show solidarity with employees," says Simmons. "What's the right action to take for the CEO? For the other proxy officers? Is there are a rationale to take different actions, particularly for the folks who are lower down in the organization?"

The impact will be particularly deep and far-reaching for companies in the hardest-hit industries. Equity awards with the number of shares determined based on the stock price on the date of the grant will be problematic for companies whose share prices remain depressed. For the hardest-hit companies, grants of three to five times as many shares due to a reduction in valuation will present difficulties on multiple levels, notes Ryterband.

"There are dilutive implications—the potential exhaustion of the pool of shares from which those grants must be made—as well as the question of granting such large numbers of shares at a time when investors have seen value plummet and employees are facing layoffs, furloughs and salary cuts," he says. "However, the companies hit the hardest will also face the greatest retention challenges because the value of outstanding awards may be entirely lost."

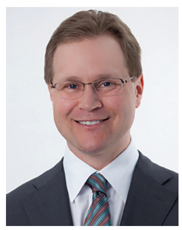
What's more, many companies that accepted federal aid offered to businesses may need to structure executive compensation to stay within the limits on total compensation defined by the CARES Act:

- For employees whose total compensation exceeded $425,000 in 2019, the total compensation limit must be no more than the total compensation received by that individual in 2019, and severance pay or termination benefits will be limited to two times the total compensation received in 2019.

- For those whose total compensation exceeded $3 million in 2019, the total compensation limit will be $3 million, plus 50 percent of total compensation over $3 million received in 2019.

"All of this means that, among the hard-hit companies, target compensation levels will fall over the course of the next year or two because companies won't be able to offer the same value due to share-burn implications and, for those that took assistance, compensation restrictions," says Ryterband. "And that could lead to serious attraction and retention issues."

This follow-on effect is serving to underscore an issue that challenged companies long before the pandemic: the need for deeper and more thoughtful succession planning. "It's raising awareness about the importance of building the bench and addressing the fact that people who are good can more or less move from one company to another without a lot of friction," says Ryterband. "Companies will begin thinking about, 'How do I keep the best people here for the duration of their careers?' And that's going to require new thinking around human capital planning and implications for executive compensation design." **CBM**



Dan Ryterband, CEO of FW Cook, has more than 30 years experience consulting with companies on all aspects of executive compensation strategy and design, as well as matters of corporate governance and investor relations.

Ted Simmons, principal at FW Cook, consults with public and private companies across a wide variety of industries on the structure and design of incentive plans and other aspects of executive compensation governance.