

COVID-19 Impact on Executive Compensation – Amending Performance Awards under Equity and Other Incentive Plans

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Performance-Based Compensation - Background

- A key compensation issue this year relates to the treatment of performance-based compensation
 - Performance goals and the corresponding targets will likely not be achieved for many companies due to economic challenges, stock price volatility and business uncertainty surrounding COVID-19
 - May impact short-term and long-term incentive awards established in early 2020 or before
 - May impact cash-based and equity-based awards
- Many companies that sponsor these arrangements have considered or are considering whether to amend or substitute such plans, programs and practices, as well as the underlying awards, including whether to modify pre-established performance goals
 - Some companies have taken action
 - Most companies have discussed the issue, but have not yet acted
- What should companies do? What are the considerations and possible consequences?

Key Action Steps/Considerations for Addressing Performance-Based Compensation

- **Review Arrangements**. Review and analyze current arrangements and the impact of current business conditions on performance-based compensation
- **Are Changes Advisable and Possible?** Determine whether changes to performance goals and targets are necessary or advisable
- **What Changes are Appropriate?** Consider what changes to performance-based awards should be made
- **Document Limitations**. Determine whether the company has the legal authority under the applicable documents to make changes (such as to the targets and the performance goals)

Key Action Steps/Considerations for Addressing Performance-Based Compensation (cont'd)

- **Award Windfalls**. In addressing performance-based compensation, care should be taken to avoid award windfalls
- **Stockholder Approval Requirements**. Depending on the actions taken to address performance-based compensation (and, specifically, equity-based incentive compensation), companies may need to seek stockholder approval (e.g., increase in share reserve, option repricings)
- **SEC Disclosure Considerations**. Actions impacting equity plans and/or the named executive officers will likely trigger SEC disclosure for publicly-traded companies
- **Views of Institutional Investor and Proxy Advisory Firms**. For publicly-traded companies, these views should be considered, including recent guidance (e.g., ISS FAQs issued in October 2020)
- **IRC Section 409A Considerations**. Care should be taken to ensure that any modification to awards complies with the deferred compensation rules under Internal Revenue Code Section 409A

Key Action Steps/Considerations for Addressing Performance-Based Compensation (cont'd)

- **Tax Deductibility**. Amendments and other modifications to grandfathered performance-based awards could jeopardize grandfathering treatment under Internal Revenue Code Section 162(m)
- **Accounting Treatment**. Changes to performance-based compensation or the use of discretion may trigger adverse accounting treatment

Review Arrangements and Determine Whether Changes are Advisable and Possible

- Take stock of relevant performance-based arrangements and awards
- Determine whether established absolute performance goals can be realistically met in light of recent economic circumstances and whether relative performance goals would be similarly impacted
- Consider whether arrangements, policies or guarantees exist that require recurring incentive compensation grants and how the size of such grants is determined
- Determine whether current arrangements appropriately incentivize and encourage retention of employees and other service providers

Review Arrangements and Determine Whether Changes are Advisable and Possible (cont'd)

- Review arrangements to determine whether the company has the discretion to make amendments and modifications under the terms of the plan and award agreements and in accordance with the company's past practices
- Is liquidity sufficient to satisfy upcoming incentive compensation payouts?

What Changes to Performance-Based Compensation are Appropriate?

- After reviewing the risks and limitations associated with such actions (described in further detail below), compensation committees may decide to make appropriate changes or modifications to performance-based and/or equity compensation plans, programs or practices.
- Actions may include:
 - Modifying or adjusting performance goals or adding new metrics, including moving from absolute performance goals to relative performance goals (e.g., absolute total shareholder return versus relative total shareholder return or other peer-based performance goals)
 - Including non-financial performance goals (e.g., operational goals like enhanced supply chain management, process improvements, increased employee and public engagement and/or ESG-based performance goals) or individual performance goals

What Changes to Performance-Based Compensation are Appropriate? (cont'd)

- Reducing performance targets for 2020 and resetting performance goals based on updated forecasts, including reducing threshold level based on performance (could be in combination with other actions)
- Splitting year for short-term performance goals
- Adding discretion to determine payouts
- Extending equity awards or bonuses during periods of furlough or leave of absence
- Pausing vesting of equity awards while employees are on furlough or leave of absence
- Delaying establishment of annual performance bonuses
- Granting special incentive awards

What Changes to Performance-Based Compensation are Appropriate? (cont'd)

- Cancelling, repricing or exchanging options
- Modifying or delaying any contractual commitments to make future equity awards, including for publicly-traded companies, changing grant practices based on a fixed cash value on a given date to an average value of a fixed number of days or a variable commitment based on a formula taking into account the number of shares to be granted and the stock price on the date of grant

Document Limitations

- **What do the Plan Documents say?** Prior to taking any actions with respect to their incentive compensation plans, companies should review the terms of the plans to understand the compensation committee's authority under the plan to amend performance awards metrics or target compensation levels
- **Problematic Plan Provisions.** Plan provisions that could be problematic include provisions that prohibit amendments to outstanding awards or that do not provide sufficient authority to the compensation committee to exercise discretion in adjusting performance metrics, interpreting performance metrics or determining award payouts
- **Discretion.** Similarly, plans (or the underlying award agreements) may not provide sufficient discretion for compensation committees to adjust results in order to disregard the effects of COVID-19

Document Limitations (cont'd)

- **Adjustment Provisions.** Even if plans permit adjustments, adjustments for COVID-19's widespread impact may not be determinable or may be so significant that any possible determination of financial results excluding COVID-19 would be impracticable or may not be consistent with other provisions of the plan
- **Employee Consent.** Companies should also consider whether actions that they take could be deemed to reduce or materially and adversely affect award holders, in which case, award holder consent may be required
- **Share Limits.** If replacement equity awards are to be granted in lieu of prior awards, determine whether the current plan limits are sufficient to satisfy upcoming awards

Award Windfalls

- **Challenges with Fixed Cash Value.** Companies that maintain arrangements with employees that guarantee a fixed cash value of an equity award may have to grant their employees a larger number of shares than originally anticipated due to falling stock prices
- **Burn Rate.** Larger awards, not only increase the equity plan's burn rate (e.g., the number of shares issued under the equity plan in relation to the total number of outstanding shares), but may create a windfall and deliver more value than intended to employees if stock prices rebound in a short period of time
- **Impact of Market Rebound.** In those circumstances, employees may realize outsized compensation as a result of a short-term downturn in the market instead of in recognition of extraordinary performance, which may subject the compensation committee to criticism from institutional investors and proxy advisory firms

Award Windfalls (cont'd)

- **Profits Interests.** For companies that grant profits interests, if a company receives a low valuation as a result of the current landscape and grants profits interests with a low threshold and if the company's value rebounds quickly, award holders will be eligible to participate in the company's profits more quickly than the company planned

Stockholder Approval Requirements

- **Determine Whether the Equity Plan has Sufficient Available Shares.** With respect to equity-based incentive compensation plans, prior to taking any actions that would grant new equity awards, companies should confirm that the equity plan has sufficient shares reserved
- **Increased Shares and Option Repricings.** If new shares are requested, such amendments, along with certain other amendments and modifications to outstanding equity awards (including for publicly-traded companies, option repricings), will require stockholder approval under the equity plan and stock exchange rules

SEC Disclosure Considerations

- Publicly-traded companies may be required to publicly disclose and explain amendments or modifications to existing incentive compensation programs and the adoption of any new arrangements, particularly to the extent they relate to executive officers, directors or equity compensation plans
- These disclosures will generally need to be made in current, quarterly and/or annual reports filed with the SEC (e.g., Forms 8-K, 10-Q and 10-K) and the compensation discussion and analysis and other executive compensation disclosures in proxy statements

Views of Institutional Investors and Proxy Advisory Firms

- Publicly-traded companies will likely be subject to heightened scrutiny by institutional investors and proxy advisory firms, such as Institutional Shareholder Services (“ISS”) and Glass Lewis, for amending performance-based awards
- For example, ISS released guidance earlier this year related to the impact of the COVID-19 pandemic on performance metrics in incentive compensation plans, which provided that:
 - Companies that modify short-term performance goals, which were previously approved for 2020, should provide contemporaneous public disclosure describing the rationale for the changes to the performance metrics

Views of Institutional Investors and Proxy Advisory Firms (Cont'd)

- ISS discourages changing performance goals mid-cycle because such awards cover multiple years and mid-cycle changes will be reviewed on a case-by-case basis
- Future plans will be reviewed under ISS's existing benchmarking policy frameworks
- ISS (in the preliminary FAQs issued in October 2020) may view some actions that would be problematic under normal circumstances as reasonable this year as long as the justification and rationale are clearly discussed and the resulting payouts appear reasonable . In these FAQs, ISS acknowledges that potential changes to bonus and annual incentives can take many forms, including changes to metrics, performance targets and measurement periods
 - Also acknowledges possible suspension of short-term programs and moves toward a discretionary approach or combination approach
 - Disclosure that includes the justification and rationale for the change is important
 - Change is problematic if it is a reflection of poor management performance
 - Consider comparing new approach to original approach in disclosure

Views of Institutional Investors and Proxy Advisory Firms (Cont'd)

- ISS views changes to in-progress long-term incentives negatively, but may view modest alterations as reasonable (e.g., move to relative metrics)
- ISS expects transparent disclosure and clear rationale for one-time grants (grants should be reasonable in magnitude and be an isolated practice, vesting of such grants should be performance-based and grants should contain shareholder-friendly guard rails)

Views of Institutional Investors and Proxy Advisory Firms (Cont'd)

- ISS notes in the FAQs that for award cycles beginning in 2020, investors generally do not expect to see drastic changes in the long-term incentive unless the underlying business strategy has fundamentally changed.
 - More modest alterations to the program (e.g., moving to relative or qualitative metrics) may be viewed as reasonable in light of uncertainty surrounding long-term forecasting.
 - However, more drastic changes (e.g., shifts to predominantly time vesting equity or short-term measurement periods) would continue to be viewed negatively.
 - In all cases companies should clearly explain any changes to the program to investors to evaluate the compensation committee's action and rationale.
- ISS will continue to view option repricing without shareholder approval/ratification as a “problematic pay practice” and if repricing approval/ratification is requested at this year's annual stockholders meeting, ISS has provided that it will generally recommend against repricing if it occurs within one year following a significant share price drop, but will review on a case-by-case basis taking into account the following factors:

Views of Institutional Investors and Proxy Advisory Firms (Cont'd)

- Whether repricing was a value-for-value exchange
- Whether surrendered options were added back to a plan's reserve
- Whether replacement awards are subject vesting conditions
- Whether the repricing excluded executive officers and directors
- Negative reviews from institutional shareholders could, in turn, lead to an unfavorable vote on the company's "Say on Pay" vote or a "no" vote on the election of company directors at the next stockholders meeting

Section 409A of the Internal Revenue Code

- **Compliance.** Companies should also confirm that any modifications to incentive compensation arrangements do not violate the complex non-qualified deferred compensation rules of Section 409A of the Code
- **Consequences of Noncompliance.** Modifications to incentive compensation plans that do not comply with the requirements of Section 409A of the Code may cause the full value of the awards, even if not yet vested, to be subject to immediate ordinary income taxation, an additional 20% income tax and penalties and interest; taxes are imposed on the employee/participant and company has certain reporting and withholding obligations
- **Option Extensions.** Extension of option exercise periods beyond the original term of an option violates Section 409A of the Code (certain other extensions may be permitted)

Tax Deductibility

- **Impact on Deductions.** The amendment or modification of incentive compensation plans may also impact the tax deductibility of those awards
- **\$1m Deduction Limit.** Publicly-traded companies (including certain publicly traded partnerships and private companies with publicly-traded subsidiaries) are subject to Section 162(m) of the Internal Revenue Code, which imposes a \$1 million compensation deduction limitation on compensation paid to their chief executive officer, chief financial officer and the next three most highly compensated executive officers
- **Tax Reform.** The passage of the Tax Cuts and Jobs Act in 2017 eliminated the performance-based exemption to the non-deductibility rules of Section 162(m) of the Code, and proposed regulations published in 2019 removed certain other exemptions intended to provide transition relief for newly public companies

Tax Deductibility (cont'd)

- **Grandfathering Rule.** However (i) qualified performance-based compensation arrangements that were in effect on or before November 2, 2017 and (ii) transition relief-qualifying compensation arrangements of newly public companies that became public prior to December 20, 2019, in each case, may be grandfathered – but would not be eligible for grandfathering if they were to be materially modified
- **Possible Loss of Grandfathering.** Companies that have grandfathered incentive compensation arrangements should closely consider whether any modifications to performance-based compensation will lead to the loss of grandfathering under Section 162(m) of the Code and whether the benefits of the modification are greater than the loss of the grandfathering

Accounting Considerations

- Companies considering modifying their incentive compensation plans or the related awards, should discuss such modifications with their accounting firms, as such changes could lead to liability accounting or treatment of modifications as the grant of new awards

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Andrea S. Rattner, a partner at Proskauer, a leading international law firm, practices executive compensation and employee benefits law and counsels clients with respect to the tax, securities, corporate governance, stock exchange, ERISA and other implications affecting all types of executive compensation arrangements and employee benefit plans. For more than 30 years, her practice has focused on a broad range of executive compensation and employee benefits matters, advising clients on an ongoing basis as well as in the context of corporate transactions (including mergers and acquisitions, debt and equity offerings, restructurings, financings and bankruptcies) and other transformative and unique situations. Her clients include public and private companies, boards and their compensation committees, and executives in wide array of industries. Andrea is also involved in Proskauer's management., serving as a member of the firm's Executive Committee and as the immediate past chair of the Tax Department.

Andrea has been lauded by various legal rankings directories including *Chambers US*, *Best Lawyers* and *Legal 500*, who cite that her "depth of knowledge and involvement in this practice area, [including] the business and trends, is terrific." She is also recognized for having an "excellent understanding of the business community" and for being "pro-active in keeping clients up to date." She writes and lectures frequently on employee benefits and executive compensation matters. Since 1993, she has served as an adjunct professor on the faculty of Cornell University (New York State School of Industrial & Labor Relations-Management Programs). Andrea is also active in Proskauer's relationship with the Women Corporate Directors Foundation (WCD), the only global membership organization of its kind focused on helping women obtain and succeed in board positions

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