Governance & Securities
Alert

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From the Public Company Advisory Group of Weil, Gotshal & Manges LLP

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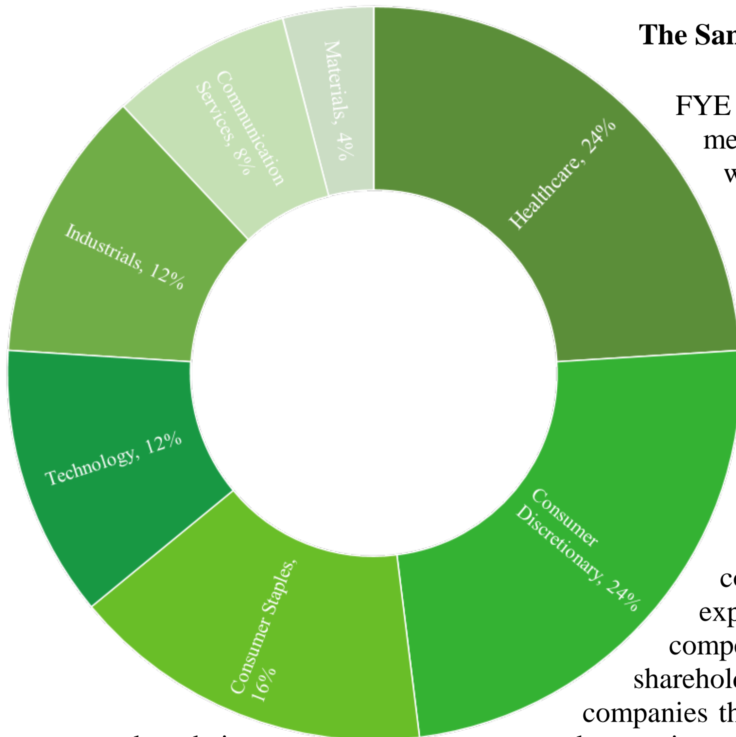
As Year-End Companies Meet to Consider COVID-19-Related Compensation Adjustments, the Question Remains – Will they "Pay the Piper" for Paying their Executives?

Say-on-Pay Vote Results for Quarter and Midyear Proxy Filers and ISS FAQs Provide Insights and Early Warnings

By Adé K. Heyliger, Andrew Holt and Evan Mendelsohn

It has been more than seven months since the full force of the COVID-19 pandemic began in the US, hitting many companies hard with shutdowns, reduced demand, operational and supply chain disruptions, along with a host of new workforce challenges – employee welfare and retention, workplace safety and adapting the workforce to remote environments, among others. Many of the hardest hit quarter and midyear fiscal year-end (FYE) companies responded to these challenges with changes to their executive compensation programs. Several held mid-pandemic annual shareholders meetings with say-on-pay on the agenda, offering the first glimpse as to how shareholders would react to these compensation adjustments.

Many calendar FYE companies, however, opted not to immediately implement adjustments to their executive compensation programs, and instead decided to wait until the end of the year to assess how events and company performance would unfold. Compensation Committees at these companies are now gearing up for year-end meetings in which they will determine whether adjustments to their executive compensation programs are warranted, and wondering how shareholders will react to decisions to implement compensation adjustments. As a preview and early warning for these year-end companies, we examined the actions of quarter and midyear FYE companies to adjust their executive compensation plans in response to the pandemic, and how those changes affected say-on-pay votes. Also informative was the release of frequently asked questions (FAQs) by Institutional Shareholder Services (ISS) on how it will evaluate COVID-19-related pay decisions, informed by feedback from direct discussions held with investors at various roundtables and the annual policy survey. The FAQs are available here, which we previously discussed here.

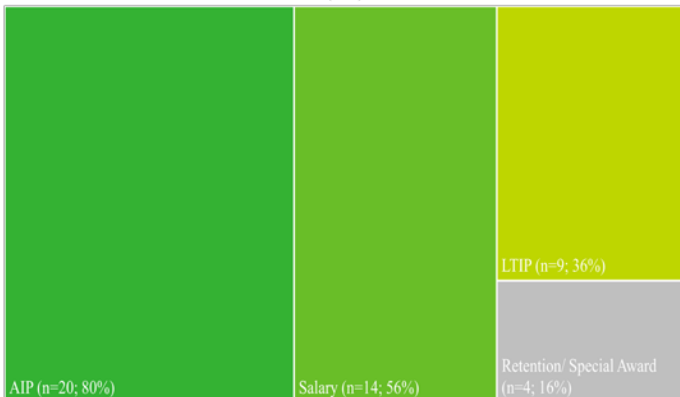


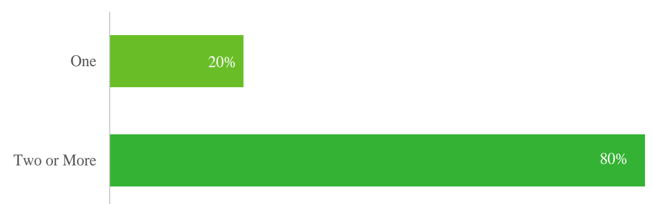
The Sample

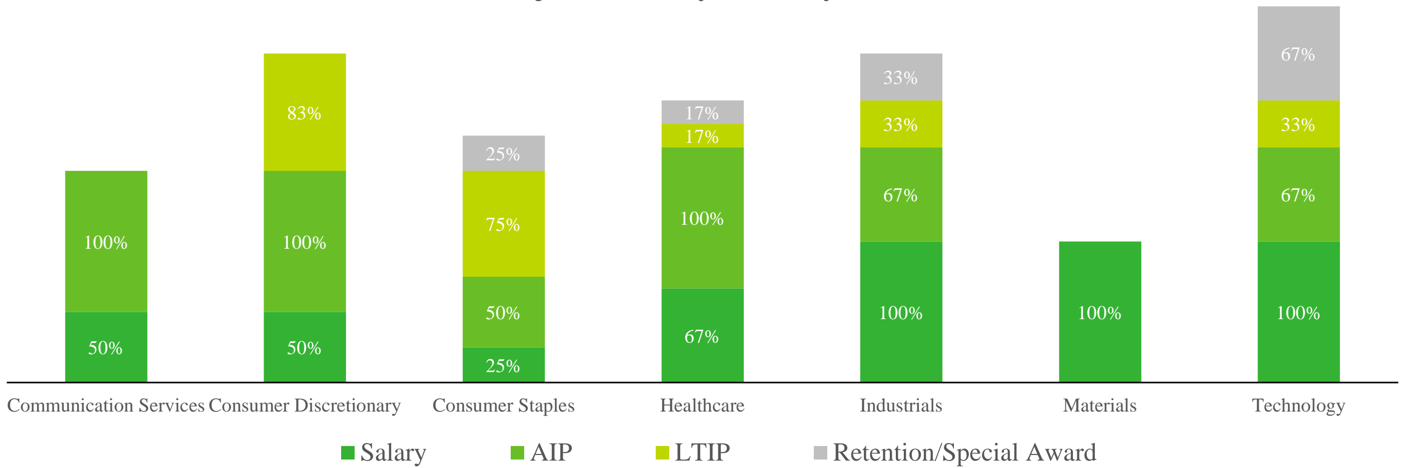
FYE March 31 – July 31 public companies with annual shareholders meetings held through October offered the first detailed view as to what adjustments were being made to executive compensation programs in response to the COVID-19 pandemic – with fulsome discussions regarding the impact of the pandemic on their fiscal 2020 compensation decisions and on their plans for 2021 compensation – and the first glimpse at shareholder reactions to those adjustments. We examined the proxy statement disclosures, ISS vote recommendations and say-on-pay vote results of the Russell 1000 companies that held their annual shareholders meeting by October 31st. **Of the 42 examined companies, 25 – or 60% – disclosed COVID-19-related changes to their compensation plans that were subjected to shareholder scrutiny**. (Note: excluded from the sample were companies whose executive compensation adjustments were not explicitly made in response to the effects of the pandemic – e.g., compensation adjustments that were solely made in response to shareholder engagement following the prior year's say-on-pay vote – and companies that made COVID-related compensation adjustments that did not extend to their named executive officers. From a sector breakdown perspective, Healthcare (24%) and Consumer Discretionary (24%) showed significant representation, making up almost half of the sample, followed by Consumer Staples (16%).

We observed changes to executive salary, annual and long-term incentive programs (both in-flight and go-forward) and discretionary or special award grants. Adjustments to annual incentive plans (AIP) were the most common type of compensation adjustment. 20 companies – or 80% – made more than one type of adjustment. (This Alert contains excerpts from certain companies in the sample, as examples of disclosures concerning the types of observed adjustments).

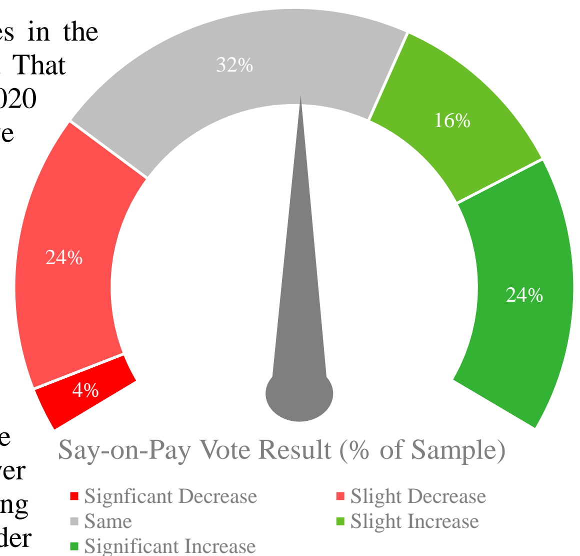
It should also be noted that the COVID-19 pandemic had a positive effect on the performance of some companies, with a few companies in the sample – particularly in the Consumer Staples sector – benefiting from increased customer demand during this period. These companies tended to leave their outstanding AIPs and long-term-incentive plans (LTIP) as is, but delay setting goals for their go-forward plans due to the ongoing uncertainty created by the pandemic.







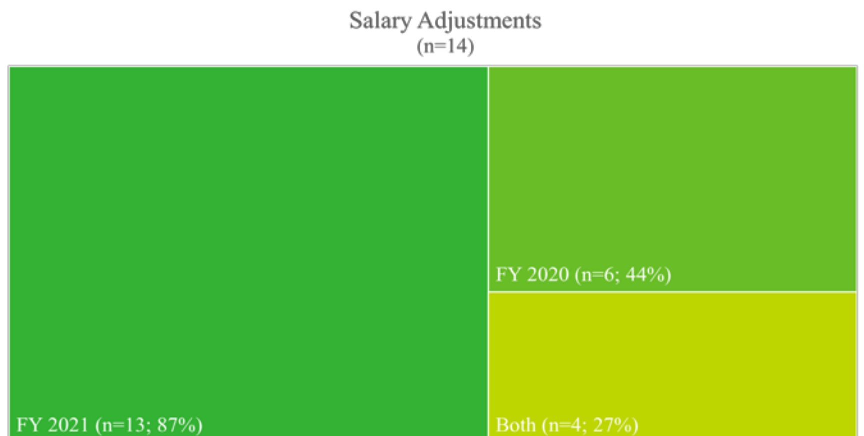
2019 and 2020 year-over-year say-on-pay vote results for many companies in the sample were close, with a majority even seeing higher shareholder support. That many companies in the sample were able to achieve shareholder support in 2020 comparable to that of 2019 is a testament to the their use of objective performance metrics, a reasonable alignment of executive pay and company performance, and their inclusion of robust disclosures to "sell the story" behind those decisions – e.g., when discretion was used, giving detailed descriptions of their rationale, with clear and reasonable outcomes. ISS noted that certain actions it would consider problematic during normal times may be viewed as reasonable in the extraordinary circumstances of the pandemic *if* clear justifications were disclosed and the outcomes were reasonably commensurate with company performance. From the proxy statement disclosures, it seems that several companies in the sample satisfied these criteria, with just over one quarter of the sample receiving lower/slightly lower shareholder support in 2020 compared to 2019, and just one company receiving an "AGAINST" recommendation from ISS with a resulting 54% shareholder support.

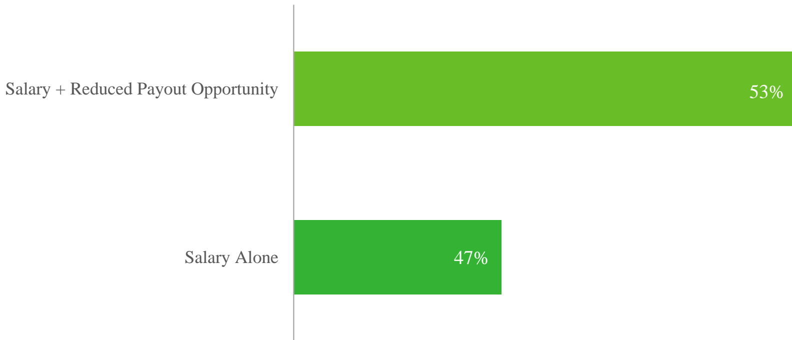


Salary Adjustments

Of the 25 companies, 15 (60%) made temporary reductions to the fiscal 2020 and/or fiscal 2021 base salaries of their top executives. The vast majority reduced 2021 salaries, with two companies opting to delay scheduled 2021 salary increases.

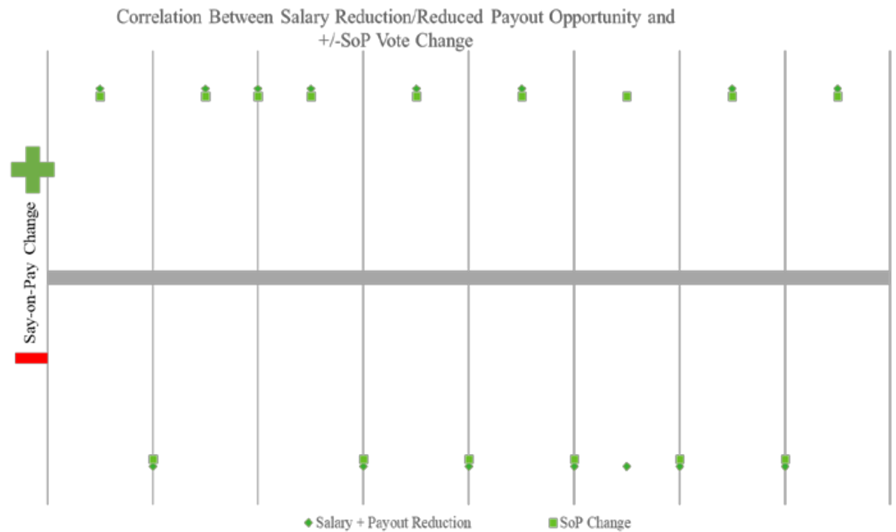
In its FAQs, ISS noted that because base salaries typically account for a small portion of the total pay for top executives, little weight would be given solely to salary reductions; instead, such reductions "will be considered more meaningful if target incentive payout opportunities are decreased to reflect the reduced salary."





From the 15 companies that instituted temporary base salary reductions, eight acccompanied the reduction with a reduction in the target payout opportunity (including one company that used negative discretion to not pay awards and another that did not reduce the payout opportunity, but made no awards because the target metrics were not met).

Further, of these 15 companies that adjusted base salaries, 13 also implemented one or more additional adjustments – e.g., to the AIP or LTIP. While it would be difficult to isolate the effect of the base salary reduction on the resulting say-on-pay vote, an almost perfect correlation was observed between companies that accompanied base salary reductions with a reduced payout opportunity and an increase in year-over-year say-on-pay support. Conversely, companies that reduced base salaries without a payout opportunity reduction tended to see some decline in their say-on-pay vote support (the one company that did see an increase seems to have been assisted by ISS' position that its compensation was generally in line with performance).



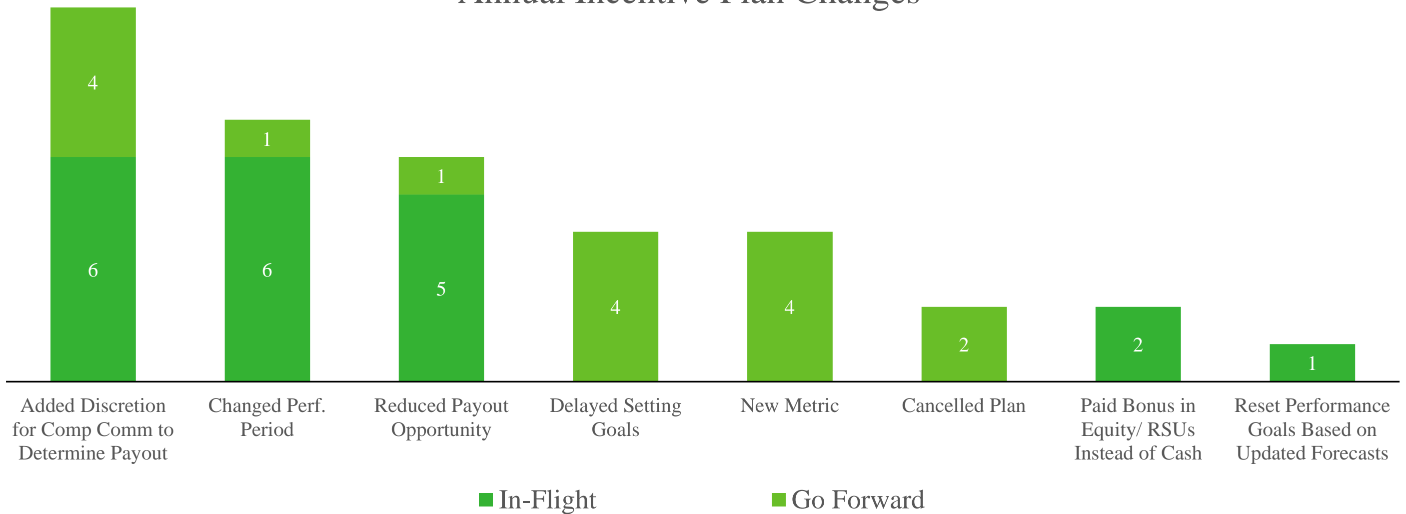
Example

Compensation Actions in Response to COVID-19

It remains critical that [Company] has an executive compensation program that appropriately attracts, retains and incentivizes management while aligning pay with performance, driving long-term value creation and reflecting the views of shareholders. In light of the environment amidst the COVID-19 pandemic, the Compensation Committee implemented a temporary base salary reduction of 10% for our executive officers, and reduced our executive officers' FY 2020 annual bonus payouts.

Annual Incentive Plan Adjustments

19 of the 25 companies in the sample made changes to their in-flight (outstanding) and/or go-forward AIP. The most frequent adjustments were adding Compensation Committee discretion to determine award amounts, modifying the performance periods and reducing the payout periods. Four companies also delayed setting goals for their go-forward plans.



"Take Your Lumps"

While the overwhelming majority of companies in the sample made one or more adjustments to their AIP, there were a few who acknowledged the pandemic's negative impact on performance, but opted not to make corresponding changes, and instead "took their lumps," making no or reduced awards. Shareholders seemed to support this (in)action, based on the say-on-pay vote results.

Example

Incentive Program Payouts

[Company's] performance in fiscal year 2020 did not meet expectations. The Company's revenue, operating income and operating margin declined year-over-year. In addition, the COVID-19 pandemic's impact on business conditions in the last month of fiscal 2020 had an unexpected negative effect on our fiscal 2020 financial results . . . .

Despite the unexpected negative impact of the COVID-19 pandemic on our fiscal 2020 results, the Compensation Committee, at the recommendation of management, did not change any performance goals or reduce performance targets for fiscal 2020. As a result of below threshold revenue and Adjusted Operating Income ("AOI") in fiscal 2020, the Annual ICP under the Company's Executive Compensation Plan was not funded, which resulted in no bonuses paid to executives under the plan.

Added Discretion

10 of the 25 sample companies (40%) explicitly added Compensation Committee discretion to determine award payouts (though the frequency with which discretion was applied is likely undercounted, as many programs contain a qualitative individual performance metric that may mask discretion). Rationales given for the use of discretion included recognizing the extraordinary efforts of the executive officers in guiding the company's response through the unprecedented pandemic, and recognizing pre-pandemic performance.

ISS notes that companies exercising discretion should provide sufficient disclosure to allow investors to evaluate that decision, including: the specific challenges experienced as a result of the pandemic and how such challenges made the original performance targets impossible to reach; disclosure as to why an approach was taken; underlying performance-based criteria (which ISS believes should still be attached to discretionary awards); and avoiding such generic descriptions as "strong leadership during challenging times." Companies in the sample that included sufficient disclosure received significant shareholder support.

Example

Annual Incentives

COVID-19 had a significant impact on Fiscal 2020 financial results, with no time to rebound given the fourth quarter timing. The Compensation Committee therefore agreed to measure performance ratably using ten months pre-COVID-19 and two months post. For the period May 1, 2019 through February 29, 2020, revenue achievement was 99% of target and operating income achievement was 106% of target, for a weighted payout of 111% for this ten-month period. For the period March 1, 2020 through April 30, 2020, revenue achievement was 98% of target and operating income achievement missed threshold performance at 88% of target, for a weighted payout of 37% for this two-month period. After applying the respective weighting to these periods, the total payout was 99% of target for the corporate performance measures.

Two companies in the sample applied negative discretion to reflect the negative effects of the pandemic and maintain pay-for-(COVID-19-impacted) performance.

Example

Calculation of Payouts

In light of fiscal 2020 performance below historical levels, due partly to external headwinds and the COVID-19 pandemic, the Board and the Compensation Committee determined that it was in the best interest of the Company to reinforce its pay-for-performance culture and used negative discretion to lower final payout amounts. Specifically, the Board and the Compensation Committee decreased the payout ranges associated with the overall rating (such that an overall rating of 4 would result in a payout up to 120%, an overall rating of 3 would result in a payout up to 100%, an overall rating of 2 would result in a payout of up to 80% and an overall rating of 1 would result in no payout) and paid all named executive officers cash bonuses at or below these levels.

Adjusted the Performance Period

Seven companies in the sample modified the performance periods for in-flight and go-forward AIPs. Regarding in-flight plans, for the most part, the pandemic only affected the fourth quarter results for these quarter and midyear FYE companies, with the first three quarters of the fiscal year left largely unchanged. As a result, these companies tended to evaluate financial performance results for AIP awards based on company performance for first three quarters of fiscal 2020. Here again, fulsome disclosure of the rationale for the change in performance period, along with clear descriptions of the resulting outcomes, resonated well with both ISS and shareholders.

Example

Performance and Pay Results for Fiscal 2020

Due to the impacts of COVID-19, the Company and each of the business units failed to meet their performance targets and thresholds under our annual incentive plan. As discussed above, while the resulting payout would have been 0% of target for each of our NEOs, the Compensation Committee and the Board assessed the Company's financial performance through the third quarter of the fiscal year, prior to the COVID-19 impact, as well as the significant actions management took to navigate the unprecedented pandemic during the fourth quarter.

Based on its evaluation of these items and all other considerations discussed above, the Compensation Committee determined that it was appropriate to calculate payouts under the fiscal 2020 annual incentive plan based on actual financial results through the first three quarters of the fiscal year rather than through the full fiscal year. Accordingly, the Compensation Committee made the following determinations:

- For the Same-Restaurant Sales Growth measures, the Compensation Committee evaluated and determined the results through the first three quarters of fiscal 2020 against the full year fiscal 2020 targets set in June 2019; and
- For the Adjusted EPS and Business Unit Adjusted Operating Income performance measures, the Compensation Committee approved performance targets for the period through the first three quarters of fiscal 2020 that were consistent with the business plan targets approved by the Board in June 2019, and then evaluated and determined the results for the first three quarters of fiscal 2020 against those three quarter performance goals.

Adjustments to go-forward AIPs tended to focus on shorter performance periods, acknowledging that goal setting, as well as setting appropriate metrics, are more difficult due the pandemic.

Example

Looking Forward to Fiscal 2021 – Short-term Incentive Plan Design Features

Two performance intervals with one payout at the end of the fiscal year. This design will allow the Company to reassess the ability to establish quantitative financial goals for the second half of the fiscal year.

- First performance interval: April 2020 – September 2020;
- Second performance interval: October 2020 – March 2021

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Added New/Adjusted Metrics

A handful of companies introduced new metrics for their AIPs – e.g., an operational health measure – or shifted away from certain financial metrics. The former seems to be driven by a desire to find a more forecastable metric for these highly-unpredictable times, while the latter appears to be a means of introducing more discretionary latitude in determining awards, and to emphasize the importance of qualitative metrics during these times.

Example

Looking Forward to Fiscal 2021

[D]ue to the inability to establish quantitative financial goals based on unprecedented levels of disruption and uncertainty, the Company will significantly modify the bonus and stock plan structure for Fiscal 2021. The Company views these changes as temporary and necessary to adequately motivate, incent and reward performance. Based upon the current COVID-19 environment, our incentive programs will not be established as quantitative financial goals, however, will continue to be driven by key performance indicators ("KPIs") that take into consideration all stakeholders and support the Company's enterprise-wide efforts to maximize its operations, reduce costs and leave the Company better positioned with its customers when more normal business operations resume (including employee health and safety). The Fiscal 2021 program designs will be driven by the following guiding principles:

- Flexibility – we are in uncharted territory and business as usual plan design will not work
- Financial Incentives – continue to be an important part of executive remuneration
- Fair and equitable – consider Fiscal 2021 financial impact to all employees
- Stakeholder Interests – design considers our 5 stakeholders: our employees, our customers and our brand, our stockholders, our suppliers, and our communities
- Simple – keep program simple to understand and focused on what matters most

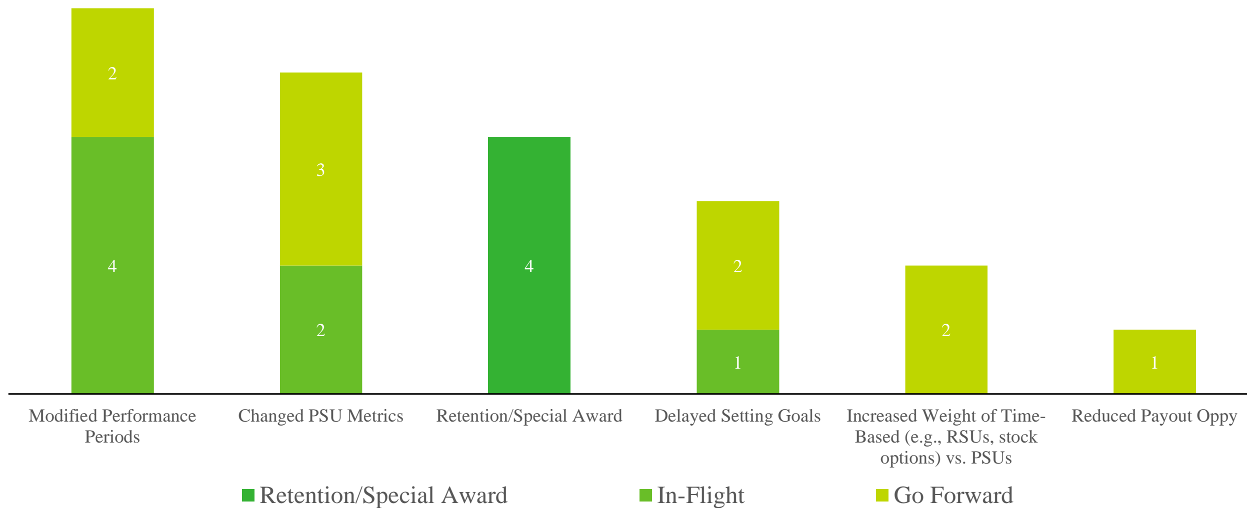
Example

Executive Officers' Compensation for Fiscal Year 2021

The Compensation Committee also agreed that the Company would introduce net sales as a modifier to adjusted operating income results for the short-term incentive compensation program for fiscal year 2021 to give the Compensation Committee discretion to modify payouts based on achievement of net sales compared to target.

Long-Term Incentive Plan Adjustments and Retention/Special Award Grants

Of the 25-company sample, 10 companies (40%) made adjustments to their in-flight and/or go-forward LTIPs. Changes included modifying the performance periods, changing the PSU metrics, delaying goal setting, adjusting the long-term incentive vehicle mix to give a higher weighting to time-vested vehicles and reducing payout opportunities. Four companies in the sample made retention/special awards.



The ISS Position on Changes to In-Flight LTIPs and Shareholder Reaction

In its FAQs, ISS noted that long-term incentives are meant to smooth performance over multiple years, and “should not be altered after the beginning of the cycle based on short term market shock.” To that end, ISS stated that changes to in-flight LTIPs “will generally be viewed negatively, particularly for companies that exhibit a quantitative pay-for-performance misalignment.” Yet, despite these warnings against altering in-flight LTIPs, ISS recommended a vote “FOR” the four companies in the sample that took such action, apparently concluding that pay and performance remained reasonably aligned in each case. Shareholders also followed suit and supported these changes. A fifth company modified its LTIP to delay setting goals.

The ISS Position on Changes to Go-Forward LTIPs and Shareholder Reaction

ISS states that while it may support more “modest changes” to go-forward LTIPs – e.g., a movement to relative or qualitative metrics when long-term financial forecasting is unclear – more “drastic changes” e.g., shifts to predominantly time-vesting equity, “would continue to be viewed negatively.” However, here too, ISS recommended a vote “FOR” the two companies in the sample that moved to time-vesting, and shareholders likewise supported the action.

Example

Special Note About Compensation and COVID-19

Equity awards have been granted on schedule in June 2020 but were granted solely in the form of RSUs due to the difficulty in setting performance targets given the uncertainty of the impact of COVID-19 on our business. Mr. [●]’s award was reduced from approximately $7.5 million in the prior fiscal year to $6.0 million (a reduction of 20%). The other NEOs received RSUs with a grant date fair value in line with the prior fiscal year. As these awards were issued in fiscal 2021, further information will be provided in next year’s proxy statement.

Retention/Special Awards

Given the unprecedented challenges faced as a result of the pandemic, ISS understands that some companies may grant one-time retention or special awards to executives. ISS notes in the FAQs that companies making such one-time grants should clearly disclose the rationale for the award, avoiding boilerplate language regarding "retention concerns," and grant awards of reasonable magnitude.

One company in the sample granted large discretionary bonuses to its named executive officers when no payouts were earned under the company's 2020 AIP and 2018-2020 LTIP "to reward strong pre-pandemic performance and to ensure sustained employee engagement and retention, and drive business results during an unprecedented period of transition." ISS recommended a vote "AGAINST" the company's say-on-pay proposal in large part because it believed the company failed to provide "sufficient explanation" for granting these discretionary awards. Shareholders largely followed the vote recommendation and the company achieved a mere 54% shareholder support, down from 97% in 2019.

Example

Retention Awards and Special Bonus for Chief Financial Officer

On July 17, 2020, the Compensation Committee of the Board of Directors, upon the recommendation of the Chairman of the Board and Chief Executive Officer, approved the payment of a discretionary cash bonus of $575,000 to Mr. [●] in recognition of Mr. [●]'s outstanding leadership during the COVID-19 pandemic. Mr. [●] played a critical role in solidifying our company's financial stability during an unprecedented global health crisis for the long-term benefit of our team members, customers and shareowners, which ranks among his greatest achievements in his decades of financial leadership at [Company].

Example

Special Performance RSU Grant

The Committee approved a special performance grant of RSUs to Mr. [●] with respect to 2,000 shares of Common Stock. The award was made in recognition of Mr. [●]'s significant contributions and efforts in leading the Company's COVID-19 "task force" which was established in March 2020 and was, and continues to be, instrumental to the Company's continued operations and performance during the COVID-19 pandemic. The RSUs will vest on June 2, 2022, generally subject to continued employment through the vesting date, except as otherwise set forth in the applicable award agreement.

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