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

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We continue our blog series on COVID-19 implications on executive compensation matters with a post that addresses considerations relating to amending performance goals under equity and other incentive awards.

Setting meaningful and effective performance goals often requires significant focus and analysis by compensation committees with the assistance of their advisors and management. In light of current economic challenges, stock price volatility and business uncertainty surrounding COVID-19, performance goals and the corresponding targets governing annual and multi-year cash and equity-based incentive awards established in early 2020 or prior will likely not be achieved for many companies. Accordingly, companies that sponsor these arrangements should consider whether to amend or substitute such plans, programs and practices, as well as the underlying awards, including whether to modify pre-established performance goals.

Companies considering taking such actions should review their current arrangements and analyze how current business conditions have affected existing arrangements, performance goals and stock prices. In addition to this review and analysis, companies should consider other issues, including Section 409A of the Internal Revenue Code (the “Code”), and if the company is publicly traded, securities laws and limitations under Section 162(m) of the Code. Set forth below are certain specific questions and limitations to be evaluated in connection with a review of performance goals and potential modifications or other adjustments.

- **Review**, outstanding compensation arrangements to
    - Determine if outstanding compensation arrangements contain performance goals;

- Determine upcoming compensation committee meetings to grant short- or long-term incentive compensation;

- Determine upcoming award cycles based on historical grant practices; and

- Determine upcoming compensation committee meetings to certify the level of achievement of performance goals related to different award cycles (*i.e.*, prior awards).

- **Identify**

  - Whether established absolute performance goals can realistically be met in light of recent economic developments and whether relative performance goals would be similarly impacted;

  - Whether arrangements, policies or guarantees exist that require recurring incentive compensation grants and how the size of such grants is determined;

  - Whether current arrangements appropriately incentivize and encourage retention of employees and other service providers;

  - Whether current equity plan share limitations are sufficient to satisfy upcoming equity awards;

  - Whether the company has discretion to make amendments and modifications under the terms of the plan and in accordance with the company's past practices; and

  - Whether liquidity is sufficient to satisfy upcoming incentive compensation payouts.

- **Act,** after reviewing the risks and limitations associated with such actions (described in further detail below), to determine appropriate changes or modifications to performance-based and/or equity compensation plans, programs or practices. Including:

  - Modifying or adjusting performance goals, including moving from absolute performance goals to relative performance goals (*i.e.*, absolute total shareholder return versus relative total shareholder return or other peer-based performance goals);

  - Including non-financial performance goals (*i.e.*, operational goals like enhanced supply chain management, process improvements, increased employee and public engagement and/or ESG-based performance goals) or individual performance goals;

  - 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;

- Cancelling, repricing or exchanging options; or
- Modifying or delaying any contractual commitments to make future equity awards, including for public 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 share price on the date of grant.

In determining whether to amend or substitute performance goals or equity awards, companies should consider: document limitations, award windfalls, stockholder approval requirements, Securities and Exchange Commission ("SEC") disclosure considerations, views of institutional investors and proxy advisory firms, Section 409A of the Code, tax deductibility and accounting considerations. We address these considerations in further detail below.

Document Limitations. 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 rights under the plan to amend performance metrics or target compensation levels. 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. 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. However, 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 (*e.g.*, provisions governing minimum vesting). 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.

Award Windfalls. 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. 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. 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. Similarly, 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, 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. Ultimately, companies will need to evaluate what makes sense in order to properly incentivize and retain key talent while meeting other business needs and considerations.

Stockholder Approval Requirements. 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. If new shares are requested, such amendments, along with certain other amendments and modifications to outstanding equity awards, will require stockholder approval (*i.e.*, for publicly traded companies – option repricings) 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. In addition to the news media's potentially negative reaction to companies seemingly easing performance metrics associated with incentive compensation plans, public companies may also be subject to heightened scrutiny by institutional investors and proxy advisory firms, such as Institutional Shareholder Services ("ISS") and Glass Lewis. For example, ISS recently released guidance related to the COVID-19 pandemic on performance metrics in incentive compensation plans, which provides that:

(1) 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;

(2) 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; and

(3) future plans will be reviewed under ISS's existing benchmarking policy frameworks.

Further, ISS confirmed that it 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: (1) whether repricing was a value-for-value exchange, (2) whether surrendered options were added back to a plan's reserve, (3) whether replacement awards are subject vesting conditions, and (4) 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 Code. 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. 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.

Tax Deductibility. The amendment or modification of incentive compensation plans may also impact the tax deductibility of those awards. Publicly traded companies (including certain publicly traded partnerships and private companies with publicly traded subsidiaries) are subject to Section 162(m) of the 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. The passage of the Tax Cuts and Jobs Act in 2017 obviated the qualified performance-based compensation exemption to the non-deductibility rules of Section 162(m) of the Code, and proposed regulations published in 2019 remove certain other exemptions intended to provide transition relief for newly public companies. 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. Companies that have grandfathered incentive compensation arrangements should closely consider whether such modifications 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. Finally, 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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