Memorandum

Compensation Impacts of COVID-19 on Performance-Based Incentive Awards

April 30, 2020

The coronavirus disease 2019 ("COVID-19") outbreak continues to impose significant and unprecedented economic harm and uncertainty for companies across numerous sectors. As companies continue to evaluate the impact of the pandemic on stock market volatility and company performance, an important issue to be addressed from both a private and public company perspective is how to address the impact of the pandemic on performance-based compensation; specifically, establishing new performance-based compensation awards for 2020, adjusting existing performance goals for both annual and long-term incentive compensation and revisiting the form and vesting terms for equity-based compensation. This memorandum discusses selected issues that companies may face and strategies that companies may take to continue to retain top talent, with the ultimate goal of ensuring alignment between the goals of companies and the incentives of their key employees during this challenging period.

Granting New Equity and Cash Performance-Based Incentive Awards

Structuring new equity and cash bonus programs to implement realistic performance goals during a period of extreme market volatility and uncertainty is a timely issue for public companies whose boards and compensation committees are currently preparing new compensation programs. Three possible approaches are to: (1) maintain the status quo, (2) delay grants or delay setting performance targets or (3) set flexible performance targets.

- *Maintain the Status Quo*. Company boards and compensation committees may determine that the best course of action is to maintain the status quo and set performance goals consistent with those historically used, particularly if a company's historically-used performance measures are already designed to account for uncertainty in the market. If this approach is taken, companies should be prepared for potentially disgruntled employees, who may express concerns that ignoring COVID-19 is a fundamentally flawed approach. Global pandemics obviously are not factored into performance goals and many believe that the long-term impact of the COVID-19 pandemic on company performance is still too difficult to project. As a result, some companies may not modify their goals until more facts can be reliably predicted. Nonetheless, employee dissatisfaction may stem from the belief that it is not appropriate to disregard this unique situation and its potential impact on the business.
- *Delay Grants or Delay Setting Performance Targets*. Alternatively, companies may decide that a better option is to delay annual grants or to make annual grants but delay setting performance goals under the

grants until there is more predictability surrounding COVID-19 and its impact on the company. For some companies, it may not make sense to set performance goals right now, knowing that it may be difficult to modify these goals once they are adopted. Delaying annual grants or choosing to set targets late in the second quarter (or even later) could provide companies with flexibility to wait and see whether more accurate and realistic performance goals may be set. As discussed below, the repeal of the performance-based compensation exception under Section 162(m) of the Internal Revenue Code ("Section 162(m)") gives companies added flexibility in when these goals need to be established without causing negative tax effects. While delaying the goal setting process may provide companies with a relatively straightforward strategy for now, there is the risk that COVID-19 continues to create instability in results and volatility in the markets well into the future. Companies should be mindful that too long of a delay may have unintended consequences, such as triggering skepticism among employees (particularly below the senior executive level as these employees typically do not have sufficient insight into the business) or altering a company's ordinary design for expense recognition related to such awards. In addition, proxy advisory firms and investors may take a view that any goals established later in the fiscal year are not strenuous enough. Finally, a delay in establishing performance targets may constitute a deferred grant date for accounting purposes, increasing additional GAAP expense and a greater value in the Summary Compensation Table in 2021 proxy statements.

- *Set Flexible Performance Targets*. Another strategy companies may adopt is to alter their historically used performance metrics to address the current marketplace based on available information, while including provisions that permit future adjustments to performance goals by boards and compensation committees. A shift from rigid formulaic measures to analysis of qualitative factors would provide boards and compensation committees with the flexibility to adjust for extreme changes to the economic climate. For example, adjusting payouts at the end of vesting periods gives companies an opportunity to address the effects of COVID-19 on an ongoing basis throughout a performance cycle. It should be noted, however, that changes to performance metrics, goals, or targets will be scrutinized by proxy advisory firms and institutional investors who generally favor formulaic performance programs. Notably, Institutional Shareholder Services ("ISS") stated in its April 8, 2020 publication "Impacts on the COVID-19 Pandemic, ISS Policy Guidance" (the "ISS Policy Guidance") that boards that decide to make any COVID-19-related adjustments are encouraged to provide contemporaneous disclosure to shareholders of their rationales. Moreover, ISS benchmark voting policies generally are not supportive of adjustments to long-term compensation plans that extend over multi-year periods. As a result, ISS will look at any changes on a case-by-case basis to determine whether boards exercised appropriate discretion and provided adequate explanations to shareholders of the rationale behind these modifications to ensure that executives are not receiving windfalls while other shareholders suffer severe losses. Alternatively, companies may choose a performance metric or award design that is designed to insulate against the shock of COVID-19. For example, companies may consider using relative or qualitative metrics rather than absolute metrics to account for uncertainty in the marketplace, lowering thresholds for minimum payouts to ensure

participants receive some level of payment, or shifting from performance-based vesting awards to time-based vesting awards.

Modifying Existing Equity and Cash Performance-Based Incentive Awards

Companies are also focused on how to address outstanding performance-based awards that are currently performing below target, while continuing to retain and incentivize employees with achievable performance goals. Many of the issues that boards and compensation committees must evaluate when deciding how to address new equity and cash performance-based incentive awards must also be addressed with respect to performance-based awards that were issued prior to the COVID-19 outbreak. The choices to be made are very similar to those outlined above. Certain companies may choose to take no action, since the award was granted with knowledge that operating results and markets could swing in either direction and making any modification at this point in the performance cycle may be premature and require additional modifications later on. To the extent equity award goals are modified during the performance period, it may also constitute a modification under accounting principles pursuant to ASC 718, which may result in an incremental accounting cost to companies, which often is undesirable from a company's perspective. In addition, if a public company modifies outstanding equity awards, it may be required to report additional compensation for impacted executives under the SEC's executive compensation disclosure rules. Companies also always have the flexibility to issue discretionary cash bonuses throughout the year for retentive purposes or as an equitable measure. Other companies may find that reducing targets or replacing awards with metrics that are more appropriate given the COVID-19 environment, or changing vesting requirements is a better approach to ensure that awards continue to serve their ultimate purposes in retaining and incentivizing employees with goals that are achievable. This approach may be preferred by companies even if doing so triggers an accounting expense for modifying an award. Examples of this approach include replacing quantitative performance with qualitative measures, replacing goals that are based on absolute TSR with those based on relative TSR or adjusting the mix of vesting criteria by replacing performance-based vesting awards with time-based vesting awards.

Other Considerations

- *Section 162(m) of the Internal Revenue Code.* As part of the Tax Cuts and Jobs Act of 2017, the performance-based compensation exception under Section 162(m) was repealed, making all compensation to covered employees that is in excess of $1 million non-deductible. In order to comply with the performance-based compensation exception prior to the law change, companies were limited on both when performance targets needed to be set and the ability to adjust performance targets during a performance period. There were also limitations on granting discretionary bonuses if performance metrics were not satisfied. As a result of the repeal, companies that are not operating under the grandfathering rules of Section 162(m) no longer need to worry about endangering their compliance with the Section 162(m) performance-based compensation exception. Companies that are relying on a grandfathered performance-based program should be mindful that any amendment to the performance terms likely would result in a loss of grandfathered status and could have unintended consequences.

- *Section 409A of the Internal Revenue Code*. Modification or removal of existing performance criteria related to 2020 annual bonus opportunities or other outstanding long-term incentive awards may result in such arrangements to cease qualifying as "performance-based compensation" for purposes of Section 409A of the Internal Revenue Code ("Section 409A"), thereby negating the ability to make a deferral election with respect to such arrangements under Section 409A that could have otherwise been made up to six months prior to the end of the relevant performance period. See here for Simpson Thacher's memorandum addressing other Section 409A issues presented by COVID-19 developments.
- *SEC Disclosure Requirements*. Public companies that adopt a new incentive plan or amend an existing plan (or if a material grant or award under such plan is made or materially modified) may voluntarily decide to, or be required to, report such adoption or amendment (or deviation) on a Form 8-K if the change is material and if certain executive officers are participants in such plan. Such changes may also need to be disclosed in the company's annual proxy statement for the fiscal year in which the change is effective. Before making any changes to existing plans or outstanding awards, or adopting a new plan or making new grants or awards, companies should be thoughtful regarding what information must be disclosed to the general public (including shareholders and employees of the company) and the response it may elicit from proxy advisory firms and institutional investors who generally disfavor modifications to performance metrics.
- *Dilution and Burn Rates*. As share prices have declined for most companies during the COVID-19 crisis, equity grant sizes will need to increase to maintain the absolute value of equity awards. Further, due to a desire to conserve reduced cash balances, some companies may shift, either in part or in full, from ordinary course annual bonuses (or other cash-based compensation) to equity-based awards. Companies should review their equity plans and consider shareholder proposals to increase or amend equity pool sizes, which will require an explanation for the requested increase, to account for higher than expected burn rates. Following the repeal of Section 162(m), equity plans for many newly public companies incorporated "evergreen" provisions that automatically increase pool sizes on an annual basis; however, in some cases, even an evergreen provision will be insufficient to provide enough shares.
- *Grant Pricing*. With stock market volatility, companies may reconsider their practices for determining the number of shares that will be subject to equity awards. When equity awards to be issued are calculated based on a dollar value, companies may use the closing price of company shares on the date of grant (or a concept similar thereto, such as an average of the high and low prices on such date) to determine the number of equity awards to be issued. With the extreme levels of volatility in the current market environment, using the closing price on a particular date could result in a significantly different number of equity awards being issued to the grantee. A more appropriate methodology may be more appropriate, such as using a weighted average price over a trailing period or granting a number of shares based on historical grant amounts to avoid a grant of an unintended size due to an extremely high or low share price on a given date.

- *Stock Option Repricing*. Several noteworthy challenges arise with respect to stock options in times of market declines. Stock options that are issued prior to a downturn may become severely "underwater", resulting in an equity award with no intrinsic value. The award may be seen by employees as an ineffective incentive or retention tool. In addition, because underwater options may present no value to the holder, they may result in an avoidable accounting expense and may be an inefficient use of a company's share reserve. As a result, companies may consider resetting the exercise price of stock options (or cancelling the underwater options in exchange for new awards). Repricing options is generally disfavored by proxy advisory firms and institutional investors, including ISS which noted in the ISS Policy Guidance that (i) boards that reprice stock options without asking shareholders to approve or ratify the repricing will be subject to scrutiny under the U.S. benchmark policy board accountability provisions and (ii) boards that seek shareholder approval or ratification will be subject to ISS' existing case-by-case policy approach for the relevant market. ISS generally recommends against repricing within one year of a precipitous drop in a company's stock price. In addition, an option repricing or exchange may result in an incremental compensation expense. An option repricing at a public company generally will be subject to the tender offer rules unless the repricing is done unilaterally, which is typically not the case as companies will often require a "value-for-value" exchange where individuals receive fewer awards in return so that the company avoids a large accounting expense. Also, issuing stock options when a company's share price is deflated may in the future result in surprisingly large spread values, creating a severely over-valued option award. Further, absent shareholder approval, repricing of options is commonly prohibited by the terms of most public company equity plans. Companies should consider these facts and applicable stock exchange rules before issuing stock options in the midst of the COVID-19 crisis.
- *Plan Document*. Prior to evaluating any change to existing awards or the grant of new equity awards, it is important for companies to review their existing equity plans and employment agreements to better understand what flexibility is provided by such documents, particularly with respect to each topic mentioned in this memorandum. With respect to performance-based equity awards, plans typically provide flexibility to amend either the plan or an award thereunder, provided that such amendment doesn't adversely (or materially adversely) affect a participant. It is also typical for a plan document to permit a mix of different types of equity awards, provided there is an appetite to revisit the types of equity awards being issued to employees. However, on topics such as option repricing and grant pricing, the plan document may include limitations that the company will need to fully understand before taking action.
- *CARES Act*. On March 25, 2020, the U.S. Senate passed the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"), which provides for Treasury-supported Federal Reserve liquidity programs that provide direct loans to eligible businesses. These loans require the business to comply with restrictions on executive compensation. As such, prior to taking any actions that may impact executive compensation, business that are considering participating in certain CARES Act benefits should be mindful of the restrictions on executive compensation, which are detailed in the Simpson Thacher memorandum found here.

Conclusion

Boards, compensation committees, and management leadership teams must address the tumultuous environment resulting from the global pandemic as company performance goals, objectives, and expected results continue to evolve. As with all compensation decisions, public companies must focus on SEC disclosure requirements, impact on say-on-pay voting, and input from proxy advisory firms and institutional investors, as well as take advice from experienced independent compensation consultants with appropriate industry experience. All companies should consider employee messaging and compliance with incentive plan documents. Finally, all companies should comprehensively analyze the legal, tax and accounting implications when implementing or adjusting equity programs.

For further information regarding this memorandum, please contact one of the following:

NEW YORK CITY

Andrew Blau
+1-212-455-2380
andrew.blau@stblaw.com

Bradley P. Goldberg
+1-212-455-2064
bgoldberg@stblaw.com

Gregory T. Grogan
+1-212-455-2477
ggrogan@stblaw.com

Karen Hsu Kelley
+1-212-455-2408
kkelley@stblaw.com

Jeannine McSweeney
+1-212-455-3349
jeannine.mcsweeney@stblaw.com

Laurence M. Moss
+1-212-455-2280
larry.moss@stblaw.com

Brian D. Robbins
+1-212-455-3090
brobbins@stblaw.com

David E. Rubinsky
+1-212-455-2493
drubinsky@stblaw.com

Jamin R. Koslowe
+1-212-455-3514
jkoslowe@stblaw.com

Patricia K. Adams
+1-212-455-7232
padams@stblaw.com

Alisa H. Tschorke
+1-212-455-3052
alisa.tschorke@stblaw.com

Eric Wolf
+1-212-455-2451
ewolf@stblaw.com

PALO ALTO

Tristan Brown
+1-650-251-5140
tbrown@stblaw.com

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