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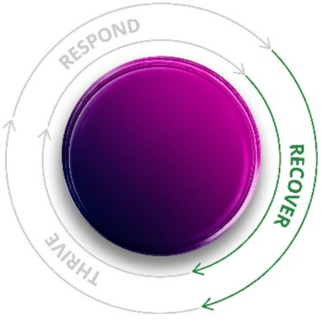

Addressing the impact of COVID-19

Evaluating executive compensation during an economic crisis

The COVID-19 pandemic is disrupting the lives of people around the globe in an unprecedented manner, devasting economies and forcing businesses into a state of uncertainty. As companies take action to protect the safety and well-being of their employees, they may face challenges with their executive compensation plans.

When addressing executive compensation program challenges, companies should review how changes align with their existing compensation philosophy, the pros and cons of decisions, and if changes balance the interests of all key stakeholders without harming the company's brand or reputation. Since the effects of COVID-19 are impacting companies in different manners and magnitudes, each company should determine which executive compensation components to amend, if any, and when these changes should be implemented.

Base salary

When a company's stock price is distressed, due to internal issues or broader systemic causes such as economic downturns, the company may wonder whether executive pay reductions are appropriate. Merit increase freezes or executive salary reductions can signal to internal and external stakeholders that executives are aligned with the interests of shareholders. Conversely, if a company is struggling financially, the absence of pay reductions may attract negative scrutiny.

Based on how much a company has been impacted by COVID-19, it may be appropriate to take the following actions:

1. Defer or eliminate merit increases for the current year
2. Issue equity in lieu of a merit increase or in light of reducing salaries
3. Reduce salaries or create a special incentive program that allows executives to earn back their salary reductions

Should you freeze or reduce executive pay?

Typically, the degree of executive salary reductions corresponds with the level of hardship experienced by the business, its employees, and shareholders. Recently, executives from the industries most impacted by the COVID-19 pandemic were the first to announce salary reductions. The amount of the reduction appears to have been calibrated to reflect the amount of employee furloughs, layoffs, and share price declines.

Annual incentives

Depending on the schedule of their annual incentive programs, many companies may have annual performance goals for the upcoming fiscal year that are now unachievable. In order to maintain executive engagement and motivation, it may be necessary to take one or more of the following actions:

- Modify performance goals: At year-end, discretion can be applied to adjust for the estimated impact of COVID-19 on performance. Alternatively, consider introducing a relative performance goal.
- Temporarily suspend mandatory deferrals of bonuses into stock: This would help to limit excess dilution (subject to cash availability and deferred compensation rules). If a deferral is required by regulators, consider creating a deferred cash account to mitigate stock price risk and control excess dilution.
- Limit potential payouts: For companies still on-track to pay bonuses, consider capping payouts based on the extent of stakeholder loss (i.e., stock price performance, number of layoffs, reductions in pay).

- **Create a new pro-rated plan:** Close the 2020 plan halfway through the performance year and create a new pro-rated incentive that covers the remainder of the year (i.e., based on quarterly or semi-annual goals).
- **Revise performance metrics and payout opportunities:** Change existing financial and operational metrics (e.g., restarting facilities, re-hiring skilled employees, restoring supply chains, paying down debt, etc.).

Long-term incentives

As the stock market crashes, companies with distressed share prices may feel pressure to modify their long-term incentive programs. For the companies contemplating modifications to outstanding performance-based awards and stock options, they may want to:

- **Change performance metrics:** Consider whether performance metrics are still aligned with company strategy. Consider what future success looks like for the business (e.g., switching to free cash flow, cost reduction, or considering relative performance metrics).
- **Flatten the performance curve:** Consider lowering the threshold performance and payout levels on a linear interpolation basis to a zero payout (compared with the more traditional 50% or 25% payout level).
- **Accelerate or delay equity grants:** Consider delaying grants in the next few months, until the market is less volatile, or accelerating grants to keep employees engaged.
- **Switch from performance-based to time-based awards:** Help alleviate the challenge of setting performance goals.
- **Create a plan to address stock options:** Consider increasing the exercise window of outstanding options or developing a shareholder-approved exchange program.
- **Switch to interim equity grants:** Consider changing from an annual grant practice to quarterly or bi-annual grants. This could help mitigate share usage concerns and limit future windfall gains.

Other program considerations

Companies should determine if it's in their best interest to…

- Suspend stock ownership guidelines, extend compliance periods, or switch to share-denominated guidelines.
- Develop a proxy disclosure strategy to communicate incentive design changes, especially those that will attract increased scrutiny from shareholders and proxy advisory firms (e.g., increasing award payout discretion, etc.).
- Review change-in-control policies to evaluate if the plans provide the intended protection.

Although companies have a wide range of executive compensation considerations to evaluate, the right answer may simply be "do nothing," hold on through the turbulence, and apply appropriate discretion after the performance year is completed. The best advice: discuss now, act later.

For more information on how to respond, recover and thrive:

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