Executive Compensation in Unprecedented Times

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Amid a global pandemic, an oil price war, and significant global stock market selloffs, we are clearly living in challenging and unprecedented times. For many of our clients, the seemingly sudden emergence of each of these events overlaps with the end of the 2019/2020 year-end compensation decision-making process. While most December 31 year-end companies have already closed out the 2019 compensation year and approved the approach for 2020, Boards are monitoring these events as they unfold to ensure these recent decisions continue to be appropriate. **We are in the early stages of these events unfolding, and as circumstances continue to evolve, we encourage caution against making any significant changes to compensation approaches or decisions at this time.**

What follows in this briefing are the implications, as we see them, on executive compensation, and practical approaches for compensation committees. We acknowledge circumstances are rapidly evolving. The perspectives discussed here are reflective of our current thinking, and we will keep our clients apprised as more information becomes available.

Lessons Learned: 2008/2009 Financial Crisis & the 2015 Oil Crash

We have seen some significant shocks to the system and related equity market downturns throughout our 15 years as a firm. The memory of the 2008/2009 financial crisis remains fresh throughout the global financial sector, and many of our Western Canadian clients continue to feel the impact of the 2015 oil crash, along with other structural changes to that sector. While the circumstances of each downturn are unique, lessons learned remain relevant:

- **Event-driven downturns vs. long-term structural change:** the implications of market downturns will vary by type and by industry. In some cases, the impacts are cyclical in nature and followed by a recovery (as we saw with the 2008/2009 financial crisis), while in others, the impacts result in structural and long-lasting changes (as we saw following the 2015 oil crash). The severity and duration of the current circumstances will affect each industry and company differently, and the degree to which a particular company or industry will be impacted should be a factor in compensation decision-making. For example, while many companies did not make any out-of-the-ordinary changes to their compensation programs in the 2008/2009 compensation periods, the financial services sector certainly did. Similarly, over the last few years many of our oil & gas clients have adjusted their overall compensation approach to reflect a long-term industry change. We advise our clients to avoid making significant changes before the broader implications are known.
- **Get informed:** boards should ensure they have a detailed understanding of the implications of this environment on customers, suppliers, and competitors, including the companies with which they compete for talent. We suggest a review of the “retention value” of current incentive plans and executive share ownership, including stress testing current results with some potential future scenarios. However, while current retention values may be lower than during the “normal course,” it is likely that the risk of executive talent moving elsewhere, under the current circumstances, may be limited.

- **Assess compensation results in the context of share price performance:** as with any compensation cycle, calculated (i.e. formula-driven) incentive plan outcomes should be considered in the context of overall performance, including share price performance. Many companies with relatively strong 2008 corporate scorecard results opted to apply downward discretion to payouts in late 2008 / early 2009 to address the drastic decline in shareholder value.
- **Monitor and, if necessary, limit excessive dilution:** several companies adjusted their normal-course grant date value-driven equity granting practices so as to minimize excessive dilution and potential for outsized windfalls (e.g., granting fewer units than the formula would otherwise dictate)

Practical Considerations for Compensation Decisions

For most companies with December 31 year-ends, the following incentive plan decisions have already been finalized and approved. However, we expect these decisions remain top-of-mind for all Boards as they continue to monitor the evolution of these global events. As such, we have outlined practical considerations for 2019 and 2020 incentive plans, below.

2019 STIP Payouts

- For companies with December 31 year-ends, it is likely that 2019 STIP decisions have been finalized (and in many cases, communicated to employees and paid out); we see limited rationale for adjusting 2019 results or payouts to reflect events that are taking place in early 2020
- For companies with March 31 or later year-ends, there may be a need to evaluate calculated STIP scores in the context of the current share price environment

2019 LTIP Payouts (i.e., awards vested December 31, 2019 and paying out in early 2020)

- Suggest no change to formulaic approach for either cash- or treasury-settled awards (e.g., avoid adjusting the defined VWAP date range for cash-settled LTIP awards)
- As this may result in disappointing LTIP payouts in some instances, committees should review tally sheet analysis for key executives / employees to understand retention implications of low share price environment
- The lower 2019 LTIP payouts may be somewhat balanced by lower 2020 grant prices, providing leverage to the upside over the mid- to longer-term

2020 STIP (or other incentive instrument) Target-Setting

- In our view, boards do not have enough information at this time to tell how the current circumstances will pan out, including whether the market downturn will be shorter- or longer-term in nature, how specific industries and companies will be affected, and to what extent year-end financial results will be impacted
- As such, we suggest companies maintain the target setting approach that had been contemplated in Q4 2019 / Q1 2020, and continue to monitor how results are tracking throughout the year
- Any contemplated adjustments to formulaic scores at year-end 2020 should be carefully assessed through the lens of pay-for-performance and shareholder experience
    - While there may be some arguments for adjusting 2020 incentive plan payouts, a pay-for-performance philosophy would suggest that lower pay outcomes may be appropriate in the event of poor results, even if they were caused by macroeconomic / global events outside of management's control

2020 LTIP Awards

- Committees should carefully consider the implications of making the 2020 LTIP grant in the current share price environment (to the extent they have not already been granted), but should avoid knee-jerk decision-making
- LTIP grant decisions in depressed share price environments should only be approved after dilution analysis and testing of potential gains upon a stock market recovery
- Approaches will be situation-specific and should be supplemented with appropriate analysis; some possible approaches include:
    - Could apply judgement to the LTIP grant formula to avoid overly dilutive grants / excessive windfalls in a recovery (e.g., could provide the grant based on a predetermined number of units as opposed to a dollar value target)
    - Could consider determining a dollar value "cap" on payouts for cash-settled LTIP
- Given the uncertainty of the stock market environment over the coming weeks and months, deferring normal-course LTIP grants risks a different share price environment than at-present, and the result that certain stakeholders will benefit from the timing of the deferral, while others will not (e.g., if stock prices recover, LTIP recipients will forego some gains; if stock prices decline further, grants will be further dilutive)

Salary Cuts or other Voluntary Actions

- Some of the hardest hit-sectors (e.g., significant layoffs, government intervention) may consider more significant actions, especially at the top of the house
- For example, this could include temporary reductions to base salaries at the C-suite level (and possibly to board pay, as well)
- Some companies have already announced such changes, most notably the CEOs of several US and global airlines

While circumstances will differ by company and industry, our overall message to Committees is to make prudent decisions based on the information that is available, avoid making drastic changes before the full circumstances are known, and monitor outcomes as time progresses. Clear dialogue between Boards and management teams regarding why and how decisions are being made (and documentation thereof) will help with 2020 year-end decision-making and related compensation disclosure.

Broader Implications

These challenging times will impact all levels of an organization, and Boards should review all decisions through the shareholder and stakeholder lens. While the context of this note is focused on executive compensation matters, it is certain that the broader workforce, and particularly hourly workers, will be significantly impacted by the events over the coming weeks and months. Boards should be mindful of this dynamic when making highly visible executive compensation decisions.

We will stay in close (virtual!) contact with our clients and friends as these circumstances evolve and will share updates as more information becomes available.

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