OPINION
Viewpoint on Executive Compensation

Considering Resilience When Assessing FY2020 Incentive Plan Performance

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re·sil·ience

/rəˈzilyəns/

noun

1. *the capacity to recover quickly from difficulties; toughness.**
2. *the ability of a substance or object to spring back into shape; elasticity.**
3. actions taken to survive the pandemic and to thrive afterwards.

   **from the Oxford Dictionary of English*

The pandemic continues to wreak havoc on the economy despite trillions of dollars in federal support. Infection rates and COVID-19-related deaths continue to mount, and unemployment remains at levels not seen since the "Great Recession." The reversal in the U.S. economy has been stunning. In early 2020, most companies set annual and long-term incentive goals following a year of record financial results and predictions of a strong future. The pandemic has made those goals unachievable, and participants face FY2020 payouts that are a fraction of prior levels — especially if payouts are formulaically generated. This is all at a time when management teams are working frantically to serve the needs of customers, employees, and shareholders.

As a country, we have never been in this place before, not during the financial crisis of 2008-2009, and not after 9/11. There is no modern precedent upon which to rely.

As a result, by now, most companies have followed the advice of "everything should be on the table" as they attempt to figure out the right path forward with respect to 2020 incentive programs. A few have simply announced that 2020 incentive plans would pay zero, either by formula or by plan override. Some lowered goals from where they were originally set. Some set new goals for the remaining quarters in the fiscal year. But most companies will be relying on compensation committee discretion to "right-size" incentive plan payouts so that they balance performance and retention needs in the context of a pandemic where tens of millions of people continue to hurt in one way or another. Indeed, a recent survey indicates 77% of companies have considered exercising discretion at the end of the performance year when determining final incentive awards.

But Isn't Discretion "Forbidden"?

The Oxford Dictionary of English's definition of discretion is "the freedom to decide what should be done in a particular situation." Compensation committees currently exercise discretion at the beginning of the performance period when they review and approve incentive plan performance metrics, the targets for those metrics, and the width of the performance curve. In addition, discretion is often exercised at the end of the performance period when certain one-time adjustments are approved in calculating the performance — however defined — that is used for incentive plan purposes.

The exercise of discretion to override pre-established performance metrics, or to add new metrics during an open performance cycle, has been rare and generally unnecessary. However, the pandemic has made those performance metrics, targets, and performance curves an unreliable gauge of management's performance over the last several months.

In anticipation of the compensation committee's exercise of discretion to adjust for the effects of the pandemic in 2020, some institutional investors and proxy advisory firms have already issued policies that serve as both a guide and a warning that the use of discretion is not unfettered:

- Vanguard expects boards to be "thoughtful about the reputational risks that may be associated with awarding large payouts at the wrong time" and that "with any change to executive pay outcomes, we expect increased communication and disclosure about the board's decision process and rationale for the changes."[1]
- Institutional Shareholder Services seeks contemporaneous disclosure and states that changes to incentive plans will be considered on "a case-by-case basis to determine if directors exercised appropriate discretion, and provided adequate explanation to shareholders of the rationale for changes."[2]
- Glass Lewis expects discretion but takes a much more negative view. Glass Lewis exhorts companies to "take a proportional approach to the impacts on shareholders and employees" and that companies with a "track record on governance, performance and the use of board discretion prior to the pandemic will be afforded more discretion in [their] analysis than those that do not."[3]

We expect additional institutional investors to publish their policies well before year end. But to answer the question "Is discretion forbidden?", Pay Governance argues "no" while also acknowledging there is a high bar for justifying its application.

Acts of Resilience

By mid-April 2020, most companies were in some level of crisis. Management teams raced to solve liquidity issues, analyzed and implemented plans to adjust costs as revenue slowed, took action to protect their employees, modified supply chains and manufacturing processes to keep delivery commitments to customers, balanced payables and receivables so that cash flow requirements were met, launched new products that served the needs of those impacted by the pandemic, and — for some — sought government assistance where it was appropriate and available. Over 20% of Russell 3000 companies announced executives' and board of directors' pay reductions to make it clear to all stakeholders that the effects of the pandemic impacted everyone.
In short, just as it was dawning on everyone that recently-set FY2020 incentive plan goals were hopelessly obsolete, management teams were already showing their resilience in the face of the pandemic. There was a concerted effort to do everything possible to survive the pandemic and to be in a position to thrive once the pandemic eased. Sadly, easing seems to be a long way off, so continued resilience actions from management teams are a must.

Operationalizing Resilience-Based Discretion

Resilience-based discretion allows the compensation committee to motivate and properly reward management teams that mustered an effective response to the unique challenges of the pandemic. Resilience-based discretion necessitates that the compensation committee conduct a rigorous assessment of performance prior to applying discretion, which can then be clearly communicated to shareholders.

To illustrate how to apply resilience-based discretion, let's take a common example. The company is forecasting a 10%-30% of target formulaic payout against adjusted goals set prior to the pandemic and could easily slip to zero by year-end. The compensation committee is resolved that such an outcome would not fairly reward the extraordinary efforts of the management team.

The projected payout already adjusts for higher direct costs associated with the pandemic, such as personal protective equipment, higher shipping costs, and disruptions in capacity due to supply chain issues. These adjustments represent the exercise of discretion, as these higher costs were not one of the "normal" adjustments built into the plan.

The compensation committee has also considered the maximum possible incentive plan outcome it could envisage approving after the formulaic outcome, any exception for direct costs of the pandemic, and the application of resilience discretion. As early as our March 23, 2020 Viewpoint "Everything Should Be On The Table," we believed — and continue to believe — that a target award will be an unusual outcome for FY2020 annual incentives for most companies significantly impacted by COVID-19.[4]

The compensation committee and management identified a number of resilience actions that should be evaluated. Those actions are summarized in a template that can be used to guide the compensation committee in evaluating management's performance holistically, which in turn can be used to communicate its rationale to shareholders. Below is an example of a resilience scorecard the compensation committee plans to use in finalizing incentive awards for FY2020. The results of a scorecard help determine how much discretion is applied, up to the maximum level that will be used to guide year-end discretion. It is important to note that a reduction in payouts (i.e., negative discretion) is also possible when applying resilience-based discretion.

Resilience Categories	Criteria for Assessment of Resilience	Discretionary Scoring		
Financial/ Operations	• Ensured manufacturing continuity of critical products • Steps taken to adjusted fixed and variable costs • Optimized revenue, cash management/liquidity without jeopardizing the future	.75	1.00	1.25
Employees	• Effectiveness of actions to keep employees safe • Preparedness of workforce if/when market rebounds • Speed and fairness of changes (e.g., executive vs. employee pay cuts)	.75	1.00	1.25
Customers/ Community	• On-time delivery and backlog during pandemic • Minimized/eliminated quality issues • Launched high impact new innovations • Delivered on milestones for other R&D programs	.75	1.00	1.25
Governance/ Shareholders	• Weekly board updates resilience progress • IR interaction with analysts and shareholders • Financial results and stock price relative to peers • Dividend actions	.75	1.00	1.25

The final pool funding is then based on the application of the resilience scorecard against the amount that the Committee determines is appropriate and affordable (e.g., between the formulaically derived amount of the pre-COVID goals and the maximum possible outcome the committee could envision).

Final Thoughts

We have been asked many questions about resilience-based discretion.

1. ***Is there a guarantee that shareholders will agree with resilience****?* There are few guarantees in life. But, clearly, a strong rationale and proof supporting discretion is far better than undefended or opaque explanations of discretion.
2. ***Is a scorecard necessary****?* No. However, a quantitative approach to the application of discretion may be helpful to shareholders who wish to understand the operational process and helpful to management teams that want to communicate to employees that they are thinking about this issue and about expectations for completing the year strong.
3. ***Should named executive officers participate in resilience discretion?*** Every compensation committee needs to make their own decision, but we would argue "yes." If resilience-based discretion is the right decision, it should be applied to all participants.
4. ***Is there such a thing as too much discretion?*** Probably, yes. The pandemic has taken a substantial toll on society at large. Vanguard said it well: "Boards should…be thoughtful about the reputational risks that may be associated with awarding large payouts at the wrong time."[1]

General questions about this Viewpoint can be directed to John D. England at john.england@paygovernance.com or Mike Kesner at mike.kesner@paygovernance.com.

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[1] "Vanguard Investment Stewardship Insights. Executive Compensation: In Uncertain Times, Good Judgement is Critical for Boards." Vanguard. May 2020. https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/ISREMUN_052020.pdf.

[2] ISS Global Policy Board. "Impacts of the COVID-19 Pandemic: ISS Policy Guidance." Institutional Shareholder Services. April 8, 2020. https://www.issgovernance.com/file/policy/active/americas/ISS-Policy-Guidance-for-Impacts-of-the-Coronavirus-Pandemic.pdf.

[3] Aaron Bertinetti. "Everything in Governance is Affected by the Coronavirus Pandemic. This is Glass Lewis' Approach." Glass Lewis. March 26, 2020. https://www.glasslewis.com/everything-in-governance-is-affected-by-the-coronavirus-pandemic/.

[4] John D. England and Jon Weinstein. "Everything Should Be On The Table." Pay Governance. March 23, 2020. https://www.paygovernance.com/viewpoints/everything-should-be-on-the-table.