COVID-19: Incentive Compensation Design in a Shifting Landscape

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The coronavirus (COVID-19) pandemic and the ensuing market uncertainty, as well as recently enacted legislation, have upended the compensation and benefit programs of many companies. This is the sixth memorandum in a series of client memoranda that we are preparing regarding how companies may wish to consider addressing their compensation programs in this context.[1]

In addition to the recent disruption caused by COVID-19, there have been a number of other significant developments over the past few years and in recent months that may impact incentive compensation program design. This memorandum gives an overview of these changes and how they have begun a gradual shift in the incentive compensation landscape, and provides both near- and long-term considerations, for companies that are or may wish to revise their incentive compensation programs in light of this changing landscape.

1. What are the key recent developments (in addition to COVID-19) that may impact incentive compensation design?

There are two key developments: (1) changes in the Internal Revenue Code under the 2017 Tax Cut and Jobs Act (TCJA) and (2) an increased focus on, and/or desire for, broader incorporation of human capital and other environmental, social and governance (ESG) metrics in incentive compensation programs.

Impact of the TCJA: Elimination of the Section 162(m) Performance-Based Compensation Deduction and Reduced Corporate Tax Rates

Prior to 2018, public companies were subject to a limitation on the tax deductibility of compensation paid to their most senior executives, with an important exception for objective formulaic incentive compensation. Practically speaking, the requirement for objective goals influenced the design of incentive compensation programs and such programs often relied heavily on criteria such as financial performance (which tend to be more easily measured) or externally-measurable criteria (e.g., relative share price performance, safety statistics), rather than qualitative criteria or criteria that, while objective, may have been subject to greater challenge than financial or other externally-measurable criteria. Compensation committees appreciate that objective formulaic incentive programs maintain an important discipline for achieving company goals, but they also know that not all goals can be easily reduced to a formula, and

[1] Please see our previously published client memoranda:

- **COVID-19: Considerations for Companies That Have Not Yet Established Their 2020 Incentive Compensation Programs (April 7, 2020)**
- **COVID-19: Considerations for Companies That Have Already Established Their 2020 Incentive Compensation Programs (April 7, 2020)**
- **COVID-19: Addressing Underwater Options and Stock Appreciation Rights (April 14, 2020)**
- **COVID-19: Impact on Nonqualified Deferred Compensation Plans (April 29, 2020)**
- **COVID-19: Reductions in Executive Pay (May 6, 2020)**

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even for those that can, an optimal program would allow some flexibility to respond to unforeseen exigencies and shifting priorities.

The TCJA eliminated the exception allowing for the deduction of incentive compensation that was payable pursuant to an objective formula,[2] removing any tax motive for companies to adhere to objective formulas under their incentive compensation programs.[3]

Greater Focus on and Broader Utilization of ESG Considerations

Recent years have seen an increasing focus on ESG disclosure and metrics. This has been, to some extent, fueled by the rise of ESG investing and the focus of certain large institutional investors on stakeholder welfare and emphasis on long-term value. For some market participants, ESG plays an important role in furthering their goals.

According to one survey, approximately 51% of companies in the S&P 500 currently use some sort of ESG metric in their incentive compensation programs and approximately 4% use them in their long-term incentive programs.[4] While the definition of what constitutes an ESG metric varies depending on who is counting, this percentage represents an approximately 45% increase in the utilization of ESG metrics in incentive compensation plans by S&P 500 companies since 2018.[5] In addition, in the month of March 2020 alone, 67 companies in Europe, Canada and the United States reportedly incorporated one or more E&S metrics in their incentive programs, possibly in light of the pandemic.[6]

Tellingly, some large-cap public companies have been entering into revolving credit facilities with ESG-linked interest rates (*i.e.*, a reduced interest rate in the event that pre-agreed objective ESG-related criteria are met). In addition, the issuance of so-called social or sustainability bonds, or bonds whose proceeds are used to further the social good, totaled $11.9 billion in the first quarter of 2020, a new quarterly record.[7] This amount is staggering as compared to a mere $13 billion in total global social bond issuances in 2019.[8] These recent developments indicate that ESG metrics can be objective and measurable and, that many market participants believe that ESG issues are important, and that ESG issues are significant enough to those companies and their lenders to affect the cost of capital.

Some investors, however, have expressed skepticism over the use of ESG metrics in incentive compensation plans. First, these investors believe that these metrics, as compared to a hard financial

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[2] For more detail regarding the former 162(m) regime and the changes implemented by the TCJA, please see our prior memoranda:

- **Administering Compensation Programs in the Wake of the Tax Cuts and Jobs Act—New Section 162(m) (January 31, 2018)**
- **IRS Issues Guidance Clarifying Tax Reform Changes to Section 162(m) (August 27, 2018)**
- **IRS Issues Proposed Regulations under Section 162(m) (December 23, 2019)**

[3] Note, however, that ISS has, not surprisingly, indicated that notwithstanding the elimination of the performance-based compensation exception under the former 162(m) regime, it will view the adoption of "discretionary" or fixed pay elements as a problematic pay practice for purposes of voting on a company's say-on-pay.

[4] R. Newbury, D. Delves, R. Resch, *ESG Issues in the Forefront*, Harvard Law School Forum on Corporate Governance, April 2020.

[5] When compared to a similar survey of S&P 500 conducted in 2018, Deloitte, *On the board's agenda, Trends in executive Compensation*, September 2019.

[6] ISS ESG, "The Pandemic's Impact on Corporate Sustainability – Potential Insights from Executive Incentives" webinar, March 31, 2020 ("ISS March 2020 Webinar").

[7] Investment Executive, **A record Q1 for green bonds, Moody's reports,** May 9, 2019.

[8] Sustainalytics, **COVID-19 and Beyond: Using sustainable finance to build social resilience**, April 7, 2020.

metric, could be more easily manipulated or could otherwise lead to larger payouts to executives. Second, these investors believe that these metrics could distract executives from focusing on financial performance. These concerns on their face and as a general matter are understandable, but some studies indicate that, depending on the industry, ESG metrics in incentive pay actually result in better financial performance in the short term, particularly in the energy, utilities and materials sectors, but perhaps not as much in the capital goods sector.[9]

Compounding Impact of COVID-19 and Other Recent Events

In light of the above, we expect that COVID-19 will result in an increased focus by company stakeholders—mainly employees, suppliers and customers, but also shareholders—on a company's response to COVID-19 itself (*e.g.*, worker health and safety, overall pandemic response, supply chain and/or workforce disruption, or specific responses tailored to their industry), and also on disaster preparedness generally. Indeed, it has been reported that a variety of issuers have floated an aggregate of over $150 billion of bonds with the proceeds focused at least in part on addressing the COVID-19 crisis.

Many such COVID-19-specific and general disaster preparedness concerns fall under the ESG umbrella, which may increase the recent trend toward the utilization of ESG considerations for incentive compensation and other purposes. In addition, in view of the recent tragic incidents that have dramatically increased attention on systemic racism in our society, there have already been some[10] and there likely will be more calls for companies to think through their policies that focus on diversity and inclusion issues, community justice and worker engagement. Given this, companies may wish to consider whether and, if so, how and when to incorporate different objective criteria or some qualitative criteria into their current and future incentive compensation programs. For companies that adopt such criteria, they should also consider how best to describe in their proxy statements how these criteria directly link to their long-term strategy and how they are objectively measured, so as to deflect any concerns that they may be too discretionary.

Of course, focusing on ESG metrics in the current environment may be particularly challenging, given that for many companies, employees and shareholders are among the stakeholders most affected by the COVID-19 crisis. ESG initiatives, especially those relating to human capital, are likely to involve near-term costs, which companies might not be positioned to take on under current circumstances. Similarly, while in theory ESG goals should sit side-by-side with financial goals, in the near term shareholders might expect an undivided focus on the bottom line in order to drive stock price recovery.

Although some broader equity indices have been surprisingly resilient thus far, many companies will continue to face stock price headwinds. Yet at the same time, there is a palpable expectation of change in how mid-size and large companies set their priorities with respect to human capital and other ESG issues, including from institutional and other investors. A key challenge for compensation committees and executive teams will be balancing these demands and communicating how ESG considerations relate to a company's overall long-term goals and prosperity.

[9] ISS March 2020 Webinar.

[10] On June 9, 2020, the Council of Institutional Investors released a "Call to Action" stating that the current protests "are a wake-up call alerting us that we must do more to fundamentally redress structures and practices that sustain racism," noting that action beyond merely addressing the need for greater racial, ethnic and gender diversity on boards and in management is needed and that "pervasive bias and injustice against African Americans and other people of color in American society needs to be remedied."

2. In light of the changed landscape for incentive compensation, what are some specific considerations for companies that are assessing whether to revise existing or implement new incentive compensation programs?

- *Stakeholder Reactions*. While some stakeholders have long agitated for companies to consider ESG and other non-traditional criteria and incorporate these items into their incentive compensation programs, as noted above, many other stakeholders remain wary of such factors, both generally and particularly as part of a company's incentive compensation programs.
- *Linking Non-Traditional Performance Criteria to Overall Company Goals*. While most performance goals are typically linked to overall company financial goals (*e.g.*, EBITDA, net sales or revenue, shareholder return, etc.), it is particularly important to consider any ESG goals in setting the financial goals and clearly communicate to employees and the market the interplay of the two. This will help ensure that employees are properly motivated and can help guard against concerns and/or criticisms that the use of non-traditional performance criteria is a way to incentivize executives in periods of poor financial performance.
- *Determining Appropriate Performance Periods*. As noted above, only a small minority of S&P 500 companies currently incorporate ESG criteria into their long-term incentive programs. We note that many non-traditional goals are likely to require a multiyear investment, even if it is possible to measure progress on an annual or shorter-term basis. In order to ensure any such longer-term performance goals are meaningful, we recommend that companies determine the expected time frame that will be needed, or an appropriate expected period, and, if possible, establish benchmarks that may be measured along the way and use that timeline when incorporating such goals into their incentive compensation programs.
    - One way to incorporate non-traditional performance criteria into longer-term performance goals is to use them as a "modifier" (much as TSR is often used as a modifier today) as part of determining the above-target payout of the program. This operates by requiring that if other minimum financial performance thresholds are not met, satisfying the non-traditional criteria cannot result in a windfall to executives, while also reducing or limiting the total payout if the non-traditional goals are not met even in light of outsized financial performance. Note, this "modifier" method can also be applied to annual or short-term incentives.

3. If a company is considering incorporating ESG metrics in its incentive compensation programs, what might those ESG metrics look like?

The prevailing wisdom is that any metric, regardless of whether it is an ESG metric or whether it is used for compensation purposes or otherwise, must be "S.M.A.R.T."[11] meaning, specific, measurable, attainable or achievable, relevant and time-bound. Particularly for incentive compensation programs, ensuring that each metric meets these criteria will help ensure that executives and other employees understand, and are properly motivated by, the particular goal and will also help stakeholders understand the program and how it relates to broader company objectives.

Below are descriptions of actual ESG metrics that have been adopted by select companies in the following industries:

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[11] S.M.A.R.T. is an acronym in the goal-setting context first attributed to Dr. Edwin Locke, a professor emeritus of motivation and leadership studies. See **https://www.achieveit.com/resources/blog/the-history-and-evolution-of-smart-goals**.

Industry	ESG Metric
Healthcare Products	Executives and employees are rewarded for specific goals tied to diversity and inclusion.
Household Products	Linking executive compensation to environmental goals, such as cutting plastics in products, lowering emissions and avoiding annual testing.
Oil and Gas	○ Linking carbon footprint targets to executive remuneration policy. ○ Progress against greenhouse gas emission reduction goals as a factor in determining bonuses of executive directors.
Mining and Metals	○ Linking annual incentive compensation to non-financial targets consisting of safety and environmental metrics and diversity. ○ Short-term incentive award includes targets relating to safety, health and rewarding workplace, supportive communities and environmental performance.
Retail	Linking culture and diversity and inclusion to named executive officer pay.
Food Company	Portion of CEO pay linked to meeting climate commitments and creating a sustainable supply chain.
Insurance	Long-term incentive compensation modifier subject to a performance objective intended to improve the representation of diversity among senior management.
Rideshare Technology	Incorporating diversity and inclusion goals into metrics used to evaluate executive officer performance and determining executive compensation.
Social Media	Executives and employees are rewarded for specific goals tied to diversity and inclusion.
Technology/Software	Executive short-term incentive awards are based on operational/strategic performance goals that include diversity metrics.

So far, companies that utilize ESG metrics in their compensation programs have primarily incorporated them into their annual or short-term incentive programs. That said, as noted above many ESG and similar considerations may be ones that require a longer-term investment or may be better measured over a multiyear period. At the same time, particularly where financial investment or other changes could negatively impact current year financial performance, companies will want to consider whether the near-term impact of actions that are intended to help achieve longer-term goals need to be taken into account for annual or short-term incentive compensation programs as well.

4. **What are some near-term considerations for companies that are designing new incentive compensation programs or are considering revising their existing programs, particularly in light of the impact of COVID-19?**

   - *Timing*. As noted in our earlier memoranda, the overall impact of COVID-19 is still unclear and for companies that have not yet made changes to their existing programs or established new near-term programs related to COVID-19, continuing to take a "wait and see" approach may still be appropriate. We note, however, that given the amount of time that is required to implement changes to an existing program or design a new one, companies may want to begin evaluating any changes or new programs in the near term before mid-year board and compensation committee meetings. Particularly for annual or short-term programs, adopting changes or establishing new programs much past the middle of the year may not sufficiently incentivize employees or clearly help the company achieve the desired goals

   - *Targeted Incentives*. Like ESG considerations generally, when considering incorporating COVID-19-specific performance criteria, we recommend assessing both the potential and actual impact of COVID-19 on a company's industry and on the company itself and the company's overall objectives relating to its response to COVID-19.[12] This will help a company to craft performance goals that measure how successful a company and its executive team have been in responding to the challenges posed by COVID-19 to the company.

     - Specific examples of ESG metrics include items such as employee retention, maintaining diversity and inclusion goals despite potential layoffs or furloughs, facilitating remote working conditions, maintaining employee engagement/culture despite the migration to remote working, improving supply chain management, access to financing and employee and community engagement.

   - *Be Wary of Windfalls*. As discussed in our prior memoranda, institutional shareholders and the proxy advisory firms have indicated that they are closely following changes that companies make to their incentive compensation programs during the COVID-19 crisis. They have indicated that they will be particularly focused on circumstances where executives receive large bonuses or other payouts despite poor financial performance by their company. Accordingly, if a company chooses to amend or establish a compensation program that may provide substantial bonuses to executives even in the face of poor financial performance, it should be prepared to discuss how incentivizing its executives in such a way has benefited and will benefit the company and its stakeholders overall, in both the short and longer term.

5. **What are some longer-term considerations for companies that may want to incorporate ESG or other disaster preparedness-type factors into their compensation programs?**

   - *Timing*. Given the current financial strain and uncertain economic conditions that many companies are currently experiencing in light of COVID-19, if a company is inclined to start incorporating ESG and/or disaster preparedness factors into its compensation programs, one important consideration is whether now is the appropriate time. In particular, where the types of investment that may be needed in order to achieve any such goals could negatively impact near

[12] For example, if a company is focused on workforce safety and retention, incorporating such goals into current or new incentive compensation programs may help companies incentivize their executives and other employees to focus on achieving such objectives, even if the achievement of such objectives negatively impacts performance goals that are part of other incentive compensation programs.

or longer-term financial performance, companies may want to assess whether it is better to focus performance goals on the company's medium-term response to the current crisis. We would suggest exercising caution in adopting changes relating to ESG considerations or other broader concerns, unless there is a clear linkage between such changes and the overall health and performance of the company.

- *Targeted Incentives.* Similar to short-term programs, companies will want to assess their own circumstances in designing ESG performance goals to ensure that they incentivize employees in a specific and measurable way to achieve the company's broader goals. Companies may also want to take into consideration input from various stakeholders in establishing such broader goals, given the increased focus on ESG-related considerations.
  - Some examples of longer-term considerations include technology and capital investments to improve resiliency as part of contingency planning, which may focus on related issues such as enabling remote working, generally or as a contingency matter, succession planning for key members of management or the board, improving worker health (including mental wellness), building redundancy into supply chains and distribution facilities, including strengthening human rights policies applicable to its supply chain, and safety and increasing cash reserves and/or putting in place other sources of liquidity that may be accessed in an emergency.
  - On the environmental side, once the effects of the pandemic are in the rear view, companies may resume a focus on concerns such as reduction of carbon footprint, waste reduction or providing affordable energy to communities.
- *Interplay of Short- and Long-Term Incentives.* As noted above, some longer-term ESG, disaster response or qualitative goals may require significant capital investment that could negatively impact short-term financial performance. When implementing such longer-term programs, companies will want to weigh the potentially negative impact on short-term incentives and whether adjustments are necessary, while also balancing concerns around the potential appearance that such programs are merely a guise to pay executives well even in light of poor overall company performance.
- *Peer Group Approach to Non-Traditional Incentives.* We recommend that companies monitor the extent to which and how their peers[13] incorporate non-traditional incentive goals into their compensation programs. This may be important from an investor relations perspective to help ensure that a company is not unwittingly "behind" its peers in such regards and to help a company to attract and retain key employee and executive talent.

In Conclusion

The context in which incentive compensation programs are designed has changed recently and will continue to change. While the impact of COVID-19 and an expected increased focus on disaster preparedness in particular may warrant assessing short- and longer-term changes to incentive compensation programs, we note that incentive compensation has, regardless of current or changing circumstances, remained under close examination from external and internal stakeholders for decades, particularly in times of economic turmoil. Thus, the key takeaway is that companies should continue to monitor the ever-changing landscape in which incentive compensation programs are designed, and gauge the response of their external and internal stakeholders and peers to those changes.

[13] For this purpose, considering all of a company's relevant peers, meaning the companies included in a company's annual proxy disclosure, its GICS peer group and other companies with whom the company may compete for talent.

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