Conducting Business Under Lockdown: Do Your Executive and Director Compensation Programs Need to Change?

Compensation Committee Series Webinar
Presented by Pearl Meyer and NACD

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Meet the Presenters

Erin Essenmacher (moderator) serves as the president and chief strategy officer for the National Association of Corporate Directors (NACD), responsible for strategy, innovation, content curation, and execution across the organization's full portfolio of educational offerings. As a member of NACD's executive team, Essenmacher has helped drive a decade of unprecedented growth.

Peter Browning has served on the board of directors of fourteen publicly traded companies, including ten years at Wachovia Corporation, sixteen years at Lowes Companies, sixteen years at Nucor Corporation where he served as non-executive chairman and lead director, and finally, fourteen years at EnPro Industries. Browning is currently the lead director of ScanSource Inc., and a member of the Board of Directors of Acuity Brands and GMS, Inc. and Equilar.

Mark Rosen is a managing director in Pearl Meyer’s Charlotte office. He has consulted on executive and board compensation issues for more than 20 years for a broad range of public companies, as well as tax-exempt organizations and academic institutions. Mr. Rosen has extensive experience with benchmarking, retirement plan design, governance issues, and tax and accounting considerations. He is a Certified Public Accountant and is also a director of a private REIT where he is the audit committee chair and sits on the compensation committee.

Deborah Lifshey is a managing director in Pearl Meyer’s New York office, where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation and corporate governance issues, negotiation contracts, and reasonableness opinion letters. She is a member of the New York and Florida Bars.

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Submit a question and receive your answer directly from Pearl Meyer, either during today's webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.

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Housekeeping

- You will automatically receive 1 NACD credit for your participation (live program only).
- Credit may be applied to NACD Fellowship programs. Contact Fellowships@NACDonline.org for more details.
- Presentation slides are available today at pearlmeyer.com/conducting-business-under-lockdown and within the webinar console.
- The replay will be available early next week at www.NACDonline.org and pearlmeyer.com/conducting-business-under-lockdown.

Today's Agenda

- Not impacting all business sectors equally
- Culture, succession planning
- Compensation actions – what are companies doing?
- Timing issues: calendar year versus fiscal year
- Regulatory update including CARES Act, ISS views
- Director cash retainer and equity grants and ownership guidelines

Crisis is Not Impacting All Business Sectors Equally

- Oil and gas, retail, hospitality, real estate and airlines are examples at one extreme with "essential businesses," many internet related and virtual services as examples at the other
- Parallels/differences between today's crisis and the financial crisis of 2008/2009
  - Not everyone is equally affected by the collapse this time ; the situation is more extreme for some, less so for others; polarization
  - Lessons from 2008/2009

Not all Companies are Equally Impacted

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Appropriate actions will vary across industries and companies based on the magnitude of the COVID-19 impact:

Organizational Context	Potential Compensation Action Items
Severely Negatively Impacted Companies (e.g., Restaurants, Hotels, Airlines, Cruise Lines, Gaming, Movie Theatres, etc.)	
Organizational Context	**Potential Compensation Action Items**
▪ Sudden and severe decline in revenue ▪ Concerns about cash flow ▪ Significant increase in borrowing ▪ Substantial reduction in spending ▪ Reduced/eliminated dividends and/or stock buybacks ▪ Reduced hiring/hiring freeze ▪ Workforce reductions/furloughs ▪ Consideration of assistance under CARES Act	1. CEO pay reduction 2. Executive pay reductions 3. Broad-based salary freeze/reductions 4. Non-employee director pay reductions 5. Re-set bonus plans when visibility improves 6. Modify/replace outstanding equity awards 7. Non-traditional methodologies for setting equity grant levels 8. Use of discretion at the end of performance periods
Moderately Negatively Impacted Companies (e.g., most companies)	
Organizational Context	**Potential Compensation Action Items**
▪ Modest decline in revenue or expected revenue ▪ Some supply chain disruptions ▪ Right size investments for potential economic recession ▪ Evaluate capital allocation strategies ▪ Reduced hiring/hiring freeze	1. Broad-based salary freeze 2. Assess impact on short-term incentive plan design/goals 3. Assess impact on outstanding long-term incentive awards 4. Assess need to change NED equity grant levels (May/June) 5. Anticipate discretion at the end of performance periods 6. Begin considering plan design changes for 2021
Positively Impacted Companies (e.g., grocery stores, food delivery services, streaming video services, etc.)	
Organizational Context	**Potential Compensation Action Items**
▪ Modest increase in revenue or expected revenue ▪ Some supply chain disruptions ▪ Right size investments for potential opportunities ▪ Add employees	1. Special incentive programs 2. Retention awards

Culture, Succession Planning

- Culture and tone at the top
  - Keeping track of employees and their health
  - Resources
- Succession planning
  - CEO and senior staff
  - Across the organization

Doing the Right Thing

Employee Health and Well-being	The most immediate concern for the board, and consequently the remuneration committee will be the health and well-being of all employees. Some may be grappling with illness or struggling to work remotely, or feel exposed to potential harm. These concerns should over-ride all others at the current time.
Demonstrate Leadership	Companies displaying strong and effective leadership will be most likely to weather the crisis, and demonstrate future sustainability. The right leadership responses will include transparent and effective messaging, which inevitably extends to remuneration decisions.
Encourage the Right Behaviours	More than ever, incentive plans should ensure that any performance measures are encouraging the right behaviours, and contributing to the whole workforce, executives and employees, pulling together
Affordability	Cash conservation will be critical if liquidity is to be preserved. Where dividends are being cut or cancelled, there will be an expectation too that executive pay packages will be aligned. In some cases this may involve freezes, suspension or cuts, but could also involve swapping cash for equity where dilution allows.
Fairness and Transparency	Whilst organisations debate broad employee reward actions, this logic should be applied consistently for executives as well. If wider business actions have had a negative impact on staff generally (e.g., redundancies, etc.), investors will scrutinise decisions to treat executives more favourably. Transparency and effective communication are critical.
Reputation Post-Crisis	Although the crisis is immediate and far-reaching, the actions taken now will impact on future reputation. Those companies that have behaved ethically and fairly, regardless of whether the pandemic has had a positive or negative effect on business operations, will be more likely to emerge with reputations intact.

Compensation Actions: Survey Findings

Pearl Meyer Quick Poll	Coronavirus Impact on 2020 Goal-Setting Process (surveyed 3/10 – 3/16)

- 39% of companies set goals and will revisit them later this year if necessary.
- 19% of companies set goals and agreed to consider excluding the coronavirus impact when evaluating performance.
- For those committees that discussed the impact of the coronavirus on performance, 31% are ready to use discretion to determine payouts. 50% have not agreed to use discretion, but they may consider it later this year.
- 35% of companies have started tracking the impact of coronavirus on financial results. 20% said it was not possible to break out the full impact.

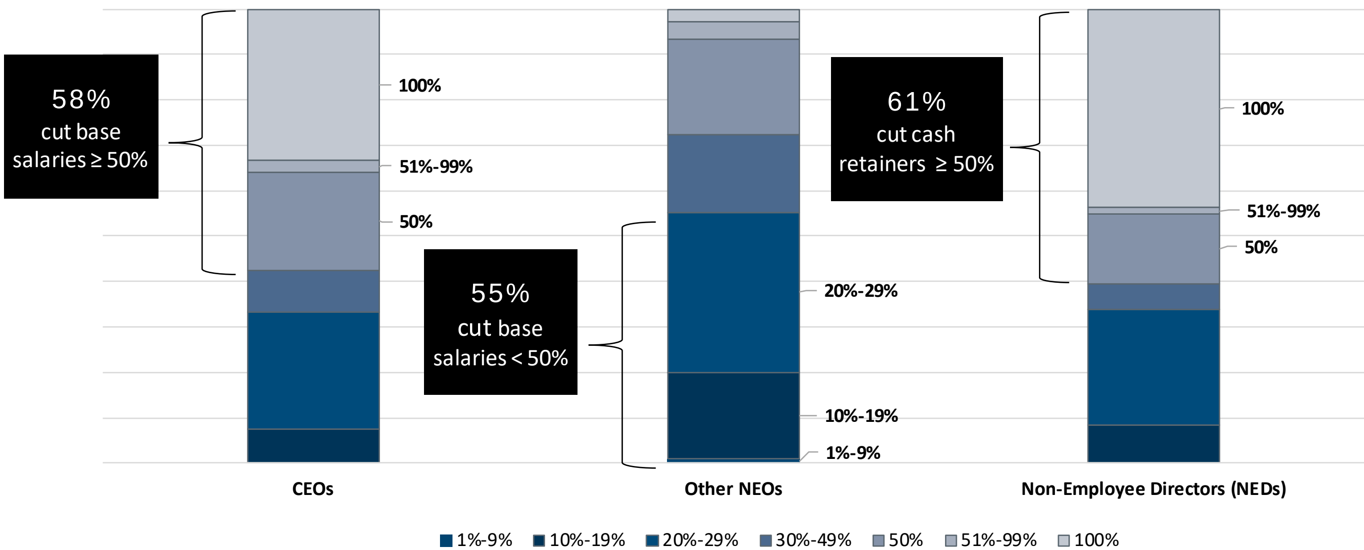
Pearl Meyer Quick Poll	Coronavirus Affecting Salary Planning (surveyed 3/24 – 3/27)

- 51% of companies indicated 2020 executive salary actions have already occurred.
- 53% of companies indicated that a final decision on executive salary actions has not yet been made. 14% are strongly considering salary freezes.
- For salary actions typically effective in June or later, 61% they are not sure if they will consider salary freezes for their executive teams.

Compensation Actions: What Are Companies Doing?

We identified ~ 140 Russell 3000 companies that disclosed pay actions connected to COVID-19. Most industries are consumer-facing — restaurants, education services, retail apparel, home furnishings, hotels, etc. These industries have been hardest hit, so the adjustments are unsurprising.

Base Salary & Cash Retainer Cuts
(Co's Disclosing Specific % Reductions)*



**Source: 8-ks filed between 2/20/2020 and 4/7/2020 as collected by Pearl Meyer (120 CEOs, 105 Other NEOs, 71 NEDs)*

- CEO base salary cuts and NED cash retainer cuts are similar in size; generally larger than other NEOs
- Majority of cuts effective 4/1, with no indication of duration
  - Many stated that cutbacks in place until the effects of COVID-19 have subsided
- To date, ~130 cut CEO salaries vs. ~71 cutting NED cash retainers
  - We expect increases in NED cash retainer cuts over the next few weeks (into Q2)

Companies w/CEO base salary cuts also took some type of broad-based action...**

***Only includes companies that disclosed both a CEO base salary cut and broad-based action(s) for its population*

- Most companies that cut CEO salary also cut broad-based salaries or furloughed employees
- Few have yet resorted to layoffs

Timing Issues: Calendar Year versus Fiscal Year

- Most calendar year companies made grants before the market decline
  - 2020 performance awards for many companies may be unattainable
  - Grant values much higher than current stock prices
- 3/31 year end companies will grant in May or June
  - Low stock price may result in unreasonable dilution/burn rate

CARES Act

Executive Compensation and Other Workforce Issues Under Title IV of CARES Act	
Compensation and Severance Limits	<u>**Employees and Officers :**</u> • Who received between $425,000 and $3M in total compensation in 2019 cannot receive more than what they made in 2019 during any 12-month period; • Who received more than $3M in total compensation in 2019 cannot receive total compensation during any 12 months period in excess of $3M + 50% of excess over $3M earned in 2019 (e.g., an executive who received $6M in compensation in 2019 cannot receive more than $4.5M); and • No severance in an amount more than 2x their 2019 total compensation. ***Note: "Total Compensation" broadly includes salary, bonus, awards of stock, and other financial benefits provided.***
Duration of Limitations	• Restrictions are in place from time company accepts loan until 1st anniversary of date the loan is no longer outstanding. • For aircraft carriers and contractors, the restrictions are in place for the two-year period ending on 3/24/2022.
Other Governance and Workforce Restrictions	• There will be no payment of dividends and no stock buybacks until 1 year following loan payoff (or until 9/30/2021 for airline carriers or contractors). • Air carriers and contractors are prohibited from conducting involuntary furloughs or reducing pay rates and benefits until 9/30/2020.

Recommended Action Steps - Companies that are considering taking aid should:

- Identify which employees or officers earned in excess of $425,000 and/or $3M in 2019
- Review all employment, change in control, or other contractual commitments with employees who earned over $425,000
- Consider whether any employees have already received compensation in 2020 that exceeds limits
- Communicate implication of taking aid with those that may be most impacted and consider retention risks of critical talent

ISS Policy "Guidance" on Impacts of COVID-19

- **Annual Bonus:** Any changes to metrics/measures should be contemporaneously disclosed
- **LTI:** Case-by-case review but generally not supportive of changes to in-flight awards; will be reviewed for appropriate director discretion and adequate disclosure
- **Repricing:** No relief; will be assessed under current standards which recommend against repricing that occurs within one year of precipitous drop
- **Attendance:** Alternative forms of attendance at meetings should be disclosed
- **Changes to Board:** May be some relief on independence, overboarding, and diversity standards if companies need to fill critical vacancies due to death, disability, incapacity, etc.
- **Postponement of Annual Meeting:** Preference for companies to use some form of communication to engage with shareholders, even if annual meetings are delayed
- **Virtual-Only Meetings:** If you hold one, explain why
- **Dividends:** Support broad discretion to set payout ratios
- **Share Repurchases:** ISS will monitor to see if directors managed risks in responsible fashion

Director Cash Retainer and Equity Grants, Ownership Guidelines

- Cash quarterly retainer
  – If adjusted, done so on the same basis as executive cuts
- Equity grant values and stock prices
  – Stock prices may be far below what employees were granted
  – Normal grant at current stock price or adjusted?
- Ownership Guidelines
  – With lower stock prices, directors may fall below the guideline

Questions

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