

Administering to Equity Compensation Programs Impacted by COVID-19

March 20, 2020

Programs Impacted. It is likely that the radical fluctuation in stock prices and the disruption of normal business activity that is occurring (and will likely continue to occur for some time) due to COVID-19 will impair business plans and financial results for 2020 and beyond. These events will likely materially impair the incentive and retentive efficacy of a company's executive compensation programs, especially those that are performance-based. Proactive decisions with regard to such programs taken sooner rather than later may provide several benefits: (i) reduce the impact of the current events on such programs; (ii) afford award holders with needed assurances in uncertain times; and (iii) potentially lower the financial accounting costs associated with these necessary adjustments. Of course, regardless of when the decision is made to address these issues, any public company will need to be prepared to explain and defend their decisions to shareholders in the company's Compensation Discussion and Analysis in the next following proxy statement.

Consider Addressing Equity Plans Now. In the numbered paragraphs that follow are considerations, some of which may appear radical, that a company's compensation specialists may wish to consider in order to rationalize equity-based long-term incentive award programs in an uncertain time. Given the rules governing equity awards that qualify for fixed accounting treatment, and the business need to assure key executives that their efforts during this tumultuous period will not go unrewarded, prompt actions in regard to long-term equity awards may prove beneficial.

Annual Cash Bonus Programs Can Wait. Although companies will likely also need to adjust annual cash bonuses for COVID-19's effects, the considerations will be somewhat different than for equity awards. Because annual cash bonus programs are fully expensed based on the cash ultimately paid, the impact of adjustments to the criteria upon which cash bonuses are payable to address unforeseen events will likely not vary materially in the aggregate based on when actions are taken (although the timing of any such action will alter the period over which such expenses are recognized). Additionally, in the context of annual cash bonus awards, executives may be more willing to accept that the employer's Compensation Committee or Board will make appropriate adjustments, as such programs generally afford flexibility to respond to unexpected

circumstances, especially since the repeal of the performance-based compensation exception to Section 162(m) of the Internal Revenue Code.

1. If You Haven't Acted Yet for 2020, Consider Waiting. If the company hasn't yet granted its 2020 equity-based long-term incentive awards, then consider delaying such grants until the impact of COVID-19 is more likely to be assessable. Performance goals established now, especially measured relative to prior performance, will almost certainly be inappropriate once the financial impact of these events is better understood. Awards granted may either be of no value or require an adjustment once a proper assessment can be made. Adjustments in performance measures made down the road may result in significant incremental financial accounting expense. If it is expected that the ability to predict future performance will be superior in a few months, then everyone may benefit from being able to establish the requisite performance measures after the initial uncertainty is behind us. Service-vesting conditions can generally be adjusted to place the executives in the same position as if the awards were made when initially intended, and the values ascribed to the stock awarded at a later date may be more stable and predictable and not as materially impacted by radical daily fluctuations.

Nothing will spare a company and its executives from the impact of COVID-19 on stock fluctuations occurring following the date that any equity-based award is granted. If one were to grant only time-vested awards in lieu of a typical performance-based award, whether today or after a period of time to let the markets better absorb this pandemic, then any further decline in the stock price in the ensuing period will diminish the value of the award compared to the target value intended to be conveyed. If, following a delay of any expected grants, stock values stabilize and head back toward pre-crisis levels, then companies could decide to grant either the original award value or the number of shares that would originally have been granted. Of course, if the stock price decreases significantly due to COVID-19 before a delayed grant is made, then the company will need to grant a greater number of restricted stock units to deliver the same targeted value, which would use more of the equity pool than it had anticipated. For employers who choose to wait, a thoughtful employee communication explaining the reasons for, and the benefits to the employees of, waiting will likely assure potential grant recipients that the employer is appropriately considering the economic impact of the current events on its key executives.

2. If Waiting Is Not Viable, Then Replace Performance Share Awards and Options with Restricted Stock Units. Following the 2008 financial crisis, because it was generally perceived as impossible to design near-term performance criteria that were achievable and were also reasonable hurdles for management to achieve, many companies eliminated performance-based awards for a period of time. Instead, they granted restricted stock units that would vest solely on the passage of time. While not optimal to eliminate performance measures entirely given the importance to

shareholders of pay for performance, doing so in the short term, when any performance objectives established could prove either unchallenging or unachievable, is a sensible response to events outside of the company's control. Depending on the performance multiplier used to determine the shares issuable for above target performance, the performance-based award may have related to a greater number of shares than would a comparably valued restricted stock unit award. Any conversion from performance-based to time-vesting awards could also address the impact of the decline in the stock price by using the current value of the restricted stock award to replace the original grant date value of the performance award. Of course, any such conversion should determine the impact positive or, especially if valued based on current stock prices, negative on the plan's share utilization (or "burn rate").

In this context, employers that have previously preferred options to restricted stock units may want to remember that options are inherently performance-based awards. If the effects of the current crisis are to depress stock prices for any considerable length of time, then options will prove to be far less effective compensation tools than they would have been in the ordinary course, as such awards would likely be neither an incentive nor retentive device in periods where market conditions exert significant pressure on stock price increases and the executives doubt that the options will become substantially in the money. Further, if the impact on stock prices proves to be transitory, such that prices return to pre-crisis levels in the short-term, then option awards with an exercise price set during the crisis could provide an undeserved windfall to the recipients. Restricted stock units reward stock price increases in a more measured manner, and assure the recipient of a level of compensation even in a flat or somewhat declining market. Restricted stock unit awards can provide anxious executives some level of certainty regarding their compensation in a very uncertain environment. Because of the repeal of the performance-based compensation exception to \$1 million limitation on tax deductibility imposed by Section 162(m) of the Internal Revenue Code, there should be no loss of a federal income tax deduction from converting the stock options into time-vesting restricted stock units.

3. If You Suspect That Rational Performance Objectives Cannot Be Established Even When Normalcy Returns, Eliminate Them Now, Especially for Awards Just Granted. If normal practices resulted in a company making its 2020 long-term incentive awards in February or the first part of March, and it did so using performance-based equity awards that largely reflected a pre-pandemic outlook, then it is likely inevitable that adjustments to such awards will be required to make the criteria potentially achievable. The longer the period between the date of grant and the date of the adjustment, the greater the likely impact of such adjustment from a financial accounting viewpoint, especially if, due to the passage of time and market developments, it becomes more likely that the performance objectives will not be achieved. Additionally, as time goes on, the executives may start to view the recently granted

award as having conditions that are unattainable, meaning that it will cease to have any meaningful incentive or retentive effect. Converting such an award to a restricted stock unit award sooner rather than later (i) may minimize the incremental financial accounting charge, (ii) would allow any incremental expense to be amortized over a longer period and (iii) likely would have the greatest impact on the ability to retain and motivate the recipients. To restore a proper balance between time- and performance-based awards, new performance awards could be granted in the next annual award cycle, assuming that at such time there is sufficient line of sight into what the going-forward objectives should be.

For previously granted performance-based awards, it may be more difficult to explain the rationale for acting now, especially since the impact of the crisis can be balanced against the period of performance preceding the discovery of COVID-19. However, if an award that is scheduled to vest based on performance through the end of the current year is reasonably expected not to pay out due to the effects of the current crisis, sooner action may be more defensible than just allocating some payment at the end of the period. Extending vesting would help explain the reasons for acting now, but changing the timing of payment will have to be carefully structured so as not to create adverse tax consequences under Section 409A of the Internal Revenue Code. This kind of prompt action may be particularly important to consider for executives holding a significant amount of options that may be out of the money or performance shares that would appear likely to die on the vine, and who should not be distracted by concern about the utility of their prior awards at a time when they are being asked to handle the unique set of circumstances that we find ourselves in currently.

4. Better to Have Asked Than Not to Have Considered. It may be that acting now on these issues may turn out to have been premature or that some critics will argue that such action is not appropriate until more facts about the impact of COVID-19 on long-term economic performance is known. But companies are facing factors that were not present just a few weeks ago, certain industries are temporarily facing a hiatus in at least some of their operations, and consumers are reacting to events that none of us has the data to fully understand. Thus, it seems prudent and logical to ask now whether there are actions that could and should be taken to minimize the consequences of an unexpected health crisis, and to solidify the ability to retain and incentivize a company's management team. If and when any action is taken to adjust previously granted awards, then public companies will have to anticipate a potentially unfavorable reaction from institutional shareholders and their proxies, which could have an adverse impact on future say-on-pay votes. Such reaction should be factored into any decision to take action to address the economic impacts of the COVID-19 crisis, particularly prompt action, as it is likely that being a trailblazer on these adjustments may bring significant public attention. But if nothing else, focusing on these questions now will form a

foundation for future actions, and may avoid the regret about having not considered and taken earlier actions to address these predictable concerns.

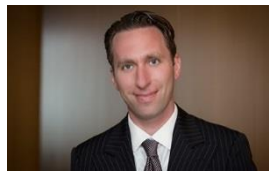
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