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Client Briefing

A Framework for Discretion

EXEQUITY

Independent Board and Management Advisors

The impact of COVID-19 on business has been profound and sudden. Strategic plans, business forecasts, and operating budgets set before the current crisis are likely to bear no semblance to plans that might be set today. Moreover, plans set today may also be quickly overtaken by events and rendered obsolete. It follows that outstanding cycles of budget-based incentive compensation programs, both short- and long-term in nature, did not contemplate this broad economic downturn. As such, the formulaic aspect of these incentive programs in many cases is likely to pay well below target or miss threshold objectives required for any payout.

As companies contemplate how to address this matter, it is instructive to revisit the oft-stated purposes of incentive programs:

- To provide a competitive benefit commonly found in the labor marketplace;
- To provide incentive or motivation toward achieving a specified set of results;
- To align a portion of compensation with performance outcomes; and
- To retain employees through the end of the incentive period.

Employee retention-related objectives could be in jeopardy if outstanding award cycles were reduced to a zero payout. However, an overly focused position on employee retention can lead to a disconnect with shareholders, and with a pay-for-performance culture. Companies wishing to provide appropriate and realistic incentive opportunities to their employees in the context of overall business results may find that their previously approved, budget-based incentive plans fall short.

The Application of Discretion

Discretion within executive incentive plans[1] has historically been avoided or relegated to a small percentage of the total. Discretion has carried a negative connotation as it pertains to executive programs, often viewed as a means for providing payments when not properly earned, or reflecting a lack of discipline around planning and goal setting. For the reasons above, discretion typically is scorned by proxy advisory firms and falls squarely outside widely held notions of “best practices” and market norms.

[1] Most notably, the application of positive discretion.

As an additional obstacle, the application of upward discretion within executive incentive programs used to result in the loss of corporate tax deductibility for such payments under Internal Revenue Code Section 162(m). However, the tax reform act of 2017 removes this obstacle as nearly all payments, regardless of their structure, above $1M to covered individuals are no longer tax-deductible. Finally, the application of discretion puts significant pressure on compensation committees to adjudicate the pay and performance question. It is much easier for all parties involved to specify goals at the beginning of a period and provide a precise formula by which payments will be made pursuant to the attainment of those goals.

A Framework

Despite the obstacles cited above, discretion is alive and well in the administration of executive incentive programs. For example, most companies use discretion to decide whether certain items are included or excluded in the financials of incentive plan results. Discretion is also used when setting base pay levels, annual incentive award opportunities, and equity grants.

The application of discretion in the above situations recognizes that nuance and a consideration of variables, too many to enumerate in a formula, are required to arrive at appropriate outcomes. Similarly, some degree of discretion may be required to arrive at appropriate outcomes with respect to outstanding incentive cycles impacted by the extraordinary COVID-19 crisis.

A framework to assist with discretion regarding 2020 results will be helpful to avoid arbitrary and confusing outcomes. To this end, we suggest the categories below as a starting point for conversations around performance evaluation:

- **Pre-COVID-19 impact**. How was the company tracking relative to plan prior to the crisis? For annual plans this may only be a few months, but for multi-year plans most of the performance period could have preceded the event. While a truncated performance sample will not be predictive of the full period, it does provide a baseline for expectations that should be taken into consideration.

- **Degree of miss**. Did a company just miss threshold performance, or was it the worst performance year ever? Understanding performance in the context of the plan and prior periods will inform whether the application of positive discretion is appropriate.

- **Relative performance**. The examination of performance relative to focused company peer sets, industry comparisons, and broad industry groupings will be informative, as the crisis is broad in scope and will likely impact close industry peers similarly. The relative metrics to be examined should include both key internal financial measures and external metrics such as total shareholder return. Outperformance on relative metrics may suggest the application of positive discretion in award determination notwithstanding underperforming absolute goals.

- **Shareholder experience**. Even in instances of relative overperformance or superior pre-crisis results, the erosion of shareholder value will likely dampen enthusiasm for robust levels of incentive payouts. Understanding how key external constituents experienced or viewed performance should inform the application of discretionary awards.

- **Actions during crisis**. If a company was forced to undergo widespread layoffs or furloughs during the crisis, a discretionary bonus might be both unseemly and difficult to justify. Alternatively, if a company redeployed assets to assist community or national relief efforts, such actions could be favorably viewed in the consideration of a potential discretionary payment.
- **Incentive results for broad-based employees**. If discretion is applied to lift results under an executive incentive program, any inconsistency with the incentive program results for non-executives could precipitate morale problems.
- **Historical precedence**. If a company has recent examples of how exogenous events have impacted their outstanding awards, some adherence to prior methodologies may be applied to this situation.
- **Market practice**. If most other companies are paying out some form of incentive during this crisis, comparable or supplemental actions may be considered to retain key talent. Conversely, given the broad economic downturn, scarcity of cash, and decrease in equity values, the ability of many organizations to provide lucrative incentives may be severely curtailed.
- **Companies receiving government assistance**. Beyond the regulatory limits on pay during the window periods defined in the CARES Act, any discretionary uplift on executive pay could be met with a negative external reaction.

Conclusions

We assume that many current formulaic incentive plans will not result in outcomes that merit payouts. This circumstance is likely true for programs that end in 2020, but may be extended to future cycles as well. At some companies, no payouts will be appropriate. At other companies, the pre-approved goals will have no connection with reality, revised performance imperatives, or actual performance.

To be clear, we are not advocating for the blanket payment of discretionary awards when the formulaic awards fail. We do, however, suggest that during an extraordinary event such as COVID-19, a holistic review of the facts and circumstances at the end of the performance cycle will be a superior means of evaluating performance versus comparisons to the front-end objectives.

We expect many companies to struggle with this issue as they contemplate year-end pay decisions. The question of whether to invoke a discretionary payment outside of the formulaic construct should be taken seriously and in contemplation of the framework provided above.

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