Harvard Law School Forum on Corporate Governance

Key Issues Facing Companies That Exceed Financial Expectations

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Editor's Note: Mike Kesner, Sandra Pace, and John Sinkular are partners at Pay Governance LLC. This post is based on their Pay Governance memorandum. Related research from the Program on Corporate Governance includes **Paying for Long-Term Performance** by Lucian Bebchuk and Jesse Fried (discussed on the Forum **here**).

We have written several posts on COVID-19's effect on executive compensation programs at severely harmed companies and the potential actions that could be considered to mitigate some of its impact. In this post, we review companies that have exceeded initial expectations during the pandemic and the unique executive compensation challenges they may face.

Background

A number of companies were labeled “essential services” by the Federal Government and were not required to shut down during the government-mandated lockdowns at the onset of the pandemic. In many cases, the demand for these essential businesses' products and services soared and will likely remain in high demand for the foreseeable future, as consumer preferences and behaviors have changed across a wide range of activities including home improvements, at-home fitness, prepared meals, and ecommerce.

Many of these companies have had to overcome significant challenges in keeping employees safe, ramping up operations to meet increased demand, addressing supply chain issues, and mitigating higher costs. In some cases, entire manufacturing facilities were repurposed to address demands in other parts of the business or to develop new products to meet business and consumer needs. Leadership, change management, and communication skills have been at a premium; successful management teams have been able to navigate these challenges and outperform pre-established incentive plan targets.

Questions facing these companies remain, however, as compensation committees must determine if payouts under existing plans should be calculated using formulae established before the pandemic or if adjustments (up or down) are warranted. In addition, compensation committees must review and approve incentive plan targets for 2021 annual incentives and performance share awards and must also evaluate if the long-term incentive plan mix (i.e., the portion of long-term incentives allocated to stock options, performance shares/units, and time- vested restricted stock/units) remains appropriate.

Observations

Based on preliminary SEC filings for S&P 1500 companies with a fiscal year ending from April 30th through August 31st, companies that experienced growth in revenue were less likely to have reduced base salaries, altered existing annual or long-term incentive plans, or modified the design of FY 2021 annual or long-term incentive plans. Our research also showed these companies had a median annual incentive payout of 117% of target and a median performance share/unit payout of 118% of target.

Shareholders appear to have overwhelmingly approved of the executive compensation programs at these companies—as evidenced by strong support for Say on Pay at recent annual shareholder meetings. While the sample size is relatively small (102 companies' proxies were reviewed as of November 13, 2020), the actions and payout information for companies that exceeded expectations contrast sharply with companies that experienced a ≥10% reduction in revenues: base salary reductions were far more common, and median annual incentive and performance share/unit payouts were 44% and 49% of target, respectively. While not unexpected, we view this contrast as further evidence that compensation committees are highly attuned to shareholder expectations and adherence to pay-for-performance philosophies.

Companies with fiscal years ending between August 31st through December 31st are likely to be more affected by the pandemic, as they will have operated in the COVID-19 environment for six to nine months. As a result, some companies that have experienced better-than-expected performance during the pandemic may exceed incentive plan targets by an even wider margin than earlier fiscal year end companies, potentially resulting in incentive plan payouts closer to maximum.

Key Issues at Companies that Exceeded Expectations

Compensation Committees may want to discuss a range of issues at companies that exceeded pre-established performance expectations, including:

- Are the performance results and corresponding payouts aligned?
- What was the impact on key stakeholders?
- Should all employees share in the company's success, or should above-target payouts flow to just those individuals or business units that directly contributed to the company's success?
- Are 2020 results sustainable? What are the potential implications of setting 2021 performance targets below 2020 actual results?

Are the Performance Results and Corresponding Payouts Aligned?

As previously noted, some compensation committees have not chosen to adjust incentive plan payouts where performance has exceeded expectations, and it is highly likely the use of discretion to reduce incentive payouts would be perceived by plan participants as unfair and potentially disruptive to participant productivity. As also noted, the impact of the pandemic is likely to be greater on certain companies based on their fiscal yearend, and compensation committees may want to confirm formulaic payouts properly align with company results.

Most companies' pre-established incentive plan financial targets were in line with investor guidance and represented a reasonable degree of stretch based on all-known variables at the time the goals were approved by the compensation committee. Companies also set a performance range around target performance with threshold performance representing the minimum level of performance required to earn a partial incentive payout and maximum performance reflecting outstanding performance.

Some companies used a narrow performance range between threshold, target and maximum performance, where small changes in performance can have a significant impact on incentive plan payouts. Other companies used relatively wide performance ranges, which serve to mitigate the effect of over- or under-target performance on payouts. When reviewing if payouts are aligned with results, compensation committees may want to consider the performance range to determine if the level of outperformance supports a payout that is well above target.

The compensation committee may also want to review how the company performed relative to peers in terms of financial performance and total shareholder return as well as how management anticipated and addressed increased production, personal protection equipment, and other unplanned costs. These additional data points may provide useful context for the company's outperformance and help the compensation committee support its incentive payout decisions.

Impact on Other Key Stakeholders

In an earlier Viewpoint, we described a "resilience scorecard" that compensation committees could use to fully evaluate a company's performance and potentially support the exercise of discretion to increase (or decrease) incentive payouts at severely harmed companies. [1] The resilience scorecard is intended to be tailored to each company's unique situation and might include an evaluation of how well the company and management (i) safeguarded employees' health, (ii) increased market share, (iii) maintained high levels of customer satisfaction, (iv) increased or maintained employment levels, (vi) strengthened the balance sheet/improved liquidity, and (vii) positioned the company for future success.

Compensation committees may consider using a resilience scorecard based on some or all of the above criteria to fully evaluate company performance and confirm that the formulaic payouts fairly reflect company performance and its impact on all key stakeholders.

Should all Employees Share in the Company's Success?

Many annual incentive plans are based on a combination of corporate, business unit, and individual performance; these plans generally allow the company to differentiate payouts between high- and low- performing business units and individuals. Other annual incentive plans may be based on overall corporate results, with all participants earning the same percentage of their target bonus based on the corporate performance score. Some companies have discretionary plans, which include several performance metrics; however, a participant's incentive payout is at the complete discretion of the compensation committee or management.

In cases where the company's outstanding 2020 financial results are not considered sustainable or are attributable to a small group of employees/business unit(s), the compensation committee and management may believe above-target incentives could be put to better use by selectively rewarding key talent with higher individual incentive awards and investing the remaining incentive dollars in expanding the company's products and services or strengthening its balance sheet. These companies may want to consider using downward discretion (if allowed for in the plan) to reduce payouts for some plan participants. While we would expect these situations to be relatively rare, such companies will need to clearly articulate the rationale for their decision to plan participants and how it may benefit them in the long run.

Are 2020 Results Sustainable? What are the Potential Implications of Setting 2021 Performance Targets Below 2020 Actual Results?

Generally, shareholders and proxy advisory firms expect companies to establish performance goals that exceed the prior year's actual results and will call out companies whose performance metrics do not appear challenging. In some cases, companies that far exceeded 2020 expectations may be able to sustain and exceed the high-performance bar in 2021 and beyond. In those cases, it is unlikely the 2021 performance targets will be viewed as problematic by shareholders and the proxy advisory firms. However, that may not make it any easier on management and the compensation committee in establishing next year's financial targets given the level of economic uncertainty and the fact that the company is in unchartered waters in terms of sustaining such high levels of output while maintaining employee safety. (See our recent post on **Establishing Meaningful and Rigorous Financial Goals**) [2]

On the flip side, some companies may have had a "one-of-a-kind" year in 2020 that is not considered sustainable. These management teams and compensation committees may have an equally difficult time establishing 2021 performance targets given the economic uncertainty and will have the added burden of explaining to investors why incentive plan targets are below prior year results. The good news is recent FAQs issued by Institutional Shareholder Services indicate they expect that some companies will report financial targets below prior year actual results; they have strongly recommended that the Compensation Discussion and Analysis (CD&A) fully disclose the rationale for the lower financial targets. [3]

Conclusion

Executive compensation continues to be intensely scrutinized; given the societal effects of the pandemic, companies that have exceeded expectations and are paying above-target/near-maximum incentives may face heightened attention by some shareholders, proxy advisors, media outlets, government officials, and employees. Compensation Committees should consider examining the company's performance holistically and disclosing the full range of considerations that support above-target incentive plan payouts in the CD&A. These companies will also need to carefully calibrate 2021 annual and long-term incentive plan targets, which may incorporate relatively wider performance goal ranges, to avoid over-promising and under-delivering or vice versa which may call the validity of incentive plan targets into question.

Endnotes

[1] John D. England and Mike Kesner. "Considering Resilience When Assessing FY2020 Incentive Plan Performance." Pay Governance. September 9, 2020. **https://www.paygovernance.com/viewpoints/considering-resilience-when-assessing-fy2020- incentive-plan-performance** (discussed on the Forum **here**).
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[2] Mike Kesner and John Ellerman. "Establishing Meaningful and Rigorous Financial Goals." Pay Governance. July 23, 2020. **https://www.paygovernance.com/viewpoints/establishing-meaningful-and-rigorous-financial-goals** (discussed on the Forum **here**).
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[3] "U.S. Compensation Policies and the COVID-19 Pandemic October 15, 2020." Institutional Shareholder Services. **https://www.issgovernance.com/policy-gateway/voting-policies/**.
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