LEGAL UPDATES AND NEWS

Impact of COVID-19 on Performance-Based Compensation – Key Considerations

The COVID-19 pandemic has caused significant upheaval and uncertainty to the operational and financial performance of banks, resulting in lower stock prices, compressed margins, increased loan modifications and enhanced loan loss provisioning. For many banks, the COVID-19-related effects have reduced or eliminated entirely the achievement of the 2020 performance-based compensation goals established before the breakout of the pandemic. As 2020 comes to an end, banks will need to evaluate the impact of COVID-19 on their performance-based compensation, particularly whether to adjust or eliminate performance goals to provide more realistic incentives for their executive officers. The decision to adjust or eliminate performance goals warrants consideration of the factors described below.

I. General Overview and Key Considerations.

If it is determined that modifying or replacing performance goals or adjusting actual performance results is warranted due to the adverse impact of COVID-19 on achievement, there are three approaches to consider:

1. ***Adjust actual performance results to exclude the effects of COVID-19.*** Under this approach, the underlying performance goals related to performance-based compensation (e.g., earnings per share or net income) would not change, except that the effects of COVID-19 would be excluded in determining the level of achievement.

2. ***Establish new performance goals.*** An alternative approach would be to replace the current performance goals with new performance goals in consideration of the reality of adverse market conditions. Examples of this would include: (1) replacing the absolute performance goals with more relative goals that compare the performance of the company against the performance of other peers; or (2) utilizing well-defined qualitative performance goals that are tailored to the executive's duties to assess performance, such as the successful implementation of risk management programs or measures to protect employees and help the community in the time of crisis. To implement the relative approach mentioned above and to facilitate the comparisons necessary to evaluate achievement of the performance metrics, a company may need to revise its performance goals to reflect the effects of the pandemic (e.g., utilizing a pre-tax, pre-provision revenue amount instead of net income) and/or evaluate the companies that constitute its peer group to make sure an apples-to-apples comparison is being performed.

3. ***Pay discretionary bonuses.*** If adjusting actual performance results or replacing performance goals is not feasible or appropriate, discretionary bonuses could be paid to offset losses that are outside an executive's control.

Other key considerations:

1. ***Review bonus plan documents.*** Prior to evaluating any change to existing performance goals, it is important to review existing bonus plan documents to determine what, if any, flexibility is allowed by such documents, particularly in consideration of the three approaches described above. For example, most bonus plans allow the compensation committee or the board of directors to adjust performance goals by excluding the effects of extraordinary or non-recurring items, such as COVID-19. If such a modifier is not explicitly provided in the plan document,

the adoption of an amendment to the plan or underlying award agreements may be necessary. For public companies, such an amendment may require disclosure to the public on a Form 8-K.

2. ***Determining the effects of COVID-19 on performance.*** Adjustments due to COVID-19 should be based solely on the pandemic's identifiable and extraordinary impact on performance. Noninterest expenditures incurred related to COVID-19, such as new air filters, plexiglass shields, technology upgrades for remote working and additional supplies (hand sanitizer, facial tissues), are easily identifiable. Determining the impact of COVID-19 on quantitative metrics may be more challenging, particularly distinguishing the pandemic's impact on financial performance compared to other traditional economic qualitative factors, such as a low interest rate environment or depressed housing market, which are simply the costs of doing business as a financial institution and generally not viewed as appropriate reasons to adjust performance goals.

3. ***Accounting implications.*** Any proposed adjustments or modification of performance awards should be vetted with the bank's accounting firm before adoption, as a modified cash-based award may result in accrual changes and a modified equity-based award could trigger an accounting charge.

4. ***Long-term performance goals.*** Greater caution should be exercised in modifying longer-term incentive goals, since an extended performance period provides a greater likelihood that performance will be smoothed-out over time or, if modifications are made, they may be premature and require additional revisions thereafter.

5. ***Reaction of key stakeholders.*** The potential reaction of key stakeholders (i.e., stockholders and employees) to performance goal changes should be considered. For example, changes that enhance payouts to executives when stockholders have seen a significant drop in the value of their stock holdings may not be well received. Similarly, employee morale could be affected if senior executives receive additional discretionary bonuses or benefit from relaxed performance thresholds while employees generally have suffered a reduction in income or have been furloughed or laid-off as a result of COVID-19.

6. ***Proxy advisory firms and institutional shareholders.*** Changes to performance goals will be scrutinized by proxy advisory firms and institutional investors who generally prefer more formulaic performance programs. For public companies, it will be essential to explain 2020 compensation decisions in their 2021 proxy statement, particularly if performance goals are adjusted or changed, and companies should provide clear and detailed disclosure regarding the reasoning for executive pay decisions. Institutional Shareholder Services ("ISS") has acknowledged the extraordinary circumstances resulting from the pandemic and, as a result, recently issued guidance in the form of a Frequently Asked Questions ("FAQ") format, as to how ISS "may approach COVID-related pay decisions in the context of ISS' pay-for-performance qualitative evaluation." A summary of the FAQ is provided below.

II. ISS FAQ Summary.

Changes to annual incentive awards. For public companies, ISS has indicated that additional disclosure will be necessary in the annual proxy statement for it to evaluate annual incentive program changes or discretionary awards. Further, ISS FAQs lists key disclosure items that would help investors evaluate COVID-19-related changes to annual incentive programs, including:

- The specific challenges that were incurred as a result of the pandemic and how those challenges rendered the original program design obsolete or the original performance targets impossible to achieve;

- For companies making mid-year changes or one-time discretionary awards, the company should explain why this approach was taken and how such actions further investors' interests;

- One-time discretionary awards should carry performance-based considerations and companies should disclose the underlying criteria, even if not based on the original performance metrics or targets. ISS specifically noted that generic descriptions such as "strong leadership during challenging times" would be insufficient;

- A company should discuss how the resulting payouts appropriately reflect both executive and company annual performance and should clarify (or estimate) how the resulting payouts compare with what would have been paid under the original program design. ISS noted that above target payouts under changed programs would be subject to close scrutiny; and

- Where companies that have made changes to the existing year's program have designed the following year's annual incentive program, ISS encouraged companies to disclose positive changes, which may carry mitigating weight in its qualitative evaluation.

Changes to long-term incentive awards. ISS has indicated that it will generally view negatively any changes to "in-progress" cycles (i.e., FY2018-2020 or FY2019-2021), particularly for companies that exhibit a qualitative pay-for-performance misalignment. According to ISS, investor feedback indicates that these programs should not be altered after the beginning of the cycle due to a short-term market shock.

For long-term programs commencing in 2020, ISS appears to have taken a slightly more relaxed view. In the FAQs, ISS noted that investors generally do not expect to see drastic changes to the long-term incentive programs, unless the underlying business strategy has changed; however, more modest alterations could be viewed as reasonable. Further, it indicated that movement to qualitative or relative metrics may be viewed as reasonable given the difficulty with long-term financial forecasting, however, shifts to predominately time-vested equity or short-term measurement periods would be viewed negatively by ISS. Lastly, ISS encouraged companies to clearly explain any changes to its programs so that investors could evaluate the compensation committee's actions and rationale.

ISS views on COVID-19-related retention and one-time awards. The FAQs address the issue of one-time incentives granted as retention tools and indicated that a company should clearly disclose the rationale for such awards (including the magnitude and structure) and should address how such awards further investors' interests. It warned that boilerplate language regarding "retention concerns" would not be considered sufficient. It further encouraged that vesting conditions attached to such awards should be "strongly performance-based" and linked to the underlying concerns that the company aimed to address. The FAQs noted that investors would not expect one-time awards to be granted as a replacement for forfeited performance-based awards. To the extent that one-time awards are granted in the year (or the year after) a performance-based award is forfeited, the company should be prepared to explain the specific issues driving the decision to grant the awards and how such awards further investors' interests.

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John Gorman ■ (202) 274-2001 jgorman@luselaw.com
Lawrence Spaccasi ■ (202) 274-2037 lspaccasi@luselaw.com
Kip Weissman ■ (202) 274-2029 kweissman@luselaw.com
Benjamin Azoff ■ (202) 274-2010 bazoff@luselaw.com
Michael Brown ■ (202) 274-2003 mbrown@luselaw.com
Scott Brown ■ (202) 274-2013 sbrown@luselaw.com
Victor Cangelosi ■ (202) 274-2028 vcangelosi@luselaw.com
Jeffrey Cardone ■ (202) 274-2033 jcardone@luselaw.com
Thomas Hutton ■ (202) 274-2027 thutton@luselaw.com
Kent Krudys ■ (202) 274-2019 kkrudys@luselaw.com
Steven Lanter ■ (202) 274-2004 slanter@luselaw.com
Gary Lax ■ (202) 274-2031 glax@luselaw.com
Marc Levy ■ (202) 274-2009 mlevy@luselaw.com
Ned Quint ■ (202) 274-2007 nquint@luselaw.com
Max Seltzer ■ (202) 274-2038 mseltzer@luselaw.com
Beverly White ■ (202) 274-2005 bwhite@luselaw.com

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