COVID-19

The Meridian community recognizes the extraordinary challenges facing our clients, friends and others in these unprecedented times. First and foremost, we hope you, your families and your colleagues are staying safe and healthy during this global health crisis.

We appreciate that normal business operations for many companies have been upended due to the COVID-19 pandemic, and that for companies in the energy and travel-related sectors the current situation is even worse. Only through the extraordinary efforts of employees, executives and boards will companies be able to manage through the social and economic upheaval brought on by the pandemic.

For our part, Meridian is ensuring the safety and well-being of our team by requiring all to work remotely. However, during this time of sheltering-in-place, Meridian is fully operational, and serving the needs of our clients.

We appreciate that in the current circumstances executive compensation issues may not be top-of-mind at your organization - nor do we suggest they should be. We offer this Client Update for your consideration at a time that is appropriate.

COVID-19 Impact on Executive Compensation

Corporate boards and senior management teams face unprecedented challenges to lead their organizations through the demand shock and substantial market downturn caused by the pandemic. After companies resolve the immediate business implications, they will eventually need to address a range of design and administration challenges with their compensation programs.

This Client Update discusses approaches to issues raised by the disruptive effects of COVID-19, in the following areas:

1. Overall approach to compensation
2. Base salaries and pay reductions
3. Annual incentives
   i. Where targets have already been set
   ii. Where targets have not yet been set
4. Long-term incentives
   i. Where awards have not yet been made
      — Grant sizing/share usage issues
      — Equity mix
      — Performance goal setting
   ii. Where awards have been made

Given the fast changing dynamic of this crisis, this update is the next in a series of Client Updates that will monitor market practices as they evolve, and provide an in-depth analysis, with Meridian-wide observations on how companies are responding to these challenges.

1. Overall Approach to Compensation

Reduced commercial activity will have the greatest impact on both short- and long-term performance-based compensation. In many cases, outstanding business plans and performance goals have been rendered much more challenging than originally intended, or made obsolete by recent events, and companies have no certainty at present about the timing or pace of a recovery on which to restate their plans with any confidence. Situations differ across industries and individual circumstances, so companies are considering a broad range of actions and potential responses.

As business strategies change in response to the current crisis, issues will cascade to all board committees, including the compensation committee. The situation may require compensation committees to be even more flexible, creative and prepared to exercise judgment to "do the right thing", than has been necessary in recent years.

Compensation committees may find it useful to develop guiding principles to inform their near-term decision-making:

- — Considering unconventional program designs, if necessary, to keep management and employees motivated and aligned with current and rapidly changing business strategies.
- — Understanding the proxy advisory firm perspectives while still taking the compensation actions that fit the organization and its situation *(we expect the proxy advisors may likewise respond to these realities by adjusting their policies, at least in the short-term)*.
- — Considering whether and how executives should share in any compensation or workforce reductions borne by employees.
- — Considering the impact on all company stakeholders: employees, shareholders, supply chain members, customers, and local communities.

While it may be too soon for most companies to make decisions or take actions on 2020 pay, there are steps companies may consider, including:

- — If the 2020 proxy has not-yet been filed, add a paragraph reminding the reader that the proxy relates to 2019 performance and compensation, acknowledging that COVID-19 is likely to have an impact on 2020 results and pay decisions, and identifying any proactive actions already taken for 2020.
- — Share guiding principles with management to provide continued motivation and set common expectations. Develop a cadence of information sharing, covering both business impacts and potential compensation implications, throughout the year.
- — Begin to evaluate the impact of the decline in equity prices on vested and unvested executive equity holdings *(including the impact on motivation and longer-term retention of having multiple open performance share unit cycles that may be tracking for performance well below target)*.

2. Base Salaries and Pay Reductions

Some sectors have taken action to shore up their liquidity through salary reductions and/or layoffs. A number of public companies have disclosed (or are considering) executive salary reductions, particularly those in hardest hit industries (e.g., retail, airlines, hospitality, and oil & gas). In other cases, companies have delayed or rescinded previously approved salary increases for management and employees (e.g., merit increase programs). Unless specifically addressed, reductions in base salary may directly affect other pay elements and contractual protections (e.g., bonus determinations, severance calculations, retirement benefits, and life and disability insurance coverage). Companies should understand the full implications of any planned salary actions.

3. Annual Incentives

Annual incentives may soon become a compensation priority. Companies will need to align annual incentive objectives with critical initiatives and realistic performance goals. However, for most companies, it is too soon to do this since a great deal of uncertainty around the unfolding crisis remains. What may be most important in the short term is for the compensation committee to convey the following key messages to business leaders:

— Take care of your people;

— Run the business, do the best you can; and

— Do not let the incentive plans get in the way, we have your back and will look favorably upon continued determination to perform in light of events.

i. Potential strategies where performance metrics and goals have already been set

Companies that have already set 2020 annual incentive metrics and goals may consider the following approaches:

— Maintain the status quo and take a wait-and-see approach until later this year *(given the current uncertainty, any changes made now could become quickly obsolete, so we suggest considering a "reflection" period later in the year once companies have a better sense of the crisis and its impact on business)*.

— Plan to exercise greater discretion in incentive outcomes to consider the impact of COVID-19 on prescribed metrics, and the affordability of a bonus, even if incentive goals are achieved *(we believe most companies expect to exercise more discretion than usual in determining 2020 pay outcomes)*.

— Modify existing performance goals to reflect anticipated effects on financial performance *(this requires reasonable certainty about the extent and impact on financial results, which seems unlikely under current circumstances but could be possible later this year; also could raise accounting issues)*.

— Temporarily eliminate incentive opportunities *(while a drastic action, executives at some of the hardest hit companies have agreed to forego bonus payouts for the current year, and in some cases companies have already acknowledged they will not pay a 2020 bonus)*.

ii. Potential strategies where performance metrics have not yet been set

We see similar approaches for companies that have not yet set their annual incentive plans and goals:

— Delay setting performance goals until there is improved visibility on what to expect for the balance of 2020 *(avoids setting goals now that significantly over or under estimate the impact of COVID-19).*

— Permit end-of-performance period adjustments to earned awards, by calculation or discretion, to take into account the impact of COVID-19 on financial performance (*mitigates the need to set performance goals that accurately predict COVID-19's impact on financial performance*).

— Incorporate greater discretion into the determination of incentive award payouts *(given ongoing uncertainties about the economic impact of COVID-19, some companies may use discretion to appropriately reward management's efforts and accomplishments after the fact)*.

— Allocate a portion (e.g., 25% or more) of the incentive awards to achievement of important strategic, operational and individual objectives not directly tied to financial performance (*for 2020 cycles, these may include critical strategic objectives designed to mitigate the adverse effects of COVID-19*).

— Split the annual incentive plan into two six-month performance periods, with metrics for each period set within the first two months of each period (*the use of six-month performance periods may improve a company's ability to develop meaningful goals that reflect current circumstances*).

— Consider shifts from business unit to corporate-wide goals this year *(encourages a team approach to addressing critical business issues during the pandemic crisis)*.

— Consider eliminating individual executive performance modifiers *(recognizes the need for all executives to work together in a cross-functional approach to address challenges)*.

4. Long-Term Incentives

i. Where awards have not been made

Grant sizing/share usage issues

Most companies made their 2020 awards before recent drops in share price. Companies that have not yet made awards have immediate challenges to deal with. We expect companies that have not yet granted their 2020 equity awards to consider the impact of lower share prices on equity grant sizes. Lower share prices require more shares to deliver comparable grant-date value, as illustrated below.

		Weight	50%	25%	25%	
Year	**Share Price**	**LTI Target Value**	**Performance Share Units (# of Units)**	**Restricted Share Units (# of Units)**	**Stock Options (# of Units)[1]**	**Total Shares**
3/15/19	$100.00	$3,000,000	15,000	7,500	30,000	52,500
3/15/20	$50.00	$3,000,000	30,000	15,000	60,000	105,000

[1] For purposes of this illustration, stock options' Black Scholes value was assumed to be equal to 25% of face value.

Individual situations differ; but from the observed ranges of share price decreases in 2020, companies may need from 20% to over 300% more shares to deliver comparable long-term incentive value in a current (or future) grant. This could put a significant strain on share availability and reduce the life of the current share pool, and the current share reserve may not be sufficient to fully fund regular annual long-term incentive grant levels.

Making awards at the current share price may also create excessive dilution and leverage, potentially resulting in realized compensation that is not aligned with shareholder experience, particularly if the recovery is faster than anticipated.

Companies whose share price has declined significantly may wish to consider any of the following actions:

— Delay grants until economic conditions settle *(may be difficult to determine optimal timing of grant and would upset normal grant practices/commitments; most companies will grant time-based long-term incentive awards in accordance with normal grant practices, with or without a reduction in grant value to reflect current price—see the discussion below)*.

— Maintain status quo grant practices where the current share pool is large enough to fund at least one full year of anticipated equity grants, and where the annual "burn rate" is reasonable in relation to a long-term average.

— Use a higher trailing average share price over the most recent 30, 60, or 90 trading days to size awards.

— Chose an "arbitrary" level of reduction in the dollar value of equity awards—e.g., a reduction of 10% or more in the grant-date award value.

— Limit grants to the same number of shares that the company awarded in the most recent previous award cycle.

— Set a floor share price to be used for determining share-based awards.

— Set an annual dilution cap and prorate planned awards as needed to stay below the cap.

Equity mix

Companies may also consider changing the equity mix, at least temporarily:

— Reduce or eliminate stock options as part of the 2020 long term incentive mix *(this is aligned with a broader shift in long term incentive mix, reduces leverage and dilution and, if options are replaced with restricted share units, increases the resilience of the long term compensation and improves the retention element of the long-term incentive program)*.

— Provide for the settlement of future awards (other than stock options) in cash, shares or a combination of both at the discretion of the compensation committee (*this would allow, but not require, the committee to manage the share reserve by balancing the use of cash/shares without the need to modify overall design and economics of 2020 equity grants; but would provide for a maximum 3 year tax deferral for performance and restricted share units. Cash-settled awards are generally accounted for on a mark-to-market basis, but there are techniques available to obtain fixed accounting even for cash-settled awards*).

— Grant only time-based restricted share units based on an evaluation of prior year performance and/or market competitive compensation levels *(avoids the need to determine appropriate performance metrics, but has potentially adverse shareholder and advisory group optics)*

— Grant long-term cash performance units, rather than equity-linked share units *(this approach has a higher risk of generating compensation outcomes that are not aligned with the shareholder experience, and, as performance cash is not awarded until the year it is paid, rather than the year of grant, can create very "lumpy" Summary Compensation Table disclosure).*

Performance goal setting

The challenges of setting long-term performance goals are similar to those faced when setting annual incentive targets, but are likely even more difficult. Alternative approaches include:

— Establish shorter performance periods within a new long-term incentive award—e.g., 3 one-year periods, 3-year service period with a one year performance period *(may ease development of appropriate performance goals; however, typically criticized by proxy advisory firms)*.

— Include a qualitative component, in conjunction with financial metrics, to allow for more holistic assessment of performance—e.g., 50% total shareholder return, 50% strategic performance *(this approach can permit greater committee judgment in the performance evaluation).*

— Provide language in award agreements for an end-of-period adjustment to earned long-term incentive awards that will take into account the impact of COVID-19 on financial performance *(may ease development of long-term performance metrics and goals, but requires some ability to distinguish and measure the ultimate impact of the crisis)*.

— Incorporate a relative total shareholder return metric *(allows companies to use the market to measure the effects of COVID-19 on share price, and alleviates some of the need to adjust performance metrics)*.

ii. Where awards have already been made

Most calendar-year companies made their 2020 awards prior to the precipitous share price decline. This raises longer-term challenges, but most companies are (appropriately) deferring the issue of financial performance goals on performance share units, at least for the time being.

For time-based long-term incentive awards, such as stock options and restricted share unit awards, compensation committees also appear headed to maintain the status quo. For a myriad of reasons and despite the plunge in share price rendering many stock option awards deeply underwater, large cap companies are not likely to consider “repricing” awards or exchanging them for full value grants or cash at this time. Similarly, changes are not being considered for in-flight performance-based equity awards subject to a market condition (e.g., relative total shareholder return).

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