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Preparing for the Next Downturn

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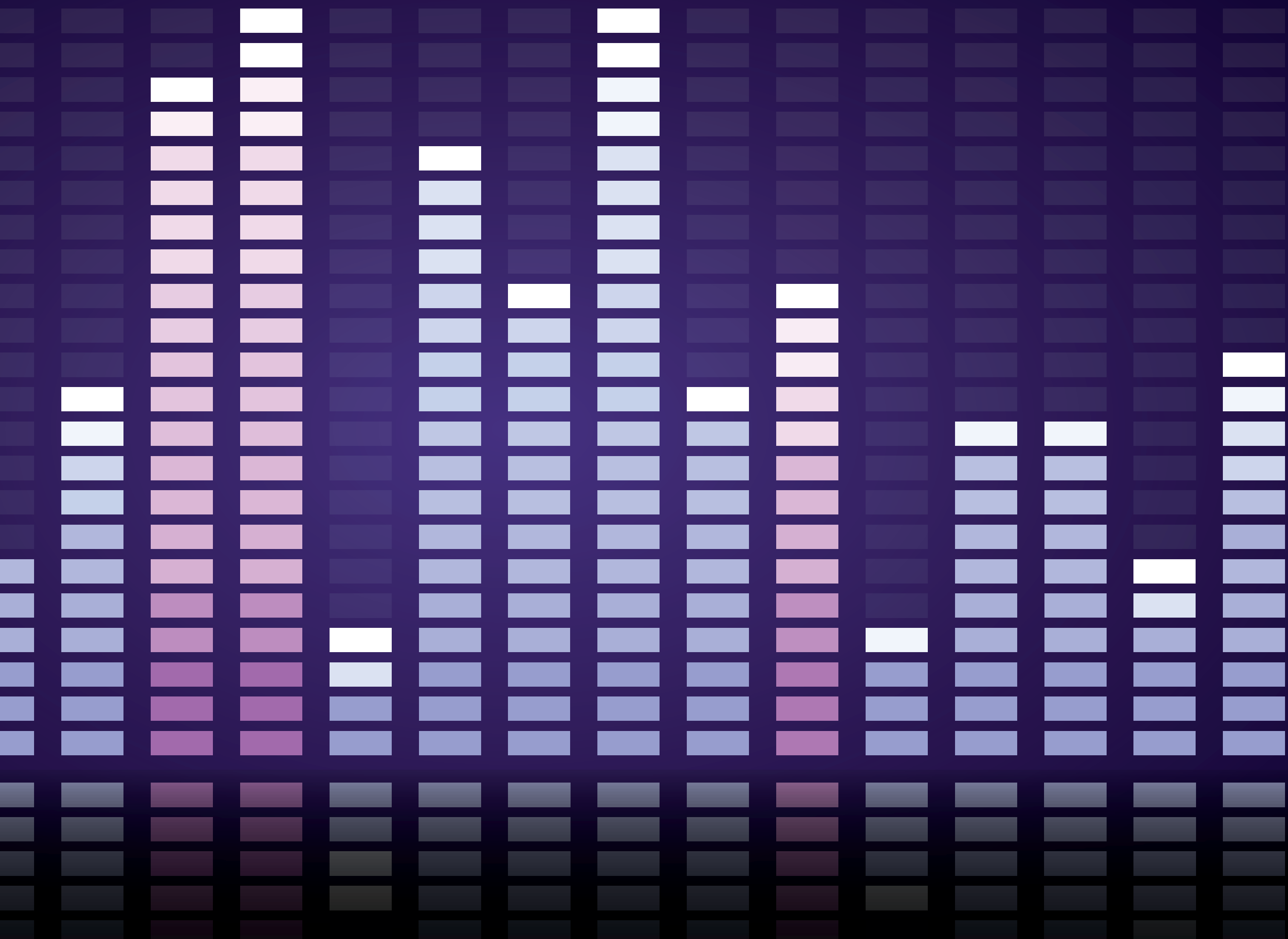

Not all executives were thrilled with the way executive compensation plans worked out during the last recession. Many felt they were paid unfairly at the time because, as hard as they worked, their pay dropped dramatically as the 2009 economy tanked. Meanwhile, shareholders felt executive pay was unfair two to three years later as markets rebounded and many executives reaped handsome — even outsized — rewards, profiting from recession-level stock and option grants that soared in value.

As we prepare for the next recession, few people expect the economy to struggle to the same extent, nor for as long. Still, many factors could trigger a serious downturn — not only trade warfare, but also slowing global growth, Brexit fallout, federal interest-rate increases, tensions with Iran and much more. The United States' economy, if not the world's, could stall.

What should compensation committees do to assure that, this time around, shareholders and executives feel that the plans work well when the economy and stock market go soft? Specifically, should directors revive the recession-related compensation tactics they used 10 years ago?

Before deciding, companies need to recognize that if a recession does occur, it would be on the heels of the longest bull market in U.S. history, in which executives have earned healthy paychecks for some time. As human nature would have it, the prolonged bull run has likely lulled executives into an expectation that the gains will continue indefinitely, even though everyone knows markets periodically correct. Boards should be careful not to be overly protective when market drops occur.

Hindsight Is 20/20

The quick answer as to whether the measures of 10 years ago should be used again is this: It depends. During the last recession, compensation committees had good intentions as they made decisions in an era of economic uncertainty few had ever experienced. They sought solutions to questions such as:

- How long will this downturn last?
- How do we keep executives and employees engaged amid so much uncertainty?
- How do we set credible goals for next year? How do we deal with underwater options and weak equity prices?
- How do we reset stock ownership guidelines?
- How do we factor in share dilution?
- In short, how can we assure design drives company success regardless of external economic factors?

Committees came up with many solutions during the last recession. Some solutions radically altered the pay design and should be reserved for extreme circumstances. Others amounted to short-term tweaks to manage pay volatility that could be easily reversed. The more radical changes included:

- Cutting salaries and 401k-plan matching contributions across the board to show that executives shared the pain with shareholders and employees. This was often played as a way to reduce layoffs. For example, Sotheby's cut the salary of each of its top five executives by around 10%.
- Emphasizing stock options, an appealing way to avoid the difficulty of setting performance goals in such an uncertain economy, and to boost payout opportunity for executives — which explains why the options grants later became the most lucrative in a decade.
- Reducing the length of performance periods, allowing the retention of at least short-term goal-based performance plans.
- Introducing relative metrics, most commonly rTSR, or price-leveraged plans, in which executives earned shares at specific stock-price hurdles, often returning to historical stock-price levels.
- Setting limits on share dilution — one managed care company forbade equity grants exceeding 2.5% of shares outstanding.
- Granting equity throughout the year, a way to dollar-cost-average the cost and size of the awards.

Short-term tweaks included:

- Flattening and lengthening payout curves, which reduced payouts at both target and maximum. This is a practice that continues in volatile industries and turnaround companies today.
- Capping annual bonus payouts, as instituted at Charles Schwab, which held payouts below target until the company regained its pre-crash high water mark.
- Cutting back on the size of maximum payouts when goals fell below prior years. This kept awards at a reasonable percentage of profits — dropping them to, say, 125% from 200% of annual salary.
- Using quarterly or semiannual performance periods, because setting annual goals was so difficult.
- Basing long-term incentives not solely on return to shareholders, but also on fulfillment of strategic goals.

In hindsight, given that nobody knew the length or depth of the downturn, some boards overreacted, yielding mixed results and some unintended consequences. For example, as the media noted with painful frequency, the changes approved by some boards made directors look like they favored the interests of executives over shareholders. Executives sometimes earned extra-healthy bonuses even as returns to shareholders went negative. The obvious question from outsiders: *Were executives winning a share of company profits out of proportion to gains by shareholders? Did directors balance the need for payouts to retain executives with setting goals, with payouts contingent on company performance?*

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Gauging the Future

History provides only so much guidance for committees faced with deciding what to do the next time the economy goes south. That's especially true because not only will the next recession inevitably play out differently, the environment for executive pay also has changed markedly in the wake of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Shareholders now have a Say-on-Pay vote. Compensation committees are more active and

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independent. Committee chairs engage with investors regularly. Proxy advisors support pay plans only so long as the plans pay for proven performance.

Experience tells us that actions to adjust pay plans in a downturn should probably not mirror those of the past. Some are still relevant, but others need to be used with caution. The best advice: Keep paying for the right types of performance, building on current plans and ensuring that they remain easy to explain:

- **Require upside stretch.** It almost goes without saying: Tie pay to performance goals that are compelling to investors. Consider what shareholders will perceive as acceptable in the business environment. For example, make maximums require more stretch, even as you set targets that will pay out enough to keep executives engaged.
- **Pay for progress**. Pay for maintaining or (re)establishing a profitable trajectory, as opposed to paying for aggressive growth goals.
- **Elevate the measures.** Pay more against measures at the enterprise level, signaling a “we’re all in this together” mentality for top executives.

In more extreme cases, change pay design or institute cuts, but communicate the reasons carefully so as not to confuse or demotivate people:

- **Stress relativity.** Shift the balance toward relative goals versus absolute ones where reasonable peer groups exist.
- **Reduce bonuses.** Consider reducing target bonuses in line with lower financial goals.
- **Go nonfinancial.** Pay against nonfinancial metrics that measure progress on key operating or strategic priorities, as in milestones for a new business.

And when appropriate, use judgment to yield desired outcomes:

- **Use more structured discretion.** Alert executives in advance of rules for after-the-fact adjustments in pay. Make clear beforehand that sometimes a rear-view mirror helps with fair judgment. But specify in advance the kinds of scenarios that will lead to goal or award adjustments.
- **Offer special awards.** If special awards are called for to retain executives, be sure they are highly selective and tied to compelling performance.

As an example of changes a committee might make, imagine an executive named Jill who takes home a target bonus in 2019 of $1 million, when she could have earned a maximum bonus for peak performance of $2 million. She earned the target for having hit an earnings goal of $100 million, well short of a maximum goal of $110 million. Jill feels well rewarded.

Looking ahead to 2020, if directors see a mild recession in the offing, they might maintain Jill’s goals, but flatten the slope of her payout curve and extend its length. The flatter/longer payout curve reflects the uncertainty and avoids the risk of underpaying or overpaying for resulting performance. On the other hand, if directors see a more dramatic downturn, they might lower Jill’s target bonus commensurate with the lower performance goals and reduce her maximum. For example, they might set her target bonus at a reduced $950,000 and her maximum at $1.5 million.

If the recession plays out as expected, Jill earns good money for both good and great performance. But like shareholders, she doesn’t earn more than the year before. Shareholders can then see that she, like the average investor, faces and accepts economic realities. No matter how hard she works, if the company makes less money, the board makes less of it available for her bonus. Jill, presumably an owner of the business through her own stock holdings, is fully aligned with non-executive owners.

Of course, no two businesses will encounter the same challenges in a recession. As a general rule, boards would do well not to overreact, but to make changes to ensure that executives remain engaged. Dramatic stopgap changes can spur the unintended consequences so often witnessed 10 years ago. What’s more, they may fail to either motivate or retain executives.

Because equity pay plans today recalibrate as results sour (lower strike prices, more shares), remember that simpler is often better. Even when directors see that the way they have tuned the pay plan isn’t working quite as expected, they can still use after-the-fact discretion to bring pay into line with reality. Most important, they should stay consistent with stated philosophies and principles. So long as executives’ expectations remain in line with the reality, the board can exercise flexibility to keep everyone happy. Executives and shareholders can then share the pain and gain — and the board doesn’t need to worry about the media taking directors to task. **ws**

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