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Coronavirus and Compensation: Highly Impacted Industries can Follow the Oil & Gas Playbook

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PRINCIPAL

The economic impact of COVID-19 has created a period of uncertainty and distress across multiple industries, some more than others. The impact on retail, transportation, and hospitality (among others) is significant, but when coupled with the low price of oil and oversupply in crude, many oil and gas companies face a potentially lengthy period of uncertainty. While the cause of this downturn may be different than the past, for better or worse, companies in the O&G industry have a long history of coping with economic downturns and their impact on compensation programs. As companies across a range of industries review pay programs, maybe they can learn from the experiences of the oil and gas sector.

Addressing the Challenges of Delivering Meaningful Pay

For publicly held companies, the retention tools available boil down to two choices: cash and stock. With depressed share prices, granting equity can present its own challenges, and many firms (particularly in the O&G sector) will have to balance preserving both cash and equity. Amplify this challenge with scrutiny from shareholders, creditors, lenders, activist law firms and (potentially) the bankruptcy code. How can a company continue to provide meaningful and competitive pay levels while managing share dilution, conserving the share pool for equity grants, and maintaining an effort to preserve cash?

The most common approach when share prices have fallen significantly and equity becomes "expensive" is to use cash as the long-term incentive (LTI) currency.

- On the plus side:
  - Shareholder approval is not needed for a separate cash-based program.
  - The plan does not use shares from the company's equity plan. The cash-based plan is separate from the shareholder-approved plan and does not have a share pool like equity-based or unit-based vehicles. Even cash-centered plans that retain the flexibility of paying in cash or stock may lead to burning shares depending on the wording and historic practices.
  - Value of the cash payout can emulate the company's share price and/or have specific performance conditions.
  - The vesting period of these awards can reflect an expected time horizon for cash preservation. For example, a company that expects a two- to three-year recovery (and needs to preserve cash in the interim) can adjust the vesting period of the award, so that cash is not used until then—even though the expense is being accrued.
- However:

- Depending upon what drives their value, cash-based vehicles trigger variable accounting which can be problematic with extreme volatility in the company's stock price. A cap on the maximum allowable payout can help mitigate some of the accounting variability.
- And, of course, payouts under the plan ultimately represent a cash outflow for the company.

Alternatively, the company may wish to adjust overall pay mix, and weight short-term cash components more heavily than long-term equity-based components. This approach is typically a harbinger of a restructuring or bankruptcy filing, in which short-term annual goals and resulting cash payouts are centered around a major turn-around strategy. Turn-around goals are typically milestone-driven or based upon necessary performance outcomes to preserve the operations and the liquidity of the company. When goals are properly focused on managing the downturn, to the benefit of shareholders, lenders, and creditors, these plans can better survive scrutiny and deliver meaningful pay during such times.

When the outlook of the company begins to turn from managing the downturn to restructuring and potential bankruptcy, there are some additional guidelines to consider. In these cases, there are separate considerations for non-executives and the executive team.

Non-Executive Programs

Turn-around pay programs for non-executives have not varied significantly since the 1980s. The focus here is to retain at least a core of non-executive talent across all levels. These programs tend to:

- Focus on retention;
- Pay in cash over a shortened period (quarterly or semi-annually);
- Mirror, in some cases, the company's share price and long-term incentive awards (with shortened vesting period); and
- Include, sometimes, a non-qualified deferred compensation feature.

The prevalence of non-qualified deferred compensation retention awards, with payouts vesting over two to three years, continues to increase and was used extensively in the 1990s to early 2000s at the office and field level. After the 1980s downturn, IRS rulings adopted a more liberal interpretation of "a select group of management," morphing into "a select group" for these short-term deferrals. This allowed short-term involuntary deferrals (vesting in three years or fewer) to be applied on a larger scale across the workforce—often including non-exempt jobs.

The old approach of offering voluntary reduction-in-force (RIF) packages to units, locations, or headquarters' employees, hoping for takers, has almost disappeared due to the unintended risk of the company's most qualified or key skilled employees taking the RIF packages. The approach since then is to focus additional awards on those who need to be retained (i.e., pay high performers to stay, rather than pay marginal performers to leave).

Executive Programs

While there is some honor in hunkering down for the fight, one must ask:

- How much change are we expecting?
- What is going to happen to our market?
- Is our current business plan what we need for the future?
- Do we stop making widgets and use our equipment for something else?
- Do we look for a partner or sell assets?

In such events, should incentive plan goals be re-visited or new ones added? Some of the old forces that kept us from thinking dynamically about incentives—like IRS Sec 162(m) that gave us one shot at goal-setting within the first 90 days of the plan year—are gone. In this environment, we may even worry less about the scrutiny from proxy advisory firms if it makes good business sense, is focused on preserving share value in the long-run, and we are transparent about what we are doing.

Re-Calibration of Incentive Goals

Establishing plan goals and performance standards for executive incentive plans each year is a standard committee agenda item. It dovetails into the business plan, assessment of market compensation data, and the determination of performance outcomes that will support incentive payouts.

During periods of potential major business challenges executive incentive plans should address current issues, rather than simply modifying the measures that were in place the previous year. In a steady-state environment, the ship may have sailed for FY2020 goals, but given the current turmoil, consider the impact on the incentive plans (both short- and long-term) and, if possible, re-calibrate. Even though the shareholder cannot "re-calibrate," it still may be appropriate for the company to do so in order to set realistic goals—with some achievability for "good outcomes" at least at the threshold level. Consider what a "good" or "very good" outcome looks like, and what type of reward or recognition is warranted. For flexibility, apply discretion at the end of the year with a "year in review" list of accomplishments that may warrant a discretionary payout. This type of framework seems applicable now in a year that changed radically in the first quarter and will continue to impact 2020.

Alternatives to Re-Calibrating

When the outlook for the company is particularly foggy and setting short-term goals is like throwing darts in the dark, some general guideposts for executive compensation changes are:

- *Pure retention bonuses to executives won't survive a bankruptcy judge/trustee or creditor committee setting.* Shareholder sentiment towards these types of programs tends to be "they are paid enough already." In a change-in-control situation, executive retention programs can survive, but the acquirer will often offset such awards from any transaction or deal bonuses that they would otherwise approve.
- *Payments to executives can't be "catch-up" awards.* Awards to executives should align with historical practice and market competitive practice, lest they be disgorged or clawed back by the bankruptcy court. In the event of a change-in-control, these types of awards may also be pulled into the excess payment calculations under IRS rules.
- *Often the driving imperative is to tackle the current situation and hopefully avoid bankruptcy and a change-in-control, developing incentives to bridge this period.* Hunkering down and

taking cost containment to the next level while looking for a turn-around opportunity, a strategic partner, or some significant economic change, still requires the considerations outlined here.

The bottom line is there is no "one size fits all" approach to compensation when a company is struggling. The best compensation programs will align the company's strategy for managing the downturn with the value delivered to its participants. When the focus shifts from managing the downturn to an imminent change-in-control or bankruptcy, there are some additional ground rules that we will cover subsequently. Topics will include the do's and don'ts of tax, share usage associated with stock-replacing cash-based LTI plans, strategic pay plans like reloading the LTI into total cash in preparation of re-organization or bankruptcy, as well as an overview of some of the basic considerations and compensation programs for a transaction or deal team.

About the Author

Malcolm Adkins has over 10 years of compensation consulting experience. Prior to joining Pearl Meyer, he served as a compensation consultant at Aon Hewitt and Longnecker and Associates. Over the course of his career, Malcolm has developed broad experience consulting to senior management and boards of directors on a variety of compensation and governance related matters. He has worked with clients spanning many different industries, with a particular focus in the energy sector.

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