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Remuneration and Financial Crisis Management

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Introduction

There is no doubt that the COVID-19 pandemic presents very challenging times for all segments of society, and on a global scale; no business will be immune from its adverse effects (even the ones doing a brisk trade in the near term). The recent government stimulus and co-ordinated response from the Reserve Bank and even the Big Four banks hold out some hope that with a little ingenuity, understanding and co-operation, we will pull through this at some stage. Notwithstanding, there is no denying that the challenges in the coming months look bleak, and lessons from the Global Financial Crisis (GFC) as well as innovations since, can be drawn upon. In this insight we explore the key governance and practical issues for remuneration that boards and executives should be considering in times of tight cash flow. Some may be surprised to learn that there is a golden wealth creation opportunity arising, if you have a modern rights plan.

Limiting Workforce Hours/Costs is Obvious but Risky

During tough times the obvious but most unpleasant solution for businesses is to try to reduce costs through cutting remuneration, terminating employees or putting them on some form of unpaid leave. Refreshingly, some governments understand the adverse effects of such things for individuals, companies and the economic outlook more broadly.

The UK Government made an unprecedented move to stump up for workers by providing grants to cover 80% of a worker's salary of up to 2,500 pounds a month if businesses kept them on. Moreover, any employer in the country is eligible for the "Coronavirus Job Retention Scheme" and there is no limit on the amount of funding available.

The Australian Government's economic survival plan revolves around keeping people employed, supporting small and medium-sized businesses to retain staff and to inject money through the social welfare network to ensure that those who are laid off can continue paying the bills. Small and medium sized businesses employ roughly 68% of the workforce so it is easy to see why the Prime Minister and Treasurer, along with the Reserve Bank, have honed in on this segment of the business world.

But that still leaves a large slice of workers employed by big businesses exposed, especially those that have been adding more workers in recent years. Apart from the obvious damaging impact on the livelihood of employees, cutting remuneration and laying off staff also puts companies at longer term business risks if talent is lost permanently; especially when key or high potential employees strive to find alternative engagements. Following GFC inspired cost cutting, many companies found that they no longer had the resources and capabilities to respond to improved economic opportunities, due to losses in the workforce and of high potential talent. This may have slowed economic recovery.

Alternative approaches to adjusting remuneration to improve cashflow or otherwise reduce cash remuneration costs, without laying off staff, are discussed below.

Convert Fixed Pay into Equity for Executives

An alternative to making executives redundant or standing them down on leave without pay or reducing the quantum of fixed pay is to replace part of fixed pay with grants of equity. In this way company cash outflows are eased yet executives do not receive a reduction in fixed pay. This approach will help companies survive the current troubled times and provide an opportunity for executives to realise financial gains in the longer term provided that the company survives and its share price returns to growth following the easing of the crisis. It will also provide an incentive for executives to work in a focussed way on business recovery in the medium term.

It is now possible to provide equity without an accompanying "real risk of forfeiture" and to allow executives significant flexibility as to when they may convert equity into cash by selling shares. Both features were not possible prior to recent developments in relation to employee share schemes.

Shareholder approval of equity grants is only required in relation to executives who are also directors of the company and if on exercise the settlement will not be with shares acquired by on-market purchase. It is likely that shareholders would be very supportive of resolutions to grant equity in lieu of fixed pay.

Convert Non-executive Directors' Fees into Equity

While the total amount of non-executive director (NED) fees are usually not a large cash flow burden for companies, boards can send a clear message to shareholders if they choose to take all or a large part of their cash fees in shares. Due to recent legislative changes it is not possible to sacrifice superannuation guarantee contributions (SGCs) and salary sacrifice of cash remuneration does not result in a lower SGC obligation for the company.

While GRG generally recommends that prior shareholder approval be obtained for NED Equity Plans and for grants to NEDs, such approvals need not delay the introduction of a NED Equity Plan. To speed up matters, NED Equity Plans can be commenced prior to receiving shareholder approval, provided that shares are acquired by on-market purchase. Of course, at the next general meeting of shareholder such approvals can be obtained. Approvals of plans last 3 years before they need to be renewed and approvals of grants to NEDs usually occur annually but can be obtained up to 3 years in advance.

Reference should be made to GRG Remuneration Insight 88 Remuneration Paid in Equities for Non-executive Directors for more information and the advantages of NED Equity Plans.

Short Term Variable Remuneration (STVR)

STVR Plans that are No Longer Relevant

The vast majority of STVR plans are target based plans. Such plans identify key performance metrics and allot to each metric a target level of performance (threshold and stretch levels of performance may also be used). The relevance of such plans relies upon the ability of management and boards to set business plans and budgets with a high degree of certainty as to future outcomes. The outcomes evidenced in the business plans and budgets are then used to set the performance goals for the outcome metrics, within a range around expectations for scaled metrics.

An impact of the COVID-19 pandemic has been destruction of the relevance/reliability of business plans and budgets for FY20 and possibly for FY21. For many businesses, management has had to change its focus to matters pertaining to survival. In these circumstances there is no point in continuing STVR plans.

Retention and motivation remain essential elements of executive remuneration even during the pandemic. Accordingly, redeployment of the STVR award opportunity may make much more sense for the next year or two. Such redeployment could take many forms including converting the STVR award opportunity into:

1. Retention grants of equity which vest based on completion of a period of service, and/or
2. Additional Long Term Variable Remuneration (LTVR) equity grants.

In both cases equity is proposed as it does not involve cash outflow and it provides an incentive to pursue improved company performance. The equity may take one of two different forms depending upon the main objectives being sought. Share rights or similar rights tend to have a high retention impact subject to the likelihood of vesting. Share Appreciation Rights (SAR), also known as cashless exercise options, tend to have a stronger motivational impact as there is no value in a SAR unless the share price increases.

STVR Plans that Remain Relevant

For companies that have not been adversely affected or have been positively affected by the pandemic, their STVR plans should be continued. However, the comments below in relation to board discretion should be considered.

Where STVR awards are expected to pay out at some level for FY20, compulsory or voluntary equity settlement (up to 100%) could be considered. However, to avoid classification as a "contribution plan" any election to settle in equity will need to be made now, rather than at the end of the financial year. This should be considered in a more structured way for FY21.

A modern rights plan should include a restricted right alternative, whereby tax and disposal are deferred, but the equity is not at risk of loss (with the exception of malus/clawback). In the case of any additional diversion of cash STVR awards into equity, this type of structure is likely to be "fairest".

For FY21 opportunities, formalised and comprehensive documentation, the use of gates and the inclusion of individual assessment metrics will be important to place the board in a good position to govern STVR during an uncertain FY21.

Long Term Variable Remuneration (LTVR)

Clearly the stock market has been disrupted by the pandemic with the ASX300 falling from over 7,100 point to 4,500 points (>36% drop) even though it has recovered at the time of writing to around 5,100 points (>28% drop). At the same time, earnings for many companies have been decimated and may take a long time to fully recover. These impacts have not affected each company equally with the range being from a major negative impact to a positive impact. In these circumstances the viability of the most frequently used performance metrics (Total Shareholder Return (TSR) and Earnings Per Share (EPS) growth) needs to be questioned.

The key questions that each board should ask are:

a) What performance metrics are most relevant for the company and its shareholders, and

b) Which equity instruments are most appropriate for the company and its shareholders?

In regard to performance metrics, it may be that Board assessment of company and individual performance will be the only viable performance metrics for the next measurement period. Further, service may need to replace performance metrics at least for part of the LTVR grants.

If there is to be a move away from traditional performance metrics then there should be a reconsideration of the types of equity instruments. Perhaps SARs will be more appropriate, either alone or in combination with rights, as they will only generate value for executives if shareholders have benefitted from growth in the share price above the exercise price.

There is no one size fits all answer to these questions, so each board will need to consider its company's circumstances and decide which approach is most fit for purpose.

Formal Board Discretion in Plan Rules is a Key Feature in Times like These

STVR and LTVR rules can never account for all the complexities of real life. However, well-written plan documents for both STVR and LTVR should include formalised board discretion to modify awards due to unforeseen circumstances, both upwards and downwards. Board discretion regarding settlement of awards can also be a useful tool.

A wide range of stakeholders now scrutinise, comment on and influence voting at Annual General Meetings (AGMs). They have made it clear that alignment of variable remuneration and, not only value creation, but also outcomes for all stakeholders, needs to be considered with regards to variable remuneration governance in particular. A key lesson learned in the years following the GFC is that it is no longer publicly acceptable to pay bonuses under STVR plans or vest high levels of LTVR when large numbers of employees in the Company have lost their livelihoods.

The Right Rights

Under the employee share scheme taxing provisions there are two types of rights:

- Rights where the value of unvested and vested but not previously taxed rights is taxed at the date of termination of employment, and
- Rights where the value of unvested and vested but not previously taxed rights is not taxed at the date of termination of employment.

This distinction is critical when unvested and vested rights need to be retained by executives to be:

a) Subjected to vesting conditions, in the case of unvested rights, or

b) Clawback provisions, particularly for executives subject to the Banking Executive Accountability Regime (BEAR) legislation.

It should be noted that rights that are not subject to tax on termination of employment, will become taxable when they are exercised. If settled in cash, then the amount received by the executive is taxed. If settled in shares, then the value of the shares at the date of the termination of employment is taxed in the year of the termination of employment and a shortfall interest charge may apply. Care needs to be applied when drafting the relevant plans rules so as to ensure that the value on which tax is payable by former employees is not more than the value that may be realised on settlement of the rights.

General Employee Salary Sacrifice Equity Plans Improve Cashflow and Profit

Employees who are paid above the minimum rates specified in awards or enterprise agreements may be more open to considering (and may even prefer) to have equity provided in lieu of some cash. This would improve the company's ability to retain their jobs and the jobs of their fellow workers through improved cashflow. Longer term, the company's profitability would also likely improve through substantial increases in tax deductions when the equity is converted to shares. This arrangement would need to be elective (other than in the cases of increases being provided) and can potentially provide employees with more money in the long run than the short term cash they are foregoing. Modern plans can offer capital protection for employees at no cost to the company, which is likely to be a key consideration in addressing employee uncertainty in these times. However, care needs to be taken to ensure that such practices do not fall foul of the Corporations Act and associated Class Orders, since such "contribution plans" are highly regulated.

This approach should not be taken if large numbers of employees are likely to be laid off, since such plans typically involve employees cashing out at termination, and if this occurs in large numbers before the market has bottomed out, capital protection features may result in no benefit flowing to the company.

Conclusions

During this period of crisis and opportunity, boards should be considering:

- The relative values of rights to the value of shares (traditional rights) vs rights to share price increases (options and SARs),
- Converting fixed pay into equity for executives,
- Converting cash fees into equity for non-executive directors,
- Redeploying STVR award opportunities into retention grants and/or additional LTVR grants,
- Changing the performance vesting conditions and/or equity instruments for executive LTVR plans,
- Ensuring that board discretion is contained in plan rules for STVR and LTVR plans,
- Ensuring that the appropriate type of rights is used in grants of equity,
- Consider implementing a salary sacrifice equity plan for general employees, and
- How to communicate the foregoing to stakeholders effectively, including in the FY21 remuneration report.

GRG's experienced consultants and plan drafting professionals can assist with the foregoing matters upon request.