Executive Compensation

Embrace the Use of Discretion in This New Era

By Michael Brittian and Quinn Gooch

So far in 2020, market volatility, economic uncertainty, severe business disruptions, and concerns over employee health have materially changed how leaders approach business planning. These breaks from the norm have and will continue to have an impact on compensation committees' assessments of the performance of companies and their management teams, which necessitates a thoughtful and disciplined approach to applying discretion in incentive plans.

Discretion. The word never fails to provoke strong, often emotional responses from board members, executives, investors, and proxy advisors. While some directors shy away from applying discretion in incentive plans, it might be one of the best tools the board has to restore balance, alignment, and clarity to the appropriate relationship of pay and performance in a time when formulas alone may prove insufficient.

For many years, the United States tax code limited the use of discretion in incentive plans for companies seeking to maximize the deductibility of executive compensation. Following significant changes to those rules at the end of 2017, companies are now afforded increased flexibility to incorporate such discretion.

Despite these relaxed rules, boards continue to favor formulaic and objective incentive plans instead of flexible, discretion-based bonus structures that require more subjective judgments of executive performance. According to Meridian's *2020 Executive Compensation Trends and Developments* survey, discretion as a discrete annual bonus metric is rarely part of the basic design; however, in our experience, discretion is a feature available for use by compensation committees more broadly.

In a typical annual incentive plan, the use of discretion has historically taken different forms, including the following:

- **A discrete, weighted metric**. Discretion is assigned a separate weighted component (e.g., 25 percent) of the annual incentive plan. The component might be purely discretionary based on company performance, or more commonly, based on the performance of individual executives.
- **A performance modifier**. The annual incentive plan is based purely on objective performance criteria; however, after calculating performance results, the compensation committee has the ability to adjust bonuses based on the application of its discretion. This takes the form of a discrete feature, allowing the committee to make upward or downward adjustments within limits (e.g., plus or minus 20 percent).
- **In evaluating overall results**. The committee may adjust formulaic incentive outcomes based on predefined parameters (e.g., mergers and acquisitions, changes in accounting rules, and major unforeseen events such as COVID-19) outside of any specified limits. This may also include subjectivity in interpreting performance outcomes for nonfinancial strategic goals.

Whatever the preferred structural approach, the current environment may empower boards to embrace greater use of discretion in incentive decisions. As committees contemplate this, either in approving decisions for 2020 incentive payouts or in establishing a framework for 2021 and beyond, we offer the following guidance:

- Establish guiding principles that clarify how and when discretion will be applied, centered around a philosophy of informed business judgment.
- Consider the messaging to employees, shareholders, and external stakeholders.
- Set clear expectations up front about what objective data the committee would like to see in order to inform decisions based on discretion and to monitor that criteria and the related incentive plan accrual throughout the year.
- On a principled basis, develop an inventory of potential adjustments to formulaic incentive plan outcomes, particularly when considering adjustments to GAAP metrics.
- Create a framework and process that allow for year-over-year consistency.
- Looking back on significant events that impacted the enterprise, consider how the company responded, its performance relative to peers, and how the company performed prior to the onset of the event.
- Take extra care in considering positive discretionary adjustments when faced with poor formulaic performance outcomes.
- Avoid discretionary adjustments that are overly biased by outcomes outside of company performance, such as retention or actions peers may be taking, and that make up for lost incentive value or opportunity.

Compensation committees will need to embrace the disciplined use of discretion in this new era to appropriately motivate and reward executives' performance in the face of increased volatility and uncertainty.

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