Harvard Law School Forum on Corporate Governance

Resetting Expectations (and Goals) on Stock Price Mega Grants

Posted by Jonathan Katz and Michael Arnold, Cravath, Swaine & Moore LLP, on Thursday, June 30, 2022

Editor's note: Jonathan Katz and Michael Arnold are partners at Cravath, Swaine & Moore LLP. This post is based on a Cravath memorandum by Mr. Katz, Mr. Arnold, John White, Eric Hilfers, and Matthew Bobby. Related research from the Program on Corporate Governance includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

Over the last few years, as many companies (particularly those with a technology focus) went public, either through traditional IPOs, direct listings or de-SPAC transactions, a very popular compensation trend emerged whereby founders and/or CEOs were granted large incentive awards with vesting tied to very challenging stock price goals. These goals often required the achievement of stock prices that were multiples (in some cases many multiples) of the baseline price to yield any value. These so-called "moonshot" awards gained popularity, in part, due to their success at a few high profile companies where incredible share price growth succeeded in unlocking the value of these high-risk/high-reward incentives.

As has been well documented, the share prices of many companies (particularly many of these same tech companies) have declined. These declines have occurred due to one or a combination of factors, such as valuations returning to less frothy levels, macroeconomic headwinds, interest rate increases and/or geopolitical factors. This means that many of these moonshot programs are deeply "out of the money" and Boards of Directors are beginning to grapple with the consequences, including considering how to restore performance incentives to potentially achievable (yet in many cases still challenging) levels to capture the awards' intended effect.

This post summarizes some of the reasons why resetting goals may be desirable, discusses some of the challenges associated with doing so and provides some practical guidance for directors, management or advisors seeking to revisit the terms of the awards.

Business Considerations for Modifying Award Goals

Restoring Realistic Incentives

An incentive award only motivates the recipient if there is a realistic chance that the goals can be achieved. While by and large the moonshot grants made over the past several years entailed extremely challenging growth targets at the outset, the level of stock price growth that would now be necessary in light of the recent swift market downturn (with some companies having lost more than half of their value) may make the goals seem simply unachievable. If viewed in that light, leaving the awards untouched results in unnecessary overhang, an ineffective use of the issuer's incentive share pool and, as described below, may result in a "phantom" accounting expense.

Modifying the goals to lower (yet still challenging levels) would restore motivational incentive and mitigate these other issues.

Avoiding "Phantom" Accounting Expense

Under ASC 718, equity-based compensation is generally valued on the date of grant and then amortized (expensed) over the service period of the award. In the case of stock price-based grants, the awards were typically valued under what is known as a "Monte Carlo" valuation model that measures a multitude of scenarios and the likelihood that the goals will be achieved. In most cases, the Monte Carlo valuation of the awards yielded a much lower valuation than the absolute value the award would have if all goals were achieved due to the low probability of achieving some or all of the goals. However, even with this discount, given the size of these moonshot awards, the initial valuation and accounting expense associated with the awards was typically very large and, in some cases, ran into the hundreds of millions of dollars. Unfortunately, under the accounting rules, the expense for stock price based awards is generally not recaptured or reversed if the award goals are not achieved or are no longer realistic. This means that if the market downturn has indeed made some of these programs unachievable, the issuers will still need to amortize large accounting expenses over the next several years. While it has been the case that many technology-focused issuers report and have been judged on "adjusted" earnings metrics (which add back several types of expenses, including, often, stock-based compensation), market focus is increasingly turning to unadjusted earnings. In that light, unachievable stock price-based awards may prove to be an earnings albatross such that it would prove beneficial to modify the awards so that the expense relates to an achievable, rather than impossible, incentive.

Legal and Other Complexities in Modifying Award Goals

While there are valid business reasons for considering the modification of these awards in light of market events, modification of performance awards is an area fraught with legal, accounting, governance and other complexities. As a result, boards and management will need to analyze the topic from a number of different angles.

Shareholder Optics: "Changing the Rules Mid-Game"

The narrative surrounding these incentive awards has always been that recipients would only benefit if the issuer's shareholders benefited from a significant increase in the value of their holdings, which would provide an incentive to make bold, decisive decisions. Therefore, modifications to the awards that could provide payouts even in light of shareholder losses would most likely be viewed negatively by legacy shareholders, even if necessary to provide a meaningful incentive effect. It should also be noted that shareholder reaction may be different among different groups of shareholders. For example, investors who may have acquired shares more recently at lower prices may not have the same negative reaction to modification as investors who were part of the shareholder base at the time awards were granted. If the awards are modified in such a way that the goals remain challenging but are rebased to represent growth from current levels, executives will still have the incentive to pursue moonshot growth and adjustments may be defensible. Boards and management seeking to alter these types of mega-grant awards should focus carefully on selecting revised targets and crafting of their messaging to reduce the risk of significant shareholder backlash.

Employee Optics: "The Rich Get Richer"

When granted, moonshot awards have typically been made only to founders and/or CEOs. These senior figures have been viewed as able to make the bold, strategic decisions that could lead to significant share price uplift and so are uniquely incentivized by the grant of a moonshot award. Notably, however, the recent share price declines that have made the moonshot awards significantly out of the money have had similar effects on more traditional equity awards offered to other employees, both "rank and file" employees and senior management just below the founder and CEO. Particularly in the technology industry, these equity awards are the key component of compensation and a critical tool for retention in an otherwise highly competitive market for skilled labor. Recalibrating the moonshot awards for a founder or CEO without resetting awards for other employees may be perceived very negatively by other employees. While modifying the targets of a moonshot award may help restore the incentive value of the award for a founder or CEO, failure to accompany the modification with any changes for other employees (or at least a carefully crafted message as to the rationale) may lead to retention challenges at other levels of the company, including among senior employees who may play a significant role navigating a turnaround.

Modification Accounting and Disclosure Implications

Under ASC 718, the modification of performance goals on a stock price-based award is a material modification that will generally require remeasurement of the fair value of the award. Typically, the fair value of the award will be measured immediately following the modification (with the new revised goals) and that new fair value will be compared to the fair value of the award immediately prior to the modification (with the old goals). The difference between the values, which may be very significant, will be expensed over the remaining period of the award. This incremental expense will not only affect the financial accounting for the award, but will also be included in the Summary Compensation Table of the issuer's proxy statement as incremental stock-based compensation in the year of the modification. There are strategies available to mitigate the compensation that appears in the Summary Compensation Table, such as shrinking the size of the award to offset, in part, the modification of the goals, but the usefulness of these strategies will depend on the particular facts and design of the original award.

Note also that changes to the award may trigger a Form 8-K and significant discussion of the rationale for the changes in the next proxy statement. Companies should also carefully consider Staff Accounting Bulletin ("SAB") 120 regarding spring-loading of incentive awards to consider the appropriate timing of a modification to moonshot award targets and that the valuation appropriately incorporates positive future developments as required by SAB 120.

Say-on-Pay and Proxy Advisor Considerations

ISS considers modification to performance goals without adequate explanation and link to performance as a "problematic pay practice." In light of this, explanation of the rationale for any change in performance metrics is critical, yet even with the best of explanations there is a high probability that a change to these metrics will generate an adverse say-on-pay recommendation from ISS, which may in turn lead to a failed say-on-pay vote or adverse votes on certain directors. However, many of the companies that granted these stock-price based awards over the past few years have dual class voting structures and/or are still eligible for transition relief from the "say-on-pay" rules because they are currently or until recently qualified as "emerging growth companies" under SEC rules.