

A year of upheavals and dashed expectations: Executive compensation developments in 2020

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Authors: [Andrew MacDougall](#), [Lynne Lacoursière](#), [Kelly O'Ferrall](#)

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Executive compensation plans were upended in 2020 as a result of the dramatic impact of the COVID-19 pandemic on business plans and the extraordinary measures taken by governments, domestic and foreign, to contain the virus. In addition, employee-friendly Canadian court decisions were handed down in 2020 that are forcing employers to revisit standard compensation practices.

Finalizing compensation decisions for 2020

Most Canadian corporations had set their 2020 short-term incentive performance targets and made their annual long-term incentive grants for the year before the World Health Organization declared COVID-19 to be a global pandemic on March 11, 2020. Within weeks of that determination, lockdown measures in many parts of the world shattered business plans, broke supply chains, plummeted the world into a recession and resulted in a sudden and dramatic drop in stock prices. As a result,

- some corporations initiated salary and short-term incentive compensation reductions or delayed paying 2019 short-term incentive compensation, conserving cash to weather the storm
- the sudden drop in stock prices caused stock option grants to suddenly fall out-of-the-money. Not only did this remove almost all economic incentive, but the decline also had a discouraging impact on employees at a time when extraordinary efforts would be demanded of them
- it was clear that performance expectations underlying incentive compensation decisions made in early 2020 would have to be revisited

In response, boards could consider repricing outstanding stock options or extending the life of previously granted stock options, as discussed in our Osler Update entitled "[Stock option repricing considerations in the COVID-19 era](#)" on osler.com, to address the impact on holders, particularly those unlucky enough to hold options due to expire during the market downturn. However, stock exchange and shareholder approval requirements and tax considerations create significant hurdles to doing so. Proxy advisory firm, Institutional Shareholder Services (ISS), indicated that it will apply its existing case-by-case policy approach to any option repricings. Surrendering options for cash or exchanging them for other types of awards give rise to similar challenges.

Consequently, many issuers began looking at alternative ways to replace or change awards for which the established performance measures were no longer meaningful. Unfortunately, amending the terms of existing equity awards or granting new awards, especially when combined with alterations to current salaries, can result in adverse Canadian and U.S. tax consequences, as discussed in an April 2020 Osler Updated entitled ["Unintended Canadian and U.S. tax consequences of changing compensation arrangements during the COVID-19 crisis"](#) on osler.com.

In many cases, issuers elected to defer decisions about compensation adjustments until later in the year. While markets have mostly recovered from the troughs in the spring, business impacts from the COVID-19 pandemic have been varied. For final 2020 compensation determinations, compensation committees will have to balance

- the need to recognize management performance in circumstances where they are under pressure to preserve operations, protect employees, shore up finances and pivot to new technologies and strategies
 - considerations relating to workforce reductions and pay cuts, if any, otherwise implemented by the issuer
 - signaling of views from proxy advisory firms which indicate a lack of sympathy for performance bonuses or adjustments, except perhaps for demonstrated success on a relative performance basis. By way of example, proxy advisory firm Glass Lewis stated in March that, "[t]he stark reality is that for many workers, including executives, they should not expect to be worth as much as they were before the crisis, because their free market value as human capital has now changed." ISS also indicated in its [Policy Guidance on the Impact of the COVID-19 Pandemic](#) that its benchmark voting policies are not supportive of changes to awards in the middle of a performance period and that any such changes will be evaluated on a case-by-case basis to determine if directors exercised appropriate discretion and provided adequate disclosure of the rationale to shareholders
 - considerations of the impact of temporary market swings, which disproportionately affect compensation outcomes that are based on rigid, periodic triggers, as compared with the longer-term perspective of investors who can defer realization until stock markets recover
- As business plans finalize for 2021, issuers need to carefully consider incentive measures that will be applied next year.

Changing practices in light of tough decisions

Judicial antipathy to standard treatment of incentive compensation awards reached new heights in 2020. Several recent court cases, including one from the Supreme Court of Canada, have tilted the playing field sharply in favour of employees. Additional detail on these decisions and their potential impact on employers is included in [COVID-19 and difficult decisions for employers: Employment challenges in 2020](#).

- Forfeiture provisions: On July 15, 2020, in [Battiston v. Microsoft Canada Inc.](#), the Ontario Superior Court of Justice concluded that forfeiture of unvested long-term incentive awards on termination of employment without cause was "harsh and oppressive," necessitating reasonable measures to make sure the employee was aware of it. The case is currently being appealed to the Ontario Court of Appeal. Osler is acting for Microsoft.

- Damages for loss of long-term incentive compensation: On October 13, 2020, the Supreme Court of Canada in Matthews v. Ocean Nutrition Canada Limited held that exclusion clauses in a long-term incentive plan did not remove the employee's entitlement to a bonus payment upon his resignation or termination of employment, with or without cause, and that the employee could still pursue a claim for *damages*. Although the exclusion clause removed the bonus entitlement, the plan terms did not expressly remove the employee's right to claim damages arising from the loss of the award.

In addition, on June 17, 2020, the Ontario Court of Appeal in Waksdale invalidated a contractual provision applicable to the termination of the employee without cause because the employment agreement provisions relating to termination for cause contravened the *Employment Standards Act, 2000* (Ontario). More details on that decision can be found in our [COVID-19 and difficult decisions for employers: Employment challenges in 2020](#).

In light of these decisions, employers should re-examine the language in their employment agreements, compensation plans and award agreements. Employers should also review their processes and practices for communicating with employees regarding compensation matters, including about the consequences of cessation of employment on outstanding awards.

Compensation decisions for 2020, and disclosure of those decisions in the proxy circulars in 2021, will be heavily scrutinized on all fronts and require extra care and attention. Compensation decisions for 2021 will be made in a very different business and legal environment from 2020. Thoughtful consideration will be required not only to determine the appropriate pay outcomes and performance measures, but also for their documentation and related disclosure.

Proposed changes to taxation of stock options granted on or after July 1, 2021

In the November 30, 2020 Fall Economic Statement, the federal government resurrected its 2019 proposals to change the taxation of stock options. The tax treatment of options granted by employers that are Canadian-controlled private corporations (CCPC) or other non-CCPC corporations that are "start-ups, emerging or scale up companies" is not affected. Non-CCPC corporations with annual gross revenue not exceeding \$500 million would fall into the category of "start-up, emerging or scaled up companies."

For options granted by other corporations or mutual fund trusts, the ability of the employee to take the 50% tax deduction in respect of the option benefit will be subject to a \$200,000 annual vesting cap. The tax treatment of options granted before July 1, 2021 would be unaffected. More details about the proposed changes can be found in our [Fall Economic Statement 2020 Briefing](#).

While the use of stock options for publicly traded companies has declined over time, they have not been eliminated entirely due to the financial benefit to employees of the favourable tax rate. However, a change in the applicable tax rate may further increase the use of performance-based full value awards.