Questions Compensation Committees Must Answer

by Keith L. Johnson and Raj Thamotheram

The proxy focus for 2006 will be on top executive pay. Compensation committees must answer for both the quantity and the quality of the pay plans they approve for executives. Now, with the SEC's proposed new rules demanding greater compensation transparency, committee members will have to answer more questions on how their pay plans drive company value—and just how much *total compensation* adds up to.

Evaluation and compensation of the CEO and management team are amongst the most difficult board responsibilities. Seventy percent of directors report having trouble controlling CEO pay, according to a 2005 survey by PricewaterhouseCoopers.

However, setting executive compensation is also one of the most important board duties. Institutional investors ranked executive pay as the issue of most concern to them in a 2005 Vivient Consulting survey for *Pensions & Investments* magazine. Ninety percent of institutional investors think that average CEO pay is too high, a 2005 Watson Wyatt survey found. Furthermore, investors often view executive compensation as an indicator of a board's effectiveness and its independence.

This should all come as no surprise. The percentage of corporate assets used to pay the top five corporate executives increased from less than five percent of aggregate corporate earnings in 1993 to about ten percent in 2003, with no apparent strengthening of management incentives.

Sixty companies in the bottom ten percent of the Russell 3000 lost $769 billion in market value and $475 billion in economic value in the five years between 2000 and the end of 2004, while paying their top five executives more than $12 billion—an average of $40 million each. Research has also found that poorly designed executive pay plans are linked to increased corporate fraud, management of earnings, destruction of long-term company value, increased rates of bond default and even credit downgrades.

The 2005 Delaware Chancery Court decision on Disney's $140 million termination package for Michael Ovitz, which is currently on appeal, limited directors' protection from liability when they fail to act in good faith. While the Disney court held that the directors did not breach their fiduciary duties or commit waste, it also clearly established that boards will be held to a higher standard of conduct now than just a few years ago. Compensation decisions that knowingly do not advance the best interests of the corporation, show dereliction of duty, or are made with a conscious disregard for director responsibilities may violate the duty of good faith.

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On top of all this, the Securities and Exchange Commission (SEC) announced a new proposal in January 2006 requiring substantially expanded disclosures relating to executive compensation. When the final rules go into effect, probably with the 2007 proxy season, they are likely to mandate providing investors with a greater level of detail about all forms of compensation. This could include salaries, perks, deferred compensation, retirement benefits, termination packages, change in control payments, incentive plans, bonus payments, option or stock holdings and the overall basis for pay plans.

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In addition, the compensation committee will have to explain, in plain English, its philosophy and approach to executive pay. The new disclosures will greatly increase investors' ability to understand and evaluate how well directors are performing their jobs. They are also likely to raise the profile of compensation committees.

The good news for directors in this environment is that effective handling of executive pay can be a good way to establish better relationships with shareholders. Perhaps the most important means to achieve this objective is to build a strong and knowledgeable compensation committee.

While oversight of executive pay plans can be complex, the basics that make compensation committees effective are straightforward. True independence of attitude is critical.

Shareholders look to company boards, particularly members of the compensation committee, as their agents on pay matters. Many shareholders and directors are coming to realize that compensation committees and independent directors should be better equipped to perform their executive compensation oversight responsibilities. As a result, institutional investors' attention is turning from the Sarbanes-Oxley reforms that focused on audit committees, and now seeks to strengthen compensation committees. Savvy directors are doing the same.

While oversight of executive pay plans at a particular company can be complex, the basic concepts that make compensation committees effective are relatively straightforward. First, true independence in attitude is critical. Directors who prize collegiality with company management may have a difficult time assuming an arms-length posture on pay issues, even though they are supposed to act as shareholders' agents.

Indeed, a review of compensation committees reported that more than two-thirds of committee members are current or former corporate executives themselves. Not surprisingly, members who were highly paid in their own positions tended to be more generous with executive compensation. Such personal biases and relationships must be set aside in favor of independent committee judgment.

Second, true independence by the consultant advising the committee on executive pay and performance plans is crucial. The consultant should be hired directly by the committee and do no other significant work for management. This was one of the main recommendations of the National Association of Corporate Directors Blue-Ribbon Panel on Executive Compensation. Conflicts of interest arise when a consultant also reports to the CEO or human resources director while advising the committee on that CEO's compensation package.

The failed audits at companies like WorldCom and Enron, with conflicted auditors simultaneously doing audits and other consulting for the same company, are good examples of the dangers that can come from ignoring conflicts of interest. Some investors even question whether consultants that do most of their business with CEOs can provide unbiased advice on CEO pay to the board at any company.

Finally, in addition to getting information on competitive compensation levels, committees need expert advice on how to link each executive's goals and performance with the company's long-term strategic plan. This might sound easy, but it can involve complex organizational design and performance measurement issues. Development of a successful pay for performance plan requires careful attention to selection of committee members and advisors to ensure that all of these planning needs are covered.

Finding an independent advisor who can integrate a company's strategic business plan and structure with goals and metrics for each executive can be a challenge. Committees should demand prior examples of an advisor's work, including how specific forward-looking performance targets and metrics were used in plans three to five years out. This may help to identify an advisor's actual experience.

Further, even though a consultant has knowledge of executive compensation practices in the marketplace, that does not necessarily mean he or she is up to designing a pay for performance plan that fits your company. Boards should ensure that a repackaged version of some other company's plan is not adopted. An "off the shelf" pay plan that is not integrated with your company's short- and long-term goals should be avoided.

Compensation committee members should ask questions and expect complete, unbiased responses from management and the consultants. Sometimes a well-placed question can be the most effective strategy for a single director to start the process of bringing a problem to the attention of colleagues on the board.

How are specific company strategic goals linked to long-term incentives? If your compensation consultant cannot answer this question, it should raise a red flag.

With new executive compensation disclosure likely to be mandated by the SEC, shareholders will be taking an even closer look at pay plans. Here are questions for compensation committee members that will help you anticipate and deal with issues that investors will ask about in 2006:

☐ *What specific goals in the company's strategic plan are linked with long-term incentive targets?* Any compensation consultant that cannot answer this question and explain how performance hurdles, measurement periods and metrics are aligned with business plan goals is not doing his or her job. That could raise a red flag about whether the consultant is an expert on pay for performance plans.

Correspondingly, boards need to devote time to development and review of the company's long-term strategic plan. This task has too often fallen by the wayside of late due to the pressing demands of Sarbanes-Oxley compliance.

☐ *How are the salary, bonus and incentive components of the compensation plan structured to reward different accomplishments?* A plan that pays an executive more than once for achieving the same goal, or that rewards an executive for operational work already being done by lower levels of leadership, is not making efficient use of capital.

☐ *What is the split of between payment for current tasks and long-term strategic duties for each executive?* In today's changing and competitive environment, most companies cannot afford to ignore the importance of three- to five-year (or longer) strategic planning. Pay plans can help focus management on it.

☐ *Do the specific positions and companies used as benchmarks for the executive compensation result in an "apples to apples" comparison?* All CEOs are not equal, even within the same industry. Executive roles should be matched with jobs that involve similar duties and skills, and compared with levels of performance between companies. Do not seek to match jobs at top quartile levels simply to justify the pay levels being sought. Beware of accepting pay comparables that differ from those used to benchmark company performance without a clear understanding of why the variance is appropriate.

☐ *Does the "all in" annual compensation for each executive reflect everything, including perks, equity awards, related party contracts, in-kind transfers, deferred pay, tax gross-ups and pension benefits?* No one wants to be surprised later by undisclosed rewards or by discovering how much an award was worth. Additional benefits should generally be valued at the amount it would have cost the executive to obtain them in an arms-length transaction from a third party. That is how outsiders will evaluate them.

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☐ *Have all incentive, equity and potential severance awards been valued under baseline, target and maximum assumptions?* Will they be paid only for sustained performance? There should be no surprises that would embarrass the board, especially awards for fleeting performance that can be obtained through financial engineering or earnings manipulation.

Research shows that plans which award excessive amounts of equity based on short-term performance are associated with earnings management fraud. Boards should also be aware of the company's cost of capital. Determine whether a plan rewards management handsomely for results that, while positive, do not provide a real economic return that exceeds the cost of capital.

☐ *How much total compensation has the executive accumulated from the company during his or her tenure?* Cumulative compensation should reasonably match the economic benefits (or lack thereof) generated by each executive over the prior five years or longer. The impact of company stock price movements on an executive's overall wealth accumulated through prior equity awards may overwhelm the effect of other pay plan components.

☐ *Will performance-based payments be recovered by the company in the event a subsequent restatement or adjustment nullifies the basis for which they were paid?* Incentive compensation targets should not be triggered by transitory performance or be susceptible to management manipulation. Companies should consider using extended performance periods before awards are made, as well as longer vesting periods or holding periods after exercise and advance notice requirements for executive stock sales.

☐ *Is the company's succession strategy for key executives integrated with its wider pay plan in a fair and reasonable way?* Internal pay equity often reflects how realistic a company's succession and talent development program is for key executive positions. Huge gaps in pay levels between the CEO and the next level of executives may also indicate the company is exposed to "iconic CEO" risk.

Boards that are consistently forced to look for outside talent to replace executives often have to pay up for it and should carefully re-evaluate the reasons for their failed executive succession plans. An internal pay equity evaluation may help to avoid future problems in this area.

☐ *Could change-in-control payments (if any) operate as a reward for failed performance of the executive?* Shareholders increasingly question whether change-in-control (and similar post-employment) payments are gratuitous transfers of corporate wealth that are inconsistent with pay for performance goals.

☐ *Have previous pay performance targets, time periods and measurement metrics been reviewed to determine whether they remain appropriate?* Changing circumstances can make earlier criteria no longer meaningful and create incentives that result in unintended consequences. In addition, an Act of God or other unforeseeable event may require that the board evaluate effectiveness of the executives in managing through the uncertainties that have made previously set performance targets irrelevant.

☐ *Has eligibility for performance-triggered payouts been verified by an auditor or other source not controlled by management?* Independent verification that incentive pay triggers were met can provide extra protection from management manipulation.

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Finally, directors can often benefit by getting input from sell-side analysts who cover the company and from sophisticated shareholders, especially long-term owners like pension funds or buy-side investors who take a fundamental research approach. Proxy voting advisory firms may also be a good source of information. These market participants have insights on how the company and its executives are perceived by the marketplace that could alert the board to otherwise unforeseen problems.

Contacts with shareholders on compensation issues can also be used to determine what their investment style is and cultivate relationships with long-term shareholders. The Conference Board's Commission on Public Trust and Private Enterprise recommended that companies develop and pursue strategies to communicate with shareholders that have long-term investment horizons.

This can be useful in attracting a strong shareholder base of "patient capital" that reduces the cost of capital and offsets short-term pressures to manage the company based on quarterly investor expectations. One way to facilitate this effort is to highlight the company's commitment to implementing an executive compensation program that builds sustainable intrinsic value and shareholder wealth over the long term.

However, this assumes that a company provides sufficient disclosure on its executive pay program and philosophy to allow long-term shareholders to understand it. Without enhanced transparency on management's financial motivations, it is more difficult for investors to get comfortable with a long-term commitment to the company. The importance of transparency has already been recognized in the UK and the Netherlands, both of which require more comprehensive and forward-looking executive compensation disclosure than the U.S.

Ultimately, compensation committees can take advantage of investors' increased scrutiny by building a compensation plan based on pay-for-performance principles. That should help to attract a stable shareholder base, and align the interests of management with long-term owners around implementation of the company's strategic plan to build sustainable wealth. ■