

# How compensation gets manhandled

*Something in the way boards review and approve executive pay frequently goes awry. To avert these common breakdowns, here are six suggestions for sharpening compensation committee foresight.* **BY ROGER BROSSY AND JOHN BALKCOM**

**T**HE TRAGIC AIRPLANE CRASH is ruled after a thorough investigation to be due to pilot error and only pilot error. How can this be when the craft was flown by an experienced and competent crew? The flight recorder indicates that the problem was not their level of experience and competence, but rather the poor communication and deficient process of interaction between the pilots.

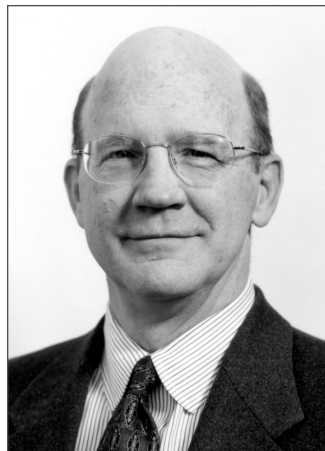
In the same vein, how can the board members of the New York Stock Exchange have voted such outsized compensation for their CEO? Even allowing for the press's misreporting it as a single year's paycheck when some of it was deferred compensation from earlier years — and allowing for the general witch-hunt environment in which previously laudable acts are now considered larceny — just how could a board pay so much money for that job? Experience and competence were clearly not the problem; by any standard of accomplishment and track record, the NYSE had one of the very best boards you could select. But something in the communication and decision-making processes of boards and their committees can

break down, and the NYSE board is not alone.

In our work as management consultants and board advisers — almost 60 years between the two of us — we've seen other boards struggle with reaching good decisions and we've thought about the reasons why. We think the struggles boil down to six different dynamics and six practical tools of resolution.

## 1. The real or imagined domineering CEO

*Situation:* After a hearty round of greetings and getting the coffee poured, the CEO opens the compensation committee meeting. "Shouldn't we get started? We've got a bunch of items on the agenda and just an hour before the full board meeting." The tone has been set: lots to cover, little time, don't take us off track. Motions and seconds are asked for in approving the minutes of the last meeting, and the CEO leads onward as they go tab-by-tab through the three-ring binders that are full of charts, graphs, tables, and legal language. The CEO is crisp and decisive. He knows this material because it is the staff work of his own team, and frankly, some of it's personal. Fifty-nine minutes later, he brings the committee through the last tab, no further questions, and a quick adjournment. Few questions have been asked anyway, and the discussion has been limited to clarification of technical details more than anything.



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*Resolution:* The emergent “good governance” tenets put a tremendous burden on CEOs. We need more than 10,000 CEOs to run the public companies in this country, and we now ask not only that they be strong, decisive leaders capable of “taking the hill” but also that they have the charm and diplomacy to ask for and promote open-ended discussion and the grace to acquiesce to the wisdom and tempered views of a board of directors. Some have it and some don’t, but it is certain that many CEOs who were successful in the old model will be driven to distraction by the new one.

So what to do when a compensation committee is intimidated by a controlling — or seemingly controlling — CEO? Our thoughts on what works:

- Schedule an annual committee discussion of philosophy and strategy, with no intention of addressing plan design. Ask the unasked questions: Does the entire program pass the test of fairness, justice, and transparency? Would the committee be at all embarrassed to have the dollar results of its decisions posted on a bulletin board at the company or a Web site subject to public review?

## 2. Dealing in piece parts

*Situation:* It’s the June meeting and the committee convenes to review and approve annual option grants. The head of HR leads the discussion. “We are recommending a similar number of shares as last year — no increases,” she indicates. “Of course, the amounts of shares we grant by individual have changed as we reflect on the incumbents’ performance and our take on their potential.”

A committee member asks, “I see the number of shares, but what about the Black-Scholes value?” The HR head nods and replies, “Well, we didn’t show those because the values are jumping all around, and we just don’t think they make a lot of sense.” A few eyebrows are raised, but she

hastens to explain: “Our volatility is lower this year than in prior years, and that’s a key input into the Black-Scholes value. We’ve also increased our dividend rate now with the favorable tax treatment on dividends ... and that’s another factor. But the stock price is up since last year’s grant, too. And that changes the Black-Scholes number even more.”

The committee member doesn’t want to let it pass, so he asks that a subsequent analysis be prepared and distributed that shows the Black-Scholes value. “Okay,” replies management, “we’ll have that

for the September meeting when we do the restricted stock.”

The committee approves the motion to accept management’s proposal for stock option grants. Nowhere in their supporting materials have they seen all the elements of pay assembled and added together. In September they will convene to make restricted stock grants. In November they will approve merit increases and target bonus adjustments. In February they will approve bonus payments for the preceding year. Their workload has been thoughtfully spread out over the calendar ... but the big picture eludes them.

*Resolution:* We’ve seen the good intentions of this approach and occasionally wondered about the less-than-good intentions. The solution is straightforward:

- In the first section of the committee book handed out at every meeting, include a table listing the estimated annual value of every element of compensation for the senior management and the rough total annual compensation value. The list of recipients could be as few as a half dozen or as many as three dozen for the large, multi-divisional company. Supplement this table with a listing of the terminal value of compensation under all existing commitments to each executive in the event of termination.

## 3. Banding together against a hostile world

*Situation:* An unflattering article has hit the newsstands. The CEO has asked the compensation committee to convene telephonically so the writer’s attack on the company’s executive pay can be discussed.

“We’re really incensed over this,” he begins. “They’ve completely blown the facts. As you know, none of us made this kind of money last year. They’ve mixed up take-home pay with the theoretical value of our option grants — which, of course, may never make any of us a dime. Then they’ve got this so-called expert weighing in on our supposed low levels of management ownership, and it’s clear he hasn’t even read our guidelines in the proxy!”

One of the committee members can truly feel the CEO’s pain. He’s on two other boards and used to be a CEO himself. He well remembers the year before his retirement when, after not having taken any option gains for his seven-year tenure, he finally exercised a sizeable chunk of his vested options. One magazine put his picture on the cover and made him a poster boy for excessive pay. “Don’t pay any

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*Nowhere in the supporting materials does the committee see all the elements of pay assembled and added together.*

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attention to them,” he advises the CEO. “They can’t get it right, and they’re just looking to sell papers. Ignore it and move on.” The other members assent.

*Resolution:* With attacks or poor reporting from activist groups, proxy advisers, commentators, and the media, there are many potential hostile forces bashing away at a company’s pay practices. This invading force can create a natural banding together of board and management to face down the critics together. To be sure, the press often fails to report pay accurately, activist groups such as the pension funds of some unions tend to pick on a specific issue to the detriment of the bigger picture, and the proxy advisory groups in the big fund companies often use rules of thumb that just don’t work (e.g., “We don’t approve new share authorizations if overhang is 15% or greater”). Nonetheless, as board and management circle the wagons a board member could feel far out of step asking a question like, “Yeah, but let’s take that reporter’s points one at a time and see if there is any merit to any of them.” Here’s what we suggest:

- Have the company annually report to the committee where the company stands or would be evaluated by the relevant constituent groups relative to those groups’ policies. These groups might include the major institutional shareholders of record, unions with a stake in the company’s employment practices, broad-based proxy advisers such as the ISS, and key political or regulatory agencies that might influence or control the company’s important contracts or potential revenue streams.

#### **4. Lob the performance review over the wall**

*Situation:* The committee has convened to review the bonus recommendations for the year just finished. Each bonus is modified by the “performance factor” assigned to each bonus recipient at the management level. The committee starts with a binder that leads them through the assessments one by one, starting with the lowest-level recipients. Out of respect for the committee’s purview on CEO pay, the review factors are shown versus results, but the final score is left blank.

*Resolution:* It’s just plain awkward to reverse an implied performance rating. In this case, the scores given to everyone else might all have to be re-examined if their results roll up to something less, in the eyes of the committee, than what is implied in the binder for the CEO. In effect, management might think they are showing respect by not providing the rating or the pay action that should fol-

low the rating, but in fact they are boxing in the committee by building the recommendations from the bottom up.

Boards and compensation committees are at a big disadvantage if the launching point for their assessment of CEO and top management performance starts with an explicit or implicit answer provided by management. Companies can avoid this by:

- Establishing a process for the committee to review CEO performance before the CEO then evaluates his or her direct reports. An annual calendar of CEO performance planning and review, with regular updates at board and committee meetings, takes the element of surprise out of year-end evaluations, as well as their associated pay and stock actions. It also gives the board the opportunity to formulate a view of CEO performance independent of the CEO’s evaluation of the management team at year end.

#### **5. Setting our own compensation, then yours**

*Situation:* The committee’s first piece of business was to review and finalize a decision on board compensation. Directors had put in considerable unscheduled time during the past year in response to SOX (the latest board-level acronym for Sarbanes-Oxley), the changes in exchange rules, and an unanticipated number of shareholder proposals. The whole board, but especially the audit committee, had been consumed with first trying to chart a reasonable course of action as its long-time auditor, Arthur Andersen, came under intense fire, and then second, having no choice but to find a replacement as that firm crumbled.

Since much of that increased workload looked certain to remain the norm, the committee agreed that its committee chair roles and committee membership stipends needed to be increased.

Finally, with the increased sense of liability and no end in sight to the off-cycle meetings, the committee decided to increase the annual restricted stock grant for all directors. With that decision made, they turned to management’s proposal to add a restricted stock component for the executive team.

*Resolution:* Directors and executives are asked to make numerous decisions in which some conflict of interest may be perceived or felt; such conflict is inherent in the nature of leadership roles. Neverthe-

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### ***What to do when a compensation committee is intimidated by a controlling CEO?***

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less, we believe the potential conflict for compensation committees in setting their own director pay while also setting their executive pay is increasingly untenable. We have come to support the idea of:

- Separating board pay from the duties of the compensation committee. Nominating or governance committees should pick up the director pay responsibility and leave the compensation committee to deal exclusively with executive and other equity-based plans.

### 6. 'Just too complex'

*Situation:* It's the early '80s, when times seemed so much simpler — even quaint — compared to what directors face today. The compensation committee of a large industrial company convenes. The directors to a person are renowned for their managerial and directorial capabilities. One of your authors is also in attendance.

At the start of the committee meeting, the committee chairman calls the meeting to order and then begins reviewing several routine matters that require committee notification or ratification: approval of new options for a few promotions and new hires; review of regular reports of options exercised in the

past quarter by senior officers of the company; updates on performance to date as defined under the company's bonus plan; confirmation of the CEO's having submitted a self-appraisal to the committee for consideration at a later meeting; and so on.

At the end of his recap of these information-only items of committee responsibility, the committee chair pauses, and in the momentary silence another

member speaks up to say: "Is this the point in the agenda when we discuss the long-term incentive plan?" No one speaks up, and the chair seems to nod in the affirmative. "Yes, then I have something I would like to say. I've given this matter considerable thought, and I have deep reservations about this plan. Four years is hardly long-term; the measures give no weight to cash flow, instead focusing on earnings related measures that are subject to many, many exceptions under the terms of the plan; the likelihood is that we'll be asked to approve large payments whether or not the shareholders have benefited in the same way over the period measured; and most of all..." An awkward pause of about 45 seconds ensues, puzzling everyone in the room.

The chair looks quizzically at the speaker, who then sits back in his chair and says with embarrass-

ment, "I'm so sorry. That's the United Airlines plan." The speaker has lost his place in the many meetings he has attended of such compensation committees, perhaps including those of his own company, and has given this committee his critical review of the wrong long-term incentive plan.

*Resolution:* Good governance guidelines now encourage a limited number of directorships. Following these guidelines, the number of directors who might get caught in an "If it's Tuesday this must be XYZ Corp." scenario are limited. Nonetheless, the factors that must be considered in any one company's compensation programs have become more complex. Committee members today must be versed in the current and potential accounting rules for equity-based and long-term compensation forms. They must be sensitive to the balance sheet and dilution impact of equity vehicles. Option valuation models and their limitations must be considered. Changing laws and exchange rules complicate a board's flexibility in making pay program decisions.

While compensation programs should be biased toward simplicity, today's complexities cannot be brushed aside. Here is an action that can help manage the complexities:

- Hold a committee executive session with the company's compensation consultant to give directors the opportunity to "ask the consultant" without management's presence. This allows for clarifying questions that a director fears would sound challenging or mistrustful if asked in front of management as well as for frank assessments and give-and-take on the overall strategy, program designs, and levels of potential value.

### Conclusion: Examine and estimate

The job of compensation committee member has become both harder and riskier. It requires careful study of the company's compensation practices and policies, and it can threaten a director's reputation for integrity and judgment. Regularly examining the underpinnings of the linkage between performance and reward — as well as more accurately estimating future events that may look unlikely (did every member of the NYSE's compensation committee anticipate that the CEO's "deferred compensation arrangements" would be fully calculated and disclosed during their board tenure?) — will give committees and their chairs a means of foreseeing the unanticipated financial outcomes and professional consequences of their decisions and ensure their processes of communication and analysis are up to the task. ■

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*Confusing his board memberships, the committee member gave a critical review of the wrong long-term incentive plan.*

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