Executive Compensation

The Tough Love of Payout Discretion

By Blair Jones

Imagine that you're on the compensation committee of a company at the end of a banner year. The CEO and executive team have exceeded all financial targets by no less than 20 percent. They have hit every milestone for strategic transformation. Their new digital business unit has leaped into the black early with a windfall of revenues in the fourth quarter. Executives can hardly contain their good cheer at the prospect of outsized bonus payouts.

But that's not the whole story. Shareholders have been following news stories about a surge of government regulation in your industry. Some analysts forecast that your sales will drop if regulators have their way. Amid the news, shareholders are carping about a sagging stock price and the potential for an additional loss of stock value. Sound remote? Consider that many companies could be staring down this scenario in a protracted trade war with China.

If you're on the compensation committee, should you exercise discretion to pare back some of the executives' annual bonuses? If you design the compensation program correctly, bonuses should recalibrate for most circumstances without after-the-fact interference by the board. Still, cases will arise, maybe once a decade, where the formulas don't yield payouts that match outside observers' sense of what's appropriate—and the following four situations may yield bonus payouts that just don't feel right:

1. **A publicity bashing.** Management achieves its goals, but the company suffers a reputational hit and the share price sags.
2. **Recalibrated goals.** In a year of lean expectations, you lower the threshold for executives to reap maximum bonuses—but your expectations turn out wrong. In spite of, say, an expected recession, the company turns in much better results than forecast, and for no reason can you credit the CEO or executive team.
3. **A strategy shortcoming.** The company does well because executives failed to follow through on spending to implement a big element of their strategy—a technology investment, for example—reaping outsized profits as a result of reduced capital outlays.
4. **A clouded future.** The payouts come at a time when factors come to light that will hammer next year's results—regulation in our example—and executives have not mitigated the financial risk.

Directors are understandably reluctant to step in and trim bonus payouts based on negotiations settled months earlier. Who wants to violate an agreement made earlier when everyone had the same set of facts? And why would you pull money out of people's hands who have worked for it in good faith? Conversely, people shouldn't get what they don't deserve. How, then, should the board work through the logic of discretionary cuts to pay?

We recommend that boards take three actions. First, directors should iron out policy early. Document how the board will pare bonuses when unexpected circumstances create a misalignment of pay and performance. Admittedly, this calls for directors to make judgments in a gray area. Still, directors must alert executives up front that the board will occasionally take action to override agreed-on formulas.

Second, thoroughly analyze the situation. What was the root cause? Who was involved? What was the historical context? What are leading indicators saying? How and how well has the strategy been executed (or not)? How has the stock market cycle affected the numbers? What are contributing factors nobody could have expected? Try to get an objective view of the source and scale of the pay-performance misalignment.

Third, consider the proper amount of the override. Generally, oversized annual bonuses should be pared back 5 percent to 50 percent. What amount seems right based on your analysis? If you put your feet in shareholders' shoes, what would your gut tell you? Alternatively, how would you have set goals if you knew at the time of the pay plan design what you know now?

An example of the need for negative discretion occurred at Acacia Communications in 2018. After the Trump administration banned commerce with Chinese telecom equipment maker ZTE, Acacia's compensation committee lowered annual incentive goals in the middle of the year to reflect the loss to Acacia of sales to a key customer. Later, the ban on ZTE was lifted and Acacia's sales rebounded. The compensation committee then adjusted the year-end incentive payout to acknowledge that the adjusted plan understated likely performance.

While being fair and being constructive are principles to guide your decision, outsiders need to feel that you treated executives as all employees are treated. People get paid in line with the market and their performance, not in line with the wheel of fortune. That's what shareholders expect. That's what stakeholders who depend on the corporation expect. And that's what good governance should deliver.

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