Higher Court Standards for Setting Executive Compensation

by Mark Van Clieaf

The prospect of a lawsuit on the issue of executive compensation can only be an investor relations headache. Now, courts are expecting more thorough and informed decision making and documentation for calculating executive compensation packages, making the issue even more of an investor relations challenge.

The Old Process Doesn't Work

In this climate, most companies will need to reconsider the process for determining executive accountability and document how they arrive at determining executive compensation. The size, revenue and headcount of an organization have little to do with determining the complexity of a CEO role, how to measure the role's contribution to customer and shareholder value and how to compensate a CEO or other executive.

Surprisingly, only 11% of the S&P 500 have disclosed a time period beyond three years for measuring business (as opposed to stock market) performance, and have linked this to executive compensation.

During the last five years of the economic cycle (boom, bust and rebound), at least 40% of boards have permitted executive compensation to ratchet up to higher and higher levels with no link to sustained business performance and wealth creation for shareholders.

Pay Increased for Head of Compensation Committee

Many members of the board of directors saw their compensation increase for services last year. The pay increase for the compensation committee chair was second only to the increase for the audit committee chair.

Compensation Board Service	Increase
Audit committee head	47%
Committee service	35%
Compensation committee head	24%
All board members	13%

Source: Pearl Meyer & Partners

Executive Pay Trends

Technology and financial brokerage industries had the largest CEO compensation pay changes in 2003. But these changes did not seem to correlate with shareholder returns.

	Average CEO Pay	Average Shareholder Returns
Technology	-36%	+26%
Financial and brokerage	+78%	+37%

Source: Pearl Meyer & Partners

What the Courts Want

Several recent court decisions appear to be refining the well-established duties for directors that relate to executive compensation decision-making. In particular, the following are current hot buttons:

- **Establishing and documenting the process.** There are now minimal procedural standards for compensation committees, and courts will ask whether a genuine process was used – not a check-the-box exercise.

- **Showing that decisions are made in good faith.** Directors must be able to show they exercised good faith in order to rely on the business judgment rule for their decisions – which includes showing they made an effort to be informed.

Fiduciary Duty

In an environment where the judiciary is scrutinizing boardroom activities more than ever, there might be an argument that a board has breached its fiduciary duties if the board cannot show that it has a process to do all of the following:

- Set goals and targets that differentiate operational work from strategic work;

- Differentiate accountabilities and metrics for the top three levels of management;

- Conduct an executive job analysis to define key executive roles and their accountabilities; and

- Use this analysis to match executive roles with compensation so that the board's compensation committee goes beyond just using titles when benchmarking roles.

A board might have difficulty establishing that it was informed when it made executive compensation decisions if it did not even consider the basic, fundamental issues related to executive officer roles and the work for which they are held accountable.

Better Performance Measures

Only through informed decisions about accountability - and *what* they are paying for - can boards and CEOs carry out their fiduciary duty and defend their decisions of *how much* to pay, and create the appropriate linkage between pay and performance.

Without being informed, directors might be found to have acted without good faith and face personal liability – and lose indemnification and directors and officers' insurance to back them up.

Mark Van Clieaf heads the consulting firm, Mark Van Clieaf Associates International. For more information, a detailed article on excessive executive compensation is available at www.mvcinternational.com.