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# An inside look at compensation committees

M Reilly
Dow Scott, *Loyola University Chicago*

# An Inside Look At Compensation Committees

**Mark Reilly**
3C-Compensation Consulting Consortium

**Dow Scott, Ph.D.**
Loyola University Chicago

"The acid test for reform will be CEO compensation. Managers will cheerfully agree to board 'diversity,' attest to SEC filings, and adopt meaningless proposals relating to process. What they will fight, however, is a hard look at their own pay and perks."

*Warren Buffett (2003, p. 18)*

Exploding pay increases for senior executives in the early 1990s brought compensation committees under increased scrutiny. This culminated in the IRS introducing tax codes stipulating that this committee must be independent to claim executive compensation as a tax deduction (Anderson & Bizjak, 2003).

The end of the economic boom of the 1990s and questionable compensation practices of Enron, Walt Disney, Hollinger International and others again have focused public attention on executive pay and the role of the compensation committee. One response to questionable executive pay practices has been the Sarbanes-Oxley Act of 2002 that requires companies to have a written code of ethics to which the chief executive officer (CEO), chief financial officer and the controller must abide. The New York Stock Exchange (NYSE) and NASDQ also have adopted independent director rules for listed companies.

Executive compensation is now highly visible and decisions must be disclosed as well as defended to shareholders, employees, the public and in some cases, government institutions. Because of this heightened public awareness and a stock market that has battered most companies' stock prices, compensation committees face public and shareholder backlash around executive compensation (Gallo, Hellerman & Jones, 2003). Arguably, this has changed the nature of work required on boards and more specifically on the compensation committee.

According to Korn/Ferry International's 30th annual *Board of Directors Study*, 23 percent of board directors on *Fortune* 1000 companies turned down additional board roles in 2002, compared to only 13 percent the previous year. Participants expressed concerns about getting involved in risky situations that could damage their reputations and having enough time to take on more board duties. All of the participants said the amount of time required to fulfill their board duties has increased significantly. Indeed, PricewaterhouseCoopers found that nearly two-thirds of corporate board members reported spending more time on their duties during the past year.

To rectify public outrage of excessive levels of executive pay, and pay practices that are questionable, numerous authors and public figures have suggested changes in the ways that corporate boards of directors operate (Cf. Bebchuk, 2004; Bertrand, 2003; Murphy & Hall, 2003; Reda, 2002). These changes are specifically focused on the compensation committee, the directors most directly involved in creating executive pay packages. These suggestions revolve around increasing the independence of the board and compensation committee from the CEO and senior company executives and increasing the diversity of perspectives on the board. Specifically, it has been suggested that the compensation committees:

- Should be comprised of independent directors
- Should limit the number of boards on which these directors serve
- Should be diverse in terms of perspective and knowledge
- Should directly retain any outside consultants and meet whenever it decides, with no company insider controlling the scheduling or agenda
- Should create pay packages that emphasize performance and do not just reflect market survey data
- Should not create employment agreements that have a term of more than three years and contain "evergreen" provisions permitting automatic renewal
- Should design agreements that allow them to reduce the amount of severance paid for poor performance.

Although many consultants, academics and institutions have weighed in on the executive compensation debate during the past few years, compensation committee members typically do not make public comments about these issues. This article reveals confidential comments from 21 compensation committee members to better understand what they think about the recent changes in regulations and their role, and to determine if the suggested changes are really taking place.

## Interview Process

Even though board members often serve on more than one corporate board, it was a bit surprising that the 21 individuals interviewed serve on 51 different boards. Each participant is currently on one or more

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compensation committees with more than half serving as committee chairman. Each structured in-person or telephone interview lasted approximately one hour. Interviews were open and candid based on a promise of confidentiality.

Questions for the structured interview were developed from a variety of sources that included the more than 50 years of combined experience of the authors, the Conference Board "best practices" guidelines for compensation committees and Richard Breeden's executive compensation recommendations for the new MCI.

The average age of the participants is 59. Eighty-eight percent of the participants in this study are male.

## Findings

### Selecting Corporate Board and Compensation Committee Members

The process and criteria for selecting board members have a major impact on compensation committee independence. The interviews indicated that the chairman of the board, who also is usually the CEO, typically assigns board members to the compensation committee (and other board committees). All of the participants said that the most important criterion for becoming a board member and subsequent assignment to the compensation committee was the person's reputation and character, which is very subjective and often difficult to define. Although guidelines have been established for selecting independent directors, they may not act independently as pointed out by Jeffrey Sonnenfeld (2004).

"Pay more mind to character than to independence. Shareholder activists are pushing for super-majorities of independent outside directors. But independent-mindedness is not the same thing as independence." (p. 11)

With this said, it is interesting to note that only 24 percent of study participants felt that compensation committees needed to act more independently.

Numerous criteria exist upon which selection decisions can be made including knowledge of the firm or industry, personal reputation, financial contacts or relationships and personal friendships. Given the increased scrutiny and recent Securities and Exchange Commission (SEC) and NYSE rule changes, it would seem that the selection process would have become more formally based on objective criterion and have resulted in a more diverse set of board and compensation committee members.

To test this assumption, a number of questions were posed on how individuals were selected to join the boards upon which they served. Although respondents agreed that it is best to get board members who are well known to other board members and the CEO, any appearance of having a close personal relationship, whether in appearance or fact, was a bad idea that could lead to "rubber stamp" board decisions. However, 19 of 21 individuals that we interviewed said the CEO had friends on the board. It is hard to pinpoint the definition of "friend." Although most respondents indicated that they did not have a close personal friendship with the CEO, they said earlier in the interview that they had been selected for the board based on a personal relationship with the CEO or another board member.

Obtaining "compatible" individuals for the board was given as justification for selecting board members who were known to the CEO or other board members. However, one study participant noted what others have pointed out, that frequent social contact between CEOs creates familiarity and a "group think" mentality on the compensation committee (Janis & Mann, 1977). Other compensation committee member study participants attributed lapses in board responsibility at Enron, Hollinger and WorldCom to complacency and "group think." This may be less of a problem in the future since 71 percent of compensation committee members said that search firms are used more frequently now and this has helped reduce the number of candidates with close ties to the CEO.

Although personal relationships are often viewed as having a negative impact on impartial judgments, one cannot ignore the fact that obtaining knowledgeable board members means appointing individuals who have had experience as CEO or as senior business leaders within their industry. The very fact of becoming a senior business leader in the industry means that you have relationships with many other leaders in that industry. Thus, avoiding relationship on boards can be very difficult indeed.

### Number of Outside Boards

Respondents agreed that there should be restrictions on the number of boards upon which they can serve. Of the compensation committee directors interviewed, 75 percent said they regularly turn down offers to be on other boards. They said the amount of time required to be on a board has more than doubled in the past few years. Study participants said that many boards are not worth the possible negative media scrutiny; not even the best board members can prevent insider fraud, which would ruin their hard-earned reputation — which no amount of money or prestige could offset. Fifteen of the 21 compensation committee members said the number of board memberships should be limited for those still working full-time. Institutional Shareholder Services (ISS) provides institutional investors with advice on how to vote on various shareholder proposals and recommends voting against board members on more than six boards.

### Membership Diversity

The directors interviewed believe that a diverse board is desirable, but unrealistic. Participants said there are not enough women and minorities available who have the necessary expertise. Many indicated that it was more important to first get good board members, regardless of background, and to secondly get women or minorities. If, as many believe, women and minorities are not getting the experience needed to be effective on boards, it seems clear that for the full benefits of diversity to be felt, more opportunity must be presented earlier in their careers. Most of the women and minority study participants supported the status quo approach to executive compensation as much as

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the other participants. Regarding industry expertise as a selection requirement, only 29 percent felt that it was an important selection criterion. This is somewhat surprising due to the complex business and financial models used in some industries.

### Relationship Between the Compensation Committee and CEO

The relationship between the CEO and the compensation committee is a source of concern for most experts seeking to increase the integrity for establishing the pay levels of senior executives. Eighty-eight percent of our respondents said the CEOs have a significant role in the executive compensation process. It has been frequently suggested that CEOs separate themselves from the compensation committee to insure the committee will act in the shareholders' best interests. However, CEOs often have been responsible for hiring the compensation consultant to determine their pay level. The vice president of human resources usually manages the consultant's work, which can put them in a position of pushing for higher CEO pay. Recently, governance authorities and experts have recommended that consultants work directly for the chairman of the compensation committee, without guidance and input from the CEO or his staff. Furthermore, it has been recommended that the CEO not be present at meetings of the compensation committee and not set the agenda for these meetings.

Even though these suggestions have received considerable exposure in the press, 88 percent of participants said the compensation consultant still works directly for the CEO, even though 47 percent acknowledge that this may not be a good idea. The sample compensation committee members suggested the CEO's involvement is important because of the desire to link business goals with executive pay.

### Compensation Consultants and Conflicts of Interest

The problems associated with having a compensation consulting firm involved in other aspects of the company's business (e.g., auditing, tax, legal, human resource outsourcing contracts, retirement benefit consulting or insurance) have not received a great deal of publicity. But this issue has caused problems for auditing firms. Arthur Andersen, Enron's auditor, has acknowledged that it did not challenge the financial practices at Enron because it did not want to lose the lucrative consulting contracts that it had at Enron. Surprisingly, interviewees said they are concerned about this potential conflict of interest problem, but not one compensation committee had discussed this issue.

### Market-Based Pay Data

One major element in determining CEO pay is data from market-based pay surveys. Regarding market data, virtually all respondents said their organization targets pay at the 50th or 75th percentile of the market. No one, it would seem, is willing to hire a CEO for less than the midpoint of the market. However, respondents indicated that they were more closely examining market pay data to determine how the peer group was chosen and whether the economics of the business support using the data from suggested peer groups. Seventy-one percent of the participants said they believed that the rapid increase in executive compensation during the past 10 years was due to the "ratcheting up" of survey data that occurs when many companies target the 75th percentile of the survey; this causes the 75th percentile to quickly become the median of future surveys. However, the interview responses suggest that considerable emphasis is still placed on market data rather than company performance in establishing pay levels for executives.

### Executive Contracts and Severance Agreements

Executive contracts and severance agreements have had substantial negative press in recent years. It angers the public, investors and company employees when executives fail to meet performance goals and still receive high levels of pay and incentives. Particularly infuriating are the large severance packages for executives who are fired for poor performance.

"I think that many compensation committees have been very, very lax in the past 10 years in accepting contracts of CEOs without knowing what's in those contracts, and in making payments to CEOs who have failed, and in permitting compensation arrangements where it is easy for the CEO to cash out with large gains just before the stock price collapses," said William W. George, the co-chair of the National Association of Corporate Directors, 2003 Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, and former Medtronic Inc. chair and CEO.

Most of the individuals interviewed do not believe executive contracts should be used. However, they acknowledged that most contracts are negotiated during the hiring process, usually when the board's negotiating position is weakest. Typically, the board is trying to hire someone from outside who can re-energize the company and feels it must provide a competitive package to get that "highly qualified" person.

The Hay Group (2004) reports that 67 percent of executives have a contract that protects them economically if they are fired. The attorney representing the new CEO candidate invariably is in a strong negotiating position and crafts the best possible package. In essence, survey participants say they try to fight excessive contracts, but they must agree to them because it is a common executive pay element.

In addition to rewarding executives who have failed, 29 percent of the participants believe that the combination of executive contracts and large stock option grants have encouraged executives to take unnecessary risks. Executives have the downside protection of the contract and the large upside potential of the stock option grant.

### Pressure from Institution Investors

One group that should have significant influence on executive pay is shareholder groups, such as the California Public Employees' Retirement System (CalPERS). As the largest public retirement system in the United States, CalPERS' board of administration has concluded that "good" corporate governance leads to improved long-term performance. CalPERS also strongly believes that good governance requires the attention and dedication not only of a company's officers and directors, but also its owners. CalPERS is not simply a passive stockholder:

"We are a shareowner, and take seriously the responsibility that comes with company ownership."

Although shareholders like CalPERS are gaining power, their proposals against management typically lose. Most investors make a "no confidence" vote against management by selling their stock instead. Only 12 percent of study participants felt that institution investors should get more involved in the executive compensation process.

## Conclusions

Although corporate boards and compensation committees are under considerable pressure from legislative mandates, stockholders, employees and the public, these compensation committee member interviews indicate that there have been few changes in the actual structure and process followed by compensation committees. It seems clear that Sarbanes-Oxley, SEC and other various outside rule-making bodies have done little to change the actual process that compensation committees use to establish executive compensation. In many cases, committee members believe that they are doing a good job and are currently using a fair process for setting pay levels. Warren Buffett's acid test for corporate governance, the adoption of changes to the process for establishing executive compensation, does not seem to be taking place. WJ

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## Author

**Mark Reilly** is a founding partner of 3C-Compensation Consulting Consortium, a boutique firm located in Chicago and Pittsburgh. 3C's sole focus is on compensation consulting. He is based in Chicago and focuses on executive compensation and incentive plan design. He has 18 years of consulting experience. Before he formed 3C, he worked for large consulting firms based in New York, Philadelphia and Princeton. He also worked for Continental Bank and Ameritech.

Reilly has consulted to companies on total compensation strategy, long and short-term incentive plan design and executive severance. He co-authored "In the Hands of Employees," published in *workspan* (October 2003). Reilly is a frequent speaker and regularly quoted in the *Wall Street Journal*.

Reilly holds a master's degree in finance and marketing from Northwestern's Kellogg School of Management and a bachelor's degree in finance and economics from Boston College. He can be reached at Mark.Reilly@3Ccomp.com.

**Dow Scott, Ph.D.** is a professor of human resources in the School of Business Administration at Loyola University Chicago. His practical approaches to teaching, research and consulting focus on helping business leaders create more productive and satisfying work environments. He has been published in more than 100 journals, books and conference proceedings, and received national recognition for team productivity improvement and human resources research. Scott's research and consulting has focused on employee retention, creation of effective teams, performance improvement strategies, pay and incentive systems, evaluation of HR programs and the development of high-performance organizations. He can be reached at dscott@luc.edu.

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