

# The Compensation Committee: From Competence to Excellence

By David N. Swinford and Matt Vnuk

As compensation committees face unprecedented scrutiny by a host of outside constituencies, many are seeking to elevate their performance from competence to true excellence—advancing from responsible oversight to a more far-sighted kind of decision making that anticipates the long-term needs of the organization and its shareholders. We believe that achieving this distinction requires the initiatives of individual directors as well as the upgrading of processes for setting priorities and ensuring the highest level of thoroughness and care.

The best compensation committees tend to share certain characteristics:

## **An Excellent Committee Is Proactive, Not Reactive**

Directors easily and understandably can be consumed by the ever-growing demands of compliance with regulatory requirements such as Sarbanes-Oxley and expanded proxy disclosure. They also must devote much closer attention to plan details that have proven potentially controversial, such as the timing and pricing of option awards. Nevertheless, the best committees insist on also maintaining an overriding perspective that is forward-looking, open-minded, and focused on future challenges.

It is good practice for committees to devote one meeting each year to an in-depth discussion of compensation strategy and programs in the context of the current and expected future business environment. The discussion should cover key executives' resource needs, current attrac-

tion and retention issues, compensation trends and the adequacy of an organization's short-term and long-term compensation strategy to meet those challenges. On an ongoing basis throughout the year, members should be vigilant about identifying and resolving issues with plans that are no longer appropriate and/or include terms likely to generate needless controversy. Additionally, a proactive board recognizes that transparency is now so fundamental that merely meeting technical reporting requirements may not be adequate. Members also need to provide investors with an understanding of the rationale underlying those decisions. In addition to formal disclosures, committees should have a formal process for responding to investor concerns about executive pay, including what kinds of questions will be addressed, the extent of information it will provide, and the appropriate forum.

## **An Excellent Committee Looks Beyond Prevalence-Based Compensation Designs**

An excellent committee understands that a generally accepted "best practice" may be very wrong for its own company's culture and business strategy. For example, a prevalence-based change-in-control agreement today probably would call for a CEO severance multiple of three-times annual compensation. However, some committees are opting to consider other factors that may suggest a different approach, such as the executive's expected remaining career, the difficulty of finding new employment, and other company-provided economic resources.

## **An Excellent Committee Differentiates Among Executives in Making Compensation Decisions**

Companies should be tracking the likely career paths of their most promising executives, continually assessing what they might be capable of over the long term, providing proper rewards along the way, and helping them build significant ownership in the company. Attention to both succession planning and compensation

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**Director Summary:** When the compensation committee decides collectively to strive for excellence, the rewards are many: better relations with management, a sound public image, improved performance, and greater efficiency. The authors provide a list of critical characteristics for directors to apply to transcend mere competency to achieve a level of superiority.



changes over time can help the board in attracting and retaining a senior management team with the necessary ability, integrity, and drive to advance its strategic priorities.

While companies should consider internal as well as external candidates, the recent experiences of several major organizations that lacked adequate succession planning highlighted the generally steeper cost of importing talent from outside the organization. Additionally, in-house executives benefit from having witnessed the failures and successes of past leadership and generally have a deeper understanding and appreciation of the organization's culture, customers, suppliers, and investors.

### **An Excellent Committee Has Developed Techniques to Assess Performance Goals and Pay-for-Performance Relationships**

All committees worry about whether performance goals are challenging enough to result in competitive or better returns for shareholders. While relative performance is not an ideal goal for every company, committees do need to maintain an awareness of how profits, returns, and key performance drivers compare to the rest of the industry. They also should be mindful of analysts' projections of current performance and of past results at similar points in the business cycle.

If performance is not meeting expectations, the committee should determine why: was it due to company decisions, or to industry-related or other external factors? Executives expect to be paid for performance, but a zero payout that was due to external factors beyond executives' influence will raise issues in award decision making. At the same time, committees must be selective about granting exceptional awards for retention reasons—wholesale exceptions to incentive formulas ultimately will erode the credibility of the entire compensation program.

### **An Excellent Committee Doesn't Negotiate in a Piecemeal Fashion**

Incremental negotiation of executive compensation by boards historically has led to unpleasant surprises down the road. Indeed, several prestigious corporate boards were caught off-guard and targeted by shareholders in recent years following widely-publicized executive severance payouts that had accrued through complex arrangements approved over a multi-year period. The key problem is that, evaluated annually, the individual elements of a complex executive compensation package—particularly deferral and severance agreements—may appear to be reasonable. But committees also must analyze their combined and cumulative impact, including a worst-case scenario of total payouts under all possible circumstances. Tally sheets have become the essential tool

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for tracking values accumulated in multi-part pay programs, particularly for deferred compensation, pensions, and equity holdings. Effective compensation committees are using dynamic tally sheets, which forecast the range of payouts that programs would provide to executives under various performance scenarios. The additional data clarifies the relationship between total compensation, company performance, and shareholder value, particularly with regard to the degree of leverage built into the program.

This approach can also be used to model compensation over time, provided the appropriate caveats about future grants are made. This may prove especially valuable information when recruiting senior candidates and in retention discussions with high-potential managers who are weighing competitive offers they believe represent significantly more value than their current compensation.

### **An Excellent Committee Can Disagree With Management Without Damaging Its Ongoing Working Relationship with the CEO**

Compensation is the classic “hot button” conflict issue, because decisions hit so close to home. Many directors strive to avoid a confrontation with management, even to the point of compromising their decisions. While an excellent committee knows it must stay in charge of the executive compensation process, it also realizes that the “Theodore Roosevelt approach” to diplomacy should be its last resort. Rather, it will navigate potential pitfalls by putting in place a communication strategy and a structured approach to handling disagreements that includes: a sound compensation philosophy; guidelines for when exceptions will be made; good communication between the chair and the CEO; and a recognition that the executive compensation program also belongs to the CEO (after all, the CEO will be utilizing the program to attract, retain, and motivate the people needed to accomplish the company's goals). At times, the communication process may include outside advisors (the consultant or the company's outside counsel) and/or the head of HR who can promote a calm, principles-based discussion between the CEO and the committee if disagreements threaten to become heated.



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### An Excellent Committee Continually Strives to Improve its Performance

Committees should regularly evaluate the job they are doing, their communications with management, and the quality of the support provided by management, staff, and outside advisors. Formal director education programs increasingly offer opportunities for committee members to talk with their peers on other boards about similar issues, providing fresh perspectives and potential solutions to some of the process-related problems that they encounter from time to time. We find that most directors embrace ongoing reviews of new trends and developments in compensation, the views of shareholder groups, and pending regulatory developments. Additionally, excellent committees maintain a specific process for “on-boarding” new members so they can get up to speed as quickly as possible and become full participants in ongoing decision making.

### An Excellent Committee Never Surprises the Full Board

Boards today take a keener interest in the details of the committee’s work as a result of the pay controversies of recent years and the more detailed disclosure of compensation programs now required by the SEC. Committees are providing more detailed reports to the board that often generate more questions and debate than a few years ago. In many cases, the committee chair may choose to preview key issues with other board members, solicit their input, and generally work more offline to ensure that decisions ultimately get the necessary support at the board level. However, these efforts to reach out must be balanced with a recognition of the committee’s need to meet its oversight responsibilities without undue interference from other directors who have strong opinions on pay programs. As with conflicts between the committee and management, the chair’s diplomatic skills may be thoroughly tested.

### Conclusion

The quality of the compensation committee’s work processes and output have come a long way over the past several years. While most have achieved a sound level of competence, raising the bar to a standard of true excellence is likely to result in a more smoothly running and efficient decision-making process—as well as more thoughtful and well supported pay programs, and a healthy working relationship with management. ■

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