Pearl Meyer

ADVISOR BLOG

Is Excessive Board Compensation an Issue or a Diversion?

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Rather than take a general hypothesis and investigate whether or not current facts support it, a recently publicized 2017 study from the *Journal of Corporate Finance* titled “Is Board Compensation Excessive?” has taken a set of historical facts and generalized them to the present-day business environment. The piece states quite broadly that “…overcompensated directors are not necessarily focused on protecting shareholder interests.”

While it includes some exaggeration, it is not a poor analysis of old data. The problem is today’s world is vastly different and the snapshot this study provides of recent history simply isn’t relevant in our current context. Nevertheless, the publication is likely to have repercussions. Directors need to be aware of its premise and take the potential for fallout seriously.

Given the recent indications by ISS and Glass Lewis that they are going to keep a sharp eye on director pay, it is clear that outside monitors are looking for simple criteria they can use to evaluate governance issues. This study provides a natural handle for them to grab on to—the relative level of director pay.

The most recent collective focus on director pay was a number of class action lawsuits of two and three years ago at Facebook, Citrix, and a fairly significant number of other companies. Ultimately, these cases were viewed as a nuisance and as being driven from the plaintiffs’ bar; thus they didn’t actually motivate any widespread cuts in director pay, nor did they really point to any real, endemic issues with board compensation. Many companies implemented limits on either director equity grants or total compensation to reduce the risk of lawsuits.

However, the recent publicizing of this academic study may be different, in large part due to its timing. Its likely influence on proxy advisors and institutional investors to double down on pay levels will have an effect on boards—making it imperative that above all, they not stand out in how they are compensated. Board pay relative to some peer group could become the basis on which effectiveness is measured, making directors vulnerable to accusations of poor oversight based on their compensation, but not on any practices themselves. So while it may spark changes in pay structure, it is highly unlikely to change anything at all about how an organization is actually governed.

To develop a thoughtful deconstruction of the study's conclusions, it's important to look in more detail at two issues: the age of the data and the changes that have taken place subsequent to the timeframe studied.

There is a point on the timeline that marks a pivot in corporate governance—the high-profile scandals of the early 2000s—and the data must be examined with that shift in mind. The study's premise is laid out based on a variety of other studies published between 1990 and 2009. The most recent, put out in 2009, begin to cite data from the 1990s, while the earlier studies are based on historical data sets that drew conclusions about executive pay from data as old as the 1970s and 1980s. The background data supporting the investigation is up to 40 years old.

Further, the authors' own data is difficult to relate to, as the concept of standard deviation isn't applied to the distribution of "over" and "under" compensation, which is central to the research. The authors' data cover 1997-2012; they note that because of the executive compensation disclosure rules implemented in 2006, the measures of director pay are divided into "before and after" periods with findings reported separately. They further note that the problems they cite—the association of high director compensation and poor governance performance—are much more present in the earlier data than in the latter. This makes sense, as it is when regulations caught up with the significant cultural shift in corporate governance that was taking place.

With the highly documented scandals of Enron, Adelphia, and WorldCom in '01 and '02, the problems in governance became too obvious to ignore. The fact is issues like cronyism, interlocking boards, and a reluctance to oust a "good guy" CEO were all facts of life at one point in the history of corporate America. This study has done a good job of mathematically demonstrating the concepts and ideas that we suspected to be true 20 years ago.

But rightful public outrage spurred productive debates and action. In 2002, Congress enacted Sarbanes-Oxley (SOX) legislation that focused on directors' legal liability for oversight. Then the Delaware courts took on a derivative suit by shareholders against the Walt Disney Company over executive compensation and that 2005 decision clearly outlined a board's fiduciary duty of care relative to compensation under the law. In 2006, the SEC implemented new and extensively detailed disclosure rules. The board's required independence from management has become abundantly clear. It is extremely hard to imagine that directors of good character can be bought off with persistently higher than average compensation. The premise of hypotheses such as the one underlying this study is that directors are essentially coin-operated, and we all know that human behavior over time is much more complex than that.

Along with the regulation and heightened stakeholder scrutiny, there has been a grassroots increase in the professionalism of directorship, partly evidenced by the growth of organizations like the American College of Corporate Directors (ACCD) and the National

Association of Corporate Directors (NACD), both of which exist in order to provide ongoing director education and improve board leadership and effectiveness.

What we've seen in practice is that the last 15 years or so have been marked by a sharpening of the "teeth" of legal responsibility and a heightened level of governance consciousness. The problem with the publicity given this paper by respected, high-profile publications lies in the attempt to use old data and old norms of behavior to demonstrate a current problem in a radically different environment.

It would be extremely disappointing to see studies like this one causing a stagnation of director compensation. Perhaps a better question for today's environment would be: what are the consequences of failing to pay adequately to ensure that we attract and retain high-quality, appropriately experienced board leadership at a time when the complexities of running a public company are higher than ever?

About the Author

David Swinford, President and Chief Executive Officer, joined Pearl Meyer in 1998. Dave works closely with boards to link compensation with business and leadership development strategies in order to build and maintain strong executive teams that create value over the long term. He provides a strong focus on developing performance standards, balancing retention with pay for performance alignment, and compensation-related corporate governance issues. For more than 35 years, Dave has worked with boards and management teams in all major industries.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, and Los Angeles.

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