Smarter Compensation

Four basic rules can help boards make better executive compensation decisions

By David A. Bjork

While boards and their compensation committees do a good job of overseeing executive compensation, there are several common flaws in what is otherwise a strong process.

First, committees often don't take time to look at larger governance issues such as compensation philosophy, peer group data and mix of pay. Meeting agendas are so full that members tend to focus only on required actions. The committee manages to complete all tasks for the year by maintaining the program and following precedent, rather than evaluating it and questioning whether past practices are right for the future.

Second, the committee chairman doesn't establish an independent relationship with the executive compensation consultant and instead lets management control the relationship. While committees generally select their consultant and make it clear that the consultant works for the committee, not for management, they often drop the ball at that point. Then, management maintains contact, tells the consultant what needs to be done, and decides which information to show the committee and whether to invite the consultant to meetings.

Third, committees tend to take a casual approach to documenting their process, even though such documentation is the only evidence of the committee's diligence. Too often, minutes don't prove the committee met the requirements for the presumption of reasonableness, and employment agreements, incentive plan documents and even supplemental retirement plan documents are out-of-date and include program details that were changed years ago.

Fourth, many boards and their compensation committees are not prepared to defend their compensation program or respond to questions from the press or medical staff. Instead, they expect staff to handle this. Even though the committee follows board policy and best practices in governing executive compensation, it still needs a clearly articulated rationale to defend its decisions.

Building a Stronger Process

There are four rules for compensation committees that will strengthen governance of executive compensation.

1. Make sure the compensation consultant works for the committee, not for management. This means the committee hires and directly supervises the consultant by explaining the issues to cover, the information to present and how to work with management and itself. The committee chair should develop an independent relationship with the consultant by engaging him or her in planning agendas, discussing issues and reviewing meeting materials prior to meetings. The committee should expect the consultant to attend, in person or by telephone, any meeting in which the committee needs to make significant decisions. It should insist on meeting with the consultant in executive session, before or after meetings, to give committee members the opportunity to raise questions, discuss sensitive issues, provide direction or feedback to the consultant, or test his or her independence and objectivity.

2. Spend enough time on executive compensation to truly understand it. To better serve the full board, the committee should focus on the structure of the compensation program as a whole and understand the total value of the compensation package. One way to do this is to ask for tally sheets that show the total value of all the package elements, including projected liabilities for retirement and severance. The committee should insist on receiving meeting materials, including any recommendations for consideration, well in advance of meetings, and meet at least three times a year. The meetings should give the committee ample time to discuss compensation philosophy, evaluate the overall structure of the compensation program and evaluate the committee's own process.

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3. Thoroughly document the committee's decision-making process in meeting minutes. Make sure decisions about salary increases, incentive plans, goals and benefits are well-documented. Minutes are the only indication that the committee is diligent about following best practices, and they are the principal evidence the Internal Revenue Service will examine in determining whether the committee has met the requirements for the presumption of reasonableness. A good process is useless if the record is slipshod, and weak minutes expose the committee, the board and executives to unnecessary risks.

4. Prepare to defend compensation decisions. The committee shouldn't make any decision it isn't willing to disclose to the board. Even with full disclosure, someone on the board is likely to question the committee's decisions. Consequently, the committee must regularly remind the board of its compensation philosophy, the structure of the program and the process the committee uses so that the board trusts the committee to make good decisions. The committee should be prepared to defend its decisions to the medical staff — not in detail, but in terms of its process and approach to decision-making.

The committee also needs to be prepared to defend its decisions to the media, which typically focus only on total compensation. The committee chair must be able to discuss the principles that justify compensation figures and put them into context. **T**

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