The compensation committee recharged

What's being asked of the committee in the coming year challenges the traditional distinction between oversight and management. How should the members fulfill their expanded role?

BY MARTIN NUSSBAUM

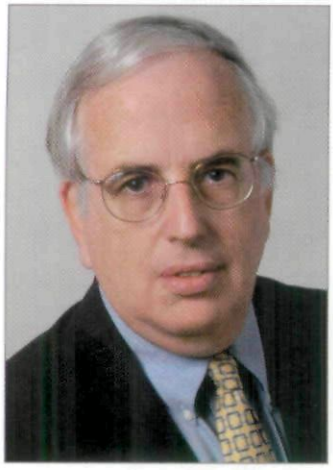
COMPENSATION COMMITTEE members, like their colleagues on the audit committee, are facing higher levels of responsibility and increased scrutiny. The focus on the audit committee intensified with the scandals leading to the passage of the Sarbanes-Oxley Act in 2002. While that law did not impose the same sorts of requirements on compensation committees, it did address certain of the compensation practices associated with those scandals, such as loans, trading blackouts, and bonuses paid on the basis of incorrectly reported earnings. More generally, tonality and approach of SOX has been extended to other areas of governance.

An obvious parallel is the relationship between the compensation committee and the consultants who assist it in making its decisions. Auditors were required to be independent before the adoption of SOX, but the precise delineation was principally a matter determined by occasional SEC pronouncements and self-regulatory mandates. SOX specifically prohibited firms functioning as independent auditors from performing services that had traditionally been deemed acceptable. While there is no list of prohibited relationships that would debar a compensation consultant from performing any particular services, disclosures concerning the compensation committee and the compensation process call for disclosure of the roles played by management and consultants in compensation decisions. To the extent that a consultant is engaged by management to perform services for the company, that too must be disclosed. Such retention of the consultant by management can become a basis for challenging the consultant's independence.

The traditional role of the compensation consultant in working with management to design programs and administer benefit plans may well be bifurcated, with one consultant working with management to create and administer plans and another, working solely for the compensation committee, charged with reviewing compensation and providing advice with respect to market standards. To the extent that such a division becomes the norm, and the number of consultants involved in the compensation process increases, there will be a greater burden placed on small and midcap companies and their boards.

Disclosure ... and more disclosure

Disclosure is also the route that is driving increased involvement by the compensation committee in the determination of compensation. The extent of compensation disclosure has been increasing over the past several years. Initially, expanded disclosure was directed at factual and historical information. There was an increase in the number of tables and footnotes describing the amounts being paid, broken into categories and surrounded by narrative descriptions of perquisites and benefits that did not neatly fit into the tables. With the adoption of a required Compensation Discussion and Analysis (CD&A), companies became required to



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disclose policies, practices, and objectives. This narrative requires a discussion of six mandated topics: compensation objectives, what is intended to be rewarded, each element of compensation, why each element was selected, how the elements are balanced, and how each element fits into the overall compensation structure. In furtherance of this requirement, the SEC lists 15 additional suggested issues for disclosure.

The compensation committee is required to confirm that it has reviewed the CD&A and agrees with its inclusion in disclosure materials. In order for the compensation committee to fulfill this requirement, it must become familiar with the decisions that underlie the compensation process. This level of participation challenges the traditional distinction between oversight and management. While many of the topics required to be disclosed in the CD&A can be addressed, in large part, on a policy level, the 15 topics "suggested" by the SEC reach a level of detail that could well involve participation in the execution of those policies.

The required disclosures undoubtedly provide additional information for shareholders and prospective investors to consider. However, they also provide substantial fodder for critics and the curious. Criticism by activist investors and the notoriety that comes from publicity tend to put greater pressure on the boards and committees that have approved the compensation.

Prospect of litigation

A separate level of pressure on the committee comes from the prospect of litigation. As a general proposition, courts are loath to become involved with and to second-guess compensation decisions. Even when the deliberative process is felt to be far from perfect — absent fraud, self-dealing, or bad faith — compensation committees can take comfort from the continued vitality of the business judgment rule. Cases brought to challenge excessive compensation have thus far created a greater danger of uncomfortable publicity than actual liability.

When, however, the acts of the committee are the central issue of a malfunction in the compensation system, the litigation and other risks are greater. Most notably, the epidemic of option backdating reflects a breakdown in the functioning of the compensation process. While the most egregious cases may have involved actual fraud by members of management who assisted in the administration of the plans and who may have benefited in some way from the backdating, many instances appear to have involved a lack of awareness by committee members of the requirements of equity-based plans and of the accounting implications of option granting practices. The resulting costs to companies of restatements, resulting loss of market value, fines, and legal expenditures have given rise to a plethora of litigation. Even non-activist governance firms have sought to hold compensation committee members accountable through the withholding of votes to impose accountability.

No more ad hoc

The most common and appropriate response of compensation committees is to bring to bear the time and resources necessary to fill their expanded role. There should be an increased reluctance of compensation committees to act on an *ad hoc* or informal basis. Acting by unanimous written consent, while technically permitted by the corporate laws, is becoming a suspect practice. Indeed, settlements with plaintiffs' counsel regularly call for an agreement by the compensation committee to abandon this practice. Similarly, compensation committees are and should be more skeptical about granting awards or making decisions at special meetings, especially those called on short notice. The opportunity for spring loading — granting performance awards on the eve of an event ensuring the attainment of the objectives — has led to a trend to require that compensation committee members generally act at regularly scheduled meetings. There may be clearly understood exogenous events requiring action between meetings, but this should be the relatively rare exception.

Compensation committees can take comfort from the continued vitality of the business judgment rule.

Human resource and compensation experience should be added to the skill sets desired when recruiting directors. While there is not yet a requirement that compensation committees have "compensation experts" like the audit committee's "financial experts," literacy on the part of compensation committee members in compensation practices and consequences should be a focus so the committee can appropriately perform its duties, including the duty to review and understand the elements and background of the CD&A.

And, as noted above, the compensation committee should have ready access to resources to assist it in formulating and obtaining the answers to the questions that diligent directors must be asking in the interests of the company and the shareholders. ■

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