Executive Compensation:
Balancing Business Needs with External Pressure

- by Annette Leckie and Marc Ullman

"This is America. We don't disparage wealth." – President Barack Obama, February 4, 2009[1]

Despite the president's words, we have certainly seen plenty of disparagement of "wealth," at least as it relates to executive compensation. In addition, there is no shortage of advice on how to "fix" executive compensation. Unfortunately, most of this advice assumes a one-size-fits-all mentality. While the principles on which this advice is based may be sound, the application to specific companies can (and should) vary significantly. A board's compensation committee, working closely with senior management, is in the best position to make that determination. At times, actions required may deviate from what is commonly viewed as "best practice." In those situations, it will be necessary to provide additional explanations in the proxy (and possibly directly to shareholders). Knowing when this additional care and attention is needed can help prevent negative shareholder reactions. Some of the more common areas of potential deviation from what might be considered "best practice" include the following:

Defining (and Paying) for Performance:

To provide some additional context for the President's comments noted above, he was encouraging Congress to pass the American Recovery and Reinvestment Act of 2009 (ARRA), which included pay restrictions for banks receiving government assistance. He went on to say "We don't begrudge anybody for achieving success. And we believe that success should be rewarded. But what gets people upset—and rightfully so—are executives being rewarded for failure."[1]

ARRA went on to eliminate bonus pay and put restrictions on the amount of equity-based incentives that could be offered at affected financial institutions. While most banks have repaid the government at this point (removing ARRA restrictions), the Fed continues to push banks to reduce upside opportunity, decrease leverage, and move away from using stock options. Taken to the extreme, this push can completely decouple pay from performance and actually contradict preferences of most shareholders. Even outside of financial services, boards come under criticism for above target awards when pay doesn't line up with recent total shareholder return, even if operational performance is strong.

Most pay-for-performance analyses necessarily focus on hindsight measurement relative to peers over a multiyear period. However, the view is retrospective; if a disconnect is found, it can only be fixed going forward. To establish and maintain ongoing pay and performance alignment requires disciplined incentive plan measure selection and appropriate targets and payout ranges for those measures. The best designed incentive plan in the world will not deliver pay and performance alignment if the measures are wrong or if the targets and ranges are not set appropriately.

Using Discretion:

In a recent Meridian survey, a minority of companies reported using discretion in annual bonus determination. This practice tends to be more common in financial service organizations where it is regarded as a best practice standard among many leading oversight and regulatory bodies. Regardless of industry, rigid pre-set goals can quickly become irrelevant as capital market conditions and the competitive landscape change during a year. Executives could end up with a financial incentive to do exactly the wrong thing in light of such changing circumstances. We know from our interactions with hundreds of compensation committee

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[1] Remarks on Executive Compensation with Secretary Geithner, Feb. 4, 2009.

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members that they want to do “what’s right,” but often feel constrained by the need to abide by a formulaic approach to incentives. Proxy advisory firms believe that annual incentives should be formulaic with fixed goals and ranges (regardless of industry) and will often criticize committees that exercise any form of discretion.

Informed use of discretion may be appropriate and even required in some situations. Compensation Committees should feel free to exercise that discretion (both upward and downward) when necessary. This use will, however, require significant discussion in disclosure materials explaining rationale and why they believe it actually enhances (rather than undermines) pay and performance alignment.

One-time awards:

Used judiciously, special one-time awards can motivate, aid in retaining key talent, ease a transition, ensure smooth succession and ensure appropriate pay for actual performance alignment. However, proxy advisory firms often take a dim view of special awards made without strong performance requirements attached. Their opposition in some cases has led to significant fall out in Say on Pay vote outcomes as well as director elections. Therefore, compensation committees must balance these external views (and potential ramifications) against the immediate needs of the business. These immediate needs may warrant going against the grain as long as there is demonstrable business rationale, awards are made selectively (i.e., not to the entire executive population) with appropriate vesting conditions, and awards are not made often.

Appropriate goal setting:

Setting appropriate goals is one of the most challenging issues facing boards and Committees. Often significant analysis, modeling, and deliberations go into final performance targets and payout ranges. Unfortunately, these performance goals can be second guessed by proxy advisory firms, especially if they do not represent significant improvement over prior year actual performance. While this principle may sound appropriate on the surface, there are situations when significant year over year improvement may not be possible, or even prudent, based on a company’s strategy, life cycle or market conditions.

The current governance climate places heightened demand on directors to explain their decisions concerning executive pay. It has become critical for committees to validate incentive plan targets and ranges even when they represent significant stretch over prior year performance, and ***especially*** when they do not. This validation can come from multiple perspectives, including recent company performance, strategic aspirations, relevant peer group performance, analyst/shareholder expectations, and long-term impact on value. The simplest approach is to compare proposed targets and ranges to historical financial performance. However, goals also need to be aligned with achieving long-term strategic objectives. Sometimes these strategic objectives require large investments that may dampen short-term results. Examining proposed targets and ranges for each measure against the company’s longer-term strategic plan is essential for shareholder buy-in and for the long-term vision to become a reality.

In Summary

While it is important for Compensation Committees to understand prevailing wisdom around “best practice” standards, and to have a thorough understanding of proxy advisor vote guidelines, they should always put the business needs of the organization and value creation for shareholders first. Sometimes, this may put the company’s Say on Pay vote, and potentially committee members, in the cross hairs. However, a well-articulated business rationale in the proxy, along with proactive shareholder outreach when needed, should help the company through any short-term turbulence. Over the long run, informed business judgment will be more likely to improve long-term value than a rigid adherence to these “best practice” standards.

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Annette Leckie is a Partner in Meridian’s Boston office. Marc Ullman is the Lead Consultant in Meridian’s New York office. Additional information about Meridian can be found at www.meridiancp.com