Reprinted with permission of the publisher: the National Association of Corporate Directors (NACD), 1828 L Street, NW, Suite 801, Washington, D.C. 20036, 202-775-0509, www.nacdonline.org

Director Liability for Compensation Decisions: How Much Is Too Much To Pay?

By Lee E. Miller

There is a common misperception that CEOs are paid more than they are worth and that board members are too beholden to the CEOs of the companies they oversee. Those misperceptions, along with the recent instances of some CEOs receiving huge compensation packages at the same time that their companies and shareholders were suffering huge losses, have led Congress and the courts to seek more accountability from the directors responsible for setting the compensation of a company's top officers.

The problem with this newfound interest in how executives are compensated is that neither Congress nor the courts are well suited to deal with these issues. Some of today's problems can be traced to 1993 when Congress passed tax legislation designed to curb "excessive compensation of top executives" by limiting the deductibility of pay in excess of $1 million. In order to encourage rewarding those executives who actually delivered results for their companies, however, performance-based pay was excluded from that limitation.

As so often is the case with legislation, the law of unintended consequences came into play. Since stock options did not count against the $1 million limit on wages nor were they deducted from corporate profits, they quickly came to dominate CEO compensation. In a rising stock market, such as the one we experienced through most of the 1990s, options increased dramatically in value. So when the inevitable recession arrived, we saw executives enriched by exercising options shortly before their companies and shareholders suffered huge losses.

Since legislation has failed to achieve the desired results, the courts are likely to step in, but they are no better suited to regulate corporate compensation than Congress. The chief justice of the Delaware Supreme Court recently warned of potential liability for corporate directors who fail to exercise appropriate oversight of executive compensation. Courts by their nature are backward-looking. While they are supposed to judge cases based on contemporaneous information, it is virtually impossible to ignore knowledge about how things actually turn out. And where juries are involved, a general bias against big corporations and an antipathy toward large CEO compensation packages inevitably surface.

This is not to say that boards of directors have not made huge mistakes in terms of executive selection, oversight, and compensation. Many of the corporate tragedies we have seen in the last two years are the result of poorly designed compensation packages that encourage executives to employ financial maneuvers that maintain and increase the stock price in the short run at the expense of creating real value over the long term.

The increased attention being paid to director oversight of compensation decisions raises two questions:

1. ***How do you avoid overpaying your top executives, particularly when they are not delivering results for the company?***
2. ***How do you as a director avoid liability if, despite your best efforts, the CEO and other top executives do well while the company, its employees, and its shareholders suffer?***

The answer to the first question is fairly straightforward, at least in theory. When you want to motivate certain behavior, align compensation with the results you are seeking to encourage. If you want your company to outperform your competitors, pay your executives based on how well they perform against those companies in terms of specific measurable criteria.

If you want to make sure that your executives do not manipulate the system by, for example, boosting

Director Summary: Compensation committees need to find ways to avoid liability if executive performance is not commensurate with pay. Choose committee members wisely; offer them training; and ensure that any consultant hired is skilled in negotiation.

short-term results at the expense of the company's future growth, ensure that the performance measures you select, as well as the form of the compensation, reward long-term growth. If you award stock options, require that they be held for a lengthy period following exercise or, as some companies have recently begun to do, award restricted stock but do not let the recipient sell those shares until he or she retires.

If the answer to the first question is so obvious, why do we need to address the second question at all? Because while it is easy to articulate the principles, actually determining the performance measures that will ensure the desired results at any given company in a rapidly changing business environment is not. More importantly, even if you could devise the perfect compensation package to provide your CEO with the right incentives, you have to get the CEO to agree to accept that package. There is the rub. It's not about designing the right compensation plan but about negotiating it.

Get Help With Negotiations

How then can directors ensure that the compensation packages they approve are the right ones to grow the company and also protect themselves from potential legal liability? By recognizing that compensation packages are the result of negotiations between the company and the executive.

Most board compensation committees recognize that they need help in designing compensation packages. There are three places one can look to for the needed advice and expertise: the members of the compensation committee, the head of human resources, and/or outside consultants. Each brings a different perspective and different strengths to the process.

Start With the Committee

In some ways, selecting the right members to serve on the compensation committee is your best defense. They are the individuals, subject to review and approval by the full board, charged with the responsibility for making compensation decisions that will either help or hurt the company and which may ultimately have to be defended in court. They are, or at least should be, knowledgeable both about the company's specific needs and the available options to meet those needs. Once selected, they should be provided with advice and training concerning the compensation issues facing the company.

Too often, however, the members of the compensation committee lack sufficient expertise in compensation and employment negotiations. Most committee members are current or former CEOs, who while they tend to be excellent negotiators, are often only familiar with the way their own company compensates its employees.

Turn to Human Resources

The compensation committee can also look to the company's head of human resources for guidance. Generally, however, HR does not deal with the CEO's compensation or that of other top executives. Moreover, the head of human resources is not a disinterested participant. His or her compensation will be directly affected by the way other senior executives are compensated. Often, the company's HR chief is too closely aligned with the CEO to give truly independent advice.

The Role of the Consultant

That brings us to consultants. They can provide the necessary expertise in compensation design and negotiating. However, as they are ordinarily hired by the CEO or the head of human resources rather than the board and do other work for the company, they may be perceived as lacking the necessary independence and be subject to attack on that basis. Moreover, their role is often limited to making recommendations as to compensation structure or providing survey data. Many have never actually negotiated a compensation package themselves. Often they are not involved in the negotiating process beyond making initial recommendations, after which the company's attorneys, headhunters, and/or members of the board negotiate the package. Properly selected and utilized, however, consultants can help devise and actually negotiate the right compensation package.

Even if the board does what it is expected to do in terms of overseeing executive compensation, there will be times when a CEO and/or other senior executives will receive compensation in excess of what might seem appropriate in light of the company's performance at that moment. That is the consequence of having to negotiate employment packages with candidates who have other options available to them.

Sought-after candidates are able to negotiate compensation packages that reward them well if things go as hoped and protect them if they do not. As long as members of the board keep that in mind, they will be able to design and negotiate compensation packages that encourage long-term growth and protect them from liability if things do not work out. ■

Lee E. Miller, a Harvard Law School graduate and former senior vice president of human resources at TV Guide, is the managing director of NegotiationPlus.com and an adjunct professor of management at Seton Hall's Stillman School of Business. He is also author of *Get More Money on Your Next Job* (McGraw Hill) and, along with his daughter, co-author of *A Woman's Guide to Successful Negotiating* (McGraw Hill). He may be reached at negotiate@earthlink.net.