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Process and Outcome:

New Clarity in Achieving Reasonable Executive Compensation

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One common legacy of the dot.com boom and various corporate scandals of the last few years is regulators' new focus on responsible corporate governance, specifically on reasonable executive compensation. In fact, the New York State Attorney General's complaint against the former chairman of a major non-profit NY institution was a sharp reminder, if one was needed, that the debate over what constitutes reasonable compensation will be neither private nor leisurely. Whatever the outcome of that action, legislators and regulators have made one thing clear: there will be no quiet return to "business as usual."

The New York State Attorney General's complaint against the NY institution's former chairman and the head of its Compensation Committee seems designed to send a broad message to corporate directors everywhere about excessive executive compensation. It's more than this case's jaw dropping numbers that make it a perfect object lesson. On one hand, because we are talking here about a non-profit institution, its compensation practices are subject to a somewhat less ambiguous standard of "reasonableness" than is the case in the for-profit world. On the other hand, no one mistakes this particular non-profit for the many charitable and humanitarian organizations that share that designation. Thus, whatever lessons come out of this case are as applicable to for-profit boardrooms as to the non-profit sector. One of those lessons may be, at long last, a widely accepted definition of what constitutes reasonable executive compensation.

This paper explores the idea of reasonable compensation, presents a brief history of legislative and judicial interpretations of the concept, and — most important for directors and executives faced with critical decisions about compensation practices — summarizes the practical application of this information for today's boards.

DEFINING REASONABLE COMPENSATION

What is reasonable? Most people agree that reasonable is neither excessive nor extreme. Common sense, sound thinking and logic bind it but not obsessively. So far, so good.

Unfortunately, while there's general agreement on the definition of reasonable, there are wide variations in applying that definition. What seems like common sense and sound thinking to staunch conservatives may seem absurd to committed liberals. At least on certain issues, men have (it has been pointed out to us on occasion) a substantially different view than women of what is reasonable. Unionized workers and corporate executives may each claim the reasonable label for widely different views.

The interpretation of reasonable is especially subjective when money is involved. Ask a cross-section of Americans whether \$10 million a year is reasonable compensation for a CEO, and the answers will almost certainly cover the spectrum from "why not, if he/she can get it" to "throw the bum in jail." The same is true for "excessive," the polar opposite of reasonable: what seems excessive to you may be just right for me — or even, perhaps, not enough. The pursuit of consensus on what constitutes reasonable executive compensation has persisted, off and on, for decades. During boom periods, debate over excessive compensation seems to disappear only to reappear during recession, when our collective attention quickly re-focuses on those we suspect are "making out like bandits." At times like these, we look to our legislative and judicial systems to confirm or deny our suspicions.

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LEGISLATING REASONABLE COMPENSATION: A BRIEF HISTORY

A patchwork of federal regulations and case law has attempted to define reasonable compensation. Although these efforts have not been particularly successful in replacing subjectivity with clarity, some recent cases reflect a developing consensus on criteria that compensation committees can apply to their executive compensation decisions.

This consensus began to emerge in the late 1990s when the focus turned from the reasonableness of outcomes — the amount of compensation the executive received — to the reasonableness of the process that ultimately determined the amount of compensation. Put more concretely, the Courts concluded that, while it might be impossible to get a consensus on the reasonableness of that \$10 million compensation package, it might, indeed, be possible for people of good will to agree that the process that produced it was, itself, reasonable.

In the meantime, Congress had made little legislative progress. Section 162(a)(1) of the Internal Revenue Code (IRC) permits a deduction for “a reasonable allowance for salaries and other compensation for personal services actually rendered.” The Code further defines reasonable as “the amount that would ordinarily be paid for like services by like organizations in like circumstances.” The focus of reasonableness here is still on the outcome — the “salaries and other compensation,” although the reference to amounts paid by like organizations implies an endorsement of a process for setting compensation levels.

Theoretically, 162(a)(1) should have spawned case law that would have provided greater clarity to reasonable. However, while the courts have addressed many subsequent cases, they have been reluctant until recently to suggest common criteria or “tests” of reasonableness.

Congress further complicated the picture in 1992 when — in the midst of an earlier recession — it entered the fray to pass the Budget Reconciliation Act. One component of the Act was the addition of Section 162(m) to the IRC. This section states “no deduction shall be allowed under this chapter for applicable employee remuneration to the extent that the amount of such employee remuneration for the taxable year with respect to such employee exceeds \$1 million.” This cap applies to the CEO and the four other highest paid employees, and stipulates that only performance-related compensation above \$1 million will be deductible.

This stipulation is famous for generating one of the most spectacular unintended consequences of all time: instead of limiting executive compensation to a reasonable \$1 million, the “performance-related” exception opened the door to the undreamed-of income-generating possibilities of stock options in a boom market. The limitations of focusing the debate on outcomes was by now clearly apparent.

In 1996, Congress tried again, with better results, passing the Taxpayer Bill of Rights II. Among its several provisions was the addition of Section 4958 to the IRC. This section of the Code, known as Intermediate Sanctions, targeted the tax-exempt organizations defined in Sections 501(c)(3) and 501(c)(4). It allowed the IRS to impose financial penalties on non-profits that engage in “excess benefit transactions” for “disqualified persons.” An excess benefit transaction occurs when a disqualified person (an officer, director, trustee, or similar individual) receives a benefit that exceeds the value of his/her services. For instance, an excess benefit transaction has occurred when a disqualified person’s compensation is above fair market value, or unreasonable.

What is especially interesting about Intermediate Sanctions is their interpretation by the IRS. A recent IRS training article by Leonard Henzke, Jr. and Lawrence M. Brauer introduced the concept of the “automatic” excess benefit transaction. Such automatic transactions may occur when an exempt organization does not satisfy the “written contemporaneous substantiation” requirement. This requirement is satisfied if the organization provides written validation that is simultaneous with the transfer of the benefit provided. Contemporaneous substantiation includes reporting the benefit on the disqualified person’s Form W-2 or Form 1099.

The article goes on to describe how a penalty will be imposed on an automatic excess benefit regardless of whether or not the benefit provided was reasonable.

Something important is happening here. Compensation may automatically be deemed excessive, regardless of the amount, if the organization does not follow proper documentation and reporting procedure. In other words, an appropriate, standardized process, rather than the outcome, is what confers reasonableness.

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Two recent court cases have added further dimension, if not clarity, to the reasonableness discussion. In *Dexsil Corporation* (2nd Cir., 6/3/98), the court used a framework of five previously established “factors” and two new tests to decide compensation reasonableness. The factors, which the court declared to be too vague when taken alone, nevertheless form the foundation of the evaluation.

They are:

- The employee’s role in the company;
- The rate of pay for similar positions in the external market;
- The fiscal integrity of the corporation;
- Any conflicts of interest in determining compensation; and
- Equity of how the compensation philosophy is applied throughout the organization.

What made *Dexsil* different are the two new tests the court added to this mix:

- The “Independent Investor Test,” which asks whether a hypothetical investor would agree with the compensation considering dividend history, increase in stock value, and company net worth; and
- The “Contingent Compensation Test,” which requires that incentive compensation be based on a formula that is applied consistently year after year.

These tests search for reasonableness in both outcomes and process, although the emphasis is noticeably shifting toward process. There is no arbitrary line dividing the reasonable from the excessive; however, there is a clear implication that if the outcome is based on a system that incorporates market competitiveness, equity, consistency and predictability, it will likely be deemed reasonable.

The following year, another court chose a similar path in *Exacto Spring Corp.* (7th cir., 11/16/99), reiterating that both factors and tests (in this case, the Independent Investor Test) have roles to play in determining reasonable compensation.

These cases suggest that, finally, courts are beginning to develop a consistent approach to interpreting reasonable compensation. They are looking at the process used to determine pay levels, focusing less on “how much?” and more on “how?” This shift confirms that the critical issue for executive compensation is governance.

PRACTICAL APPLICATIONS: LESSONS FOR THE COMPENSATION COMMITTEE

Case law has not yet provided any black-and-white rules for reasonableness, but it does provide a clear set of indicators that the future belongs to good governance. The Compensation Committee of any organization — non-profit and for-profit alike — should be asking some key questions about the process of determining compensation:

- What is the core role of the employee in the company and how does he/she influence its strategic direction?
- How much do comparable organizations pay employees for comparable jobs? How do these numbers align with the company’s stated compensation philosophy?
- What is the advice of our independent compensation consultants, and how did they arrive at that recommendation?
- How has the organization performed over the period in question, and what would a hypothetical independent investor say about that performance?
- Can the independence of the Compensation Committee be confirmed?
- Is the process for establishing compensation levels fully documented?

The core lesson here is that reasonableness does not reside in the amount, but in the process through which compensation decisions are made. Many organizations can address concerns about excess or unreasonable compensation simply by establishing better documentation and review standards. For others, it may require a more fundamental assessment of corporate governance policies affecting compensation. They may need to create an independent Compensation Committee or invite independent advisors to review current pay levels and policies.

Rules of the Road to Reasonableness

Reasonable compensation depends on the facts and circumstances relating to the position, the person and the organization. You can take several steps to ensure that you are able to address any questions that may arise about the compensation of executives, physicians or employees.

1. **Adopt a compensation philosophy** and policy statement about the “how and why” of your rewards program. This roadmap for decision-making communicates to everyone what is included and excluded from the program. Align your philosophy statement with your vision, values and mission.
2. **Establish collateral policies** on ethics and decision-making (Compensation Committee charter and a conflict of interest policy). The rules should define what compensation issues are covered and who can approve changes. For example, the Board may reserve for itself compensation decisions relating to the “top five” and delegate all other compensation decisions to the CEO. In addition, the Board should also have policies on approving reimbursements for travel or other business expenses, the use of organization assets, and on general business practices.
3. **Define the market** from which you will recruit different types of talent in various ways. Some examples:
 - **Nationally** — We will recruit our top executives from anywhere in the United States.
 - **Regionally** — Our executive market encompasses an area within 100 miles of our corporate office.
 - **Specific areas** — We will recruit our talent from a pool of large metropolitan areas, or we will recruit our executives from mid-sized markets.
 - **Industry or roles** — For our technology roles, we will recruit from health care and health care-related organizations.
 - **Talent pool** — We seek executive talent from a pool of candidates ready to move to the next higher level of accountability.
4. **Organizations are at different states in their existence:** growth, decline, steady, or regeneration. Each state demands a different type of talent. In some cases, a specific person with unique capabilities may require you to set a compensation level at variance with the philosophy. For example, you may need a physician to lead a critical service line with demonstrated experience that raises the bar from what would typically be required. This may mean that you will need to pay a premium. If this is the case, state it in the candidate selection criteria to ensure that you are remaining true to your compensation philosophy.
5. **Define the elements of the reward package** — The entire compensation package should be communicated both in terms of cost and value. Cost is what you pay. Value is what the participant will receive. In many cases, cost and value are the same. The biggest difference is with retirement. Some organizations use funding vehicles, such as insurance products or investments to provide a benefit. You should communicate what the organization is paying for the benefit and what the individual will receive, along with how the reward package aligns to the mission, values and vision of the organization.
6. **Document your decisions** — It is difficult to resurrect your thinking two or three years after the fact. Create a record of what you are doing, and why and when you do it. The documentation should include a summary of the issues, the subsequent discussion, and a record of each board member’s vote.
7. **Inform the board** — The Selection or Compensation Committee should inform the board of trustees about compensation decisions. This is typically done annually when changes are made or as new members join the board. You should document any discussion and, if there is a vote, record each board member’s vote.
8. **Avoid conflicts** — Your executive compensation consultant should be above reproach. But it is sometimes impossible to avoid the appearance of a conflict. The best example is a firm that advises on executive or physician compensation and also provides substantial services or products to support the executive compensation program. Insurance providers are a case in point. If you elect to use the same provider for executive compensation advice and insurance, get a second, independent compensation expert, to render a “compensation reasonableness” opinion.
9. **Assess compensation “governance” practices** — Have an independent advisor review your governance practices, particularly as they relate to conflicts of interests, “disqualified persons,” documentation and similar areas to ensure that you are “state of the art.”
10. **Get a reasonableness opinion** — Your compensation advisor should produce a written compensation reasonableness opinion. Along with counsel, this opinion should provide the documentation necessary to ensure that you are in a rebuttable position if the IRS ever questions the pay package.

A good first step is to document everything related to the topic including:

- The organization's compensation philosophy;
- Compensation strategies;
- Incentive plans, and especially their performance measurement components;
- Benefits plans (including all non-qualified retirement plans);
- Compensation Committee minutes;
- Executive employment agreements; and
- Compensation reviews performed by independent advisors.

Documentation can demonstrate that compensation decisions are not arbitrary. It can also help reveal any areas of compensation administration where the organization may lack the internal resources with the requisite expertise to help the Compensation Committee achieve the necessary standards of good governance. Although this is not an issue for most large public companies, smaller, for-profit organizations and many not-for-profits may not have the internal expertise to meet these higher administrative and documentation standards. It is critical for these organizations to seek counsel from independent advisors who can fill these gaps and provide the necessary level of professional counsel.

A CONCLUDING WORD ABOUT THE NEW YORK CASE

The huge numbers involved in the New York case — \$130 million or more — seem, on the surface, to return the reasonableness spotlight to outcomes. But a closer examination of the complaints confirms that, while the numbers are indeed eye-popping, it is the underlying process that is at issue.

Commentator's criticisms of the former chairman's pay package are typically most concerned with the process — or lack of it — by which compensation decisions were made by the Board and its Compensation Committee. It is the allegations of cronyism, intimidation, conflict of interest, lack of information, and anear-total absence of "due process" that will linger in the public consciousness long after the specific amounts involved are forgotten.

The lesson for other organizations and their Compensation Committees is clear: while the public debate about excessive executive compensation may have brought us no closer to a universal consensus on how much is too much, we have clearly arrived at a point where common standards of good governance are emerging. Adherence to those standards, most of us agree, will produce results that are at least acceptable. Failure to meet them, however, will put the offending organization beyond today's boundaries of reasonableness.

ABOUT THE AUTHOR

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