
Viewpoint

More Unintended Consequences

The SEC, institutional shareholders, activists and the media, in their drive to reduce perceived executive pay abuse, are following a path that could have serious unintended consequences by limiting the exercise of business judgment by Directors in their determinations.

Beginning with Sarbanes-Oxley and reinforced by external pressures, today's Boards are focused on process and sound corporate governance practice with noticeable result. Director involvement and time commitment have increased to the point where the average Board member may expend between 250 to 270 hours annually, up from about 200 to 220 hours a few years ago. A major area of concentration has been Board purview over executive compensation with Compensation Committees directly engaging independent consultants in setting goals and assessing results achieved to ensure total alignment of pay and performance on behalf of the stockholder.

However, current demands by the SEC to have Directors provide increasingly specific facts regarding their qualitative or discretionary assessment of senior executive performance is beginning to result in totally numeric and quantitative measures and a short-term orientation in the management of American business. This formulaic focus is particularly troubling given the current business climate. Especially during this period, the flexibility to respond to rapidly changing conditions and the courage to stay a sound course during a short-term downturn will differentiate good performers from poor. In either case, the judgment of Directors will be critical and regulations that curtail their ability to exercise such judgment will undermine the very tenets of America's system of corporate governance.

The SEC's new guidance has given rise to a whole host of new questions and challenges for Directors. How will Boards explain in specific terms a decision to award a salary increase or bonus, and the determination of its amount, to encourage and recognize exceptional leadership or actions by one or more executives in the face of unanticipated or uncontrollable difficulties that resulted in missing performance targets? How will they publicly explain rewarding some executives and not others without inferring unintended and probably unwarranted criticism? How will they explain the importance of motivation and retention in the face of underwater employee options and similar shareholder losses, when critical talent can walk across the street and start anew?

Sixty-seven percent of the major companies recently surveyed by Accenture cite their inability to attract and retain top talent as one of the principal threats facing their businesses in 2008. At the same time, Boards are being hog-tied with potential criticism and the threat of withhold votes when confronted with the need to exercise their judgment in this area, while feeling free to make decisions and take action in matters of far greater magnitude such as capital investments and acquisitions.

Certainly, forcing Boards to think through compensation decisions strategically and endeavoring to ensure that decisions are not made arbitrarily are important goals, and ones that should not be overlooked. But it is also important to recognize that it can be extraordinarily difficult to set realistic targets and financial performance expectations in today's uncertain economic and interest rate environment and that a retrospective or "look-back" assessment of performance may be the best approach.

While it is true that corporate performance can be quantified, judging and rewarding the annual performance and long term contribution of an individual executive is a much more subjective proposition. And such decisions do not take place in a vacuum – success must be carefully defined in challenging times in the face of unforeseen risks and opportunities. Rather than penalizing and demoralizing an executive team for harvesting lemons, it may be more prudent to recognize the fact that they were able to make lemonade. One can only hope that Boards will continue to be permitted to exercise their business judgment to make decisions in the long-term interests of the company without regulatory interference or unwarranted/unnecessary disclosure regarding individual executives.

