



North Texas Compensation Association/website article

Weapons of Mass Excess: Avoiding the Shock and Awe of Executive Pay

By Brent Longnecker

From Enron and Tyco to Adelphia and even the New York Stock Exchange --- Corporate America has been rocked with one executive compensation scandal after another. . Battles are being waged in the courtroom. By drawing great media attention, this has become an issue causing collateral damage to HR departments and corporate reputations. With one broad brush, the headlines are threatening to taint the character of executives as a whole --- thus inspiring many executives and boards to re-examine their compensation strategies.

Compensation "boot camp" involves learning:

- what the "inspectors" are looking for
- who are the leading abusers
- how to diffuse the weapons to avoid similar "blow ups"

The inspectors are coming

The time for a weapons inventory check is *now*, as the SEC, New York State Attorney General, FASB, FBI and IRS begin an all out assault on violations in connection with gargantuan executive pay packages. Inspectors are concerned with processes, personal tax returns of executives, corporate tax returns and the way packages are constructed. A top IRS spokesperson says, "Our issue is not with how much executives are paid. Our issue is whether the rules are being followed and the proper amount of tax is being paid." Rest assured, each "inspector organization" wants to find something to legitimize their existence.

Compensation abuse

The IRS has jumped into the fray with an "Eight Point Audit." The IRS is focused on split dollar life insurance arrangements, whether the employee has included the value of term protection in income, and auditors are scrutinizing the amount of income where the insurance is transferred to an employee. Inspectors are also examining loans to executives, golden parachutes (are amounts exceeding safe harbor limits?) and non-qualified deferred compensation (the use of offshore/rabbi trusts, compliance with Section 404(a)(5) and application of employment taxes.) With regard to equity compensation arrangements, the IRS is checking for proper withholding in both public and private companies as well as the use of restricted stock, ISOs, NQSOs, SARs and Phantom stock. Fringe benefits are also a topic for hot debate. On one hand you have the Conoco executives following a mandate to use the corporate jet for protection against terrorism and on the other extreme you have Westar Energy executives jetting their family and friends to France for a shopping spree. With regard to 162(m) compliance, IRS representatives want to know if statutory exceptions have been met and if independence criteria are being followed. As they probe for information on asset protection schemes, they also want to make sure that executives are playing fast and loose with estate plans by transfers of

compensatory options to family limited partnerships and “listed transactions.” These eight areas could keep the IRS busy for decades!

Diffusing the bombs

By conducting pre-audit “weapons checks” for clients, Longnecker & Associates and other advisors are making recommendations on how to spot red flags and avoid the “bunker mentality” of *playing not to lose* rather than *playing to win*. For example, in the area of long-term incentive programs, excessive one-time grants could send the wrong signal to inspectors. Other red flags include using the wrong peer group to set compensation levels and paying high bonuses for poor business results. We also evaluate companies’ market competitiveness and the reasonableness of the executive perks, knowing it is much less expensive to be proactive than reactive.

How did this happen?

With Enron, the mother of all WME’s, good people were motivated (i.e.: compensated) to do bad things, and ethically-challenged people were motivated to do terrible things. With a Who’s Who board blinded by the incredible profits, the “less cash/more options” plan sounded good. Enron’s “rank and yank” culture put employees in a position to cook the books, or turn a “blind eye.”

While it is easy to blanket all executives with the blame, the fact of the matter is that there are an array of clear culprits. First and foremost, boards and committee members, are often under qualified on the issues. Secondly, consultants can often be biased or under qualified themselves. In the highly publicized corporate examples, how many consultants were offering truly independent advice? How many watered down their advice under the influence of opportunities to render other services. It’s time to purpose as a profession to provide training and use independent consultants who specialize in this highly specialized and quickly-changing arena.

The fear is mounting for existing and potential board members reading today’s headlines: most notably, the Disney and Cendant cases where courts concluded that the boards had *not met* their fiduciary standards and were penalized accordingly. Additionally, the high-profile NYSE case involving former CEO Dick Grasso and his board will likely result in serious actions against individual board members as well.

This unprecedented epidemic of greed and corruption has even attracted the attention of the academic world. In a recent study entitled, “Board Composition and Corporate Fraud,” the researchers drew this ironic conclusion:

*“A troubled finding of our study is that, in general, the **presence** of a compensation committee INCREASED the likelihood of corporate fraud in the sample. The implication is that compensation committees have been ineffective in evaluating and properly rewarding the performance of top executives. They may also have designed compensation packages with dysfunctional incentives, as claimed by many critics. Whatever the reason for our findings, compensation committees deserve more attention from regulators, rule-making bodies (such as the NYSE and NASDAQ), and shareholders.”*

Defusing the weapons

Multiple compensation elements can look reasonable from an individual perspective, but someone must look at the big picture – while considering how reasonable it will look to the media and shareholders. Strategic solutions might include:

- Diversification and customization

If all their compensation eggs are in one basket, executives will face higher temptations to make desperate moves. Consequently, a customized package with restricted stock, performance units and NQDC, for example, might be tougher to design but will be more motivational in the long run.

- Competitive awards should be reviewed in the context to total direct compensation
- HR executives need a direct communication line with the Compensation Chairman

- Compensation committees need HR expertise and totally independent advisors that exercise self-governance
- Compensation policies and decisions should be documented for successors/auditors to follow the logic and come to the same conclusions
- Provide more disclosure on plan mechanics, payouts, participants
- Avoid dueling consultants

As war is waged on executive pay, Corporate America must think like a chess player – several moves out. Compensation components must be viewed individually and holistically, with ramifications and optics considered each step along the way. Compensation committees need to be constructed with an eye toward true expertise. Independent advisors and trustworthy information is critical in these times, more than ever. America's CEOs need to be able to do what they do best – and be rewarded for that. With executive pay up nationally, and Fortune 500 profits up, it just might prove that "pay for performance" is working and can continue to do so, if ***designed and defended*** in the proper way.

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