IS YOUR BOARD AT RISK FOR EXECUTIVE COMPENSATION ISSUES?

By Patricia Farrell, *The Legal Intelligencer*

Does the CEO really provide enough value to the company to justify a salary equal to the median salaries of 100 workers at the company? 300 workers? 1,000 workers?

On average, CEOs of companies on the S&P 500 list take home 204 times the median pay of other workers at their companies, according to a report from job and recruiting website Glassdoor. Among those companies, Discovery Communications came in at the top of the list, with the CEO making 1,951 times the median worker's salary. The CEOs of Chipotle, CVS Health and Wal-Mart likewise reported salaries more than 1,000 times the compensation of the median worker at their respective companies. Other organizations, such as the American Federation of Labor and Congress of Industrial Organization (AFL-CIO), estimate even higher ratios for these companies.

In the wake of the 2008 U.S. financial crisis, corporate counsel must be more vigilant than ever about the company liability created by excessive executive compensation packages. In particular, attorneys who work with public companies must ensure that the company is adhering to the standards set by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

Among Dodd-Frank's many requirements, corporate counsel need to assume compliance with the U.S. Securities and Exchange Commission's (SEC) new rule on pay ratio disclosure. In August 2015, the SEC released a new amendment to Section 953(b) of the act to require that companies disclose the total annual compensation for the company's CEO, the total median compensation for all employees (excluding the CEO) and the ratio of the CEO's pay to the median worker's pay. The amendment is set to take effect for fiscal years beginning on or after Jan. 1, 2017.

It's likely that the new reporting requirement may spark new rounds of scrutiny from shareholders and the public regarding executive pay. Corporate counsel will need to ensure that companies can justify the pay rates of their executives or risk facing lawsuits.

One of the most effective ways to ensure that the company is paying executives appropriately is to hire a compensation consultant who is completely independent of the company, management and non-independent members of the board of directors. Prior to Dodd-Frank, many companies hired compensation consultants, but the consultants often weren't truly independent. Some consultants had personal ties to the company's executives, worked for one of the company's subsidiaries or received other sources of compensation from the company. These conflicts of interest often influenced the consultants to disguise and justify excessive compensation packages for executives. In most cases, the companies did not disclose to the shareholders the consultants' conflicts of interest.

Under Dodd-Frank, the SEC requires public companies to appoint a compensation committee to be responsible for hiring independent compensation consultants and legal counsel. The committee must be made up of independent members of the board of directors. While the SEC leaves it up to the individual securities exchanges such as the Nasdaq and the New York Stock Exchange to specifically define the qualifications of independent board members, it does advise companies to carefully consider (1) a director's source of compensation, including any consulting, advisory or other compensatory fee paid by the company, and (2) whether a director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

Privately-owned companies, of course, don't necessarily have to follow SEC regulations. In some cases, it may be strategically beneficial, however, for corporate counsel to suggest that certain private companies follow the SEC standards regarding executive compensation. It's likely that, like shareholders of public companies, private investors and shareholders will increasingly scrutinize executive compensation. By hiring an independent consultant, the company can structure executive compensation based on industry standards.

In particular, startup companies can often benefit from hiring independent compensation consultants. These companies often need to hire experienced executives to help get the company up and running, but the boards of directors often don't necessarily have a lot of experience negotiating executive compensation packages. An independent compensation consultant can help these companies attract well-qualified candidates without promising the executive more than the company can reasonably afford.

An appropriate executive compensation consultant should be able to:

- Advise the company about the tax, legal and accounting structure of the executive's package.
- Develop a package that adheres to industry standards and best practices.
- Appropriately devise a structure that maximizes shareholder value, which may mean that a large portion of compensation is in company equity or is tied to performance goals.

Corporate counsel should also keep in mind that hiring an independent compensation consultant can be a proactive measure to protect the company against a shareholder lawsuit. In one example, my law firm worked with two brothers who were the CEOs of two private companies, and each was a shareholder in the other's company. Over time, the brothers' relationship deteriorated and each questioned the other's work ethic and performance.

One of the companies ended up being much more successful than the other. The brother that ran the more successful company wanted to increase his compensation, but feared that his litigious brother would question the amount of the compensation. To defend himself, we advised the successful brother to hire an independent compensation consultant to help structure an appropriate compensation package. When the other brother eventually sued (over compensation and many other issues), the court relied on the independent consultant's recommendation to help determine that the successful brother's compensation package was reasonable.

Nearly every company, public and private, has a blind spot when it comes to deciding the paychecks of their top executives. Interpersonal relationships among management, board members and corporate counsel and a lack of outside perspective can often lead to a skewed view of what is truly appropriate. Letting the CEO or other executives take home too much of the company profit could lead to shareholder lawsuits, major public relations issues and dissatisfied employees, all of which may seriously threaten the financial health of the company. Corporate counsel should make it a top priority to hire competent third-party compensation consultants to ensure that the CEO's paycheck isn't crippling the company.

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