



Executive Compensation

The Implications for Business Strategy and the Role of HR

by David Madison, Ph.D.

Director of The Five O'Clock Club National Guild of Career Coaches

The following article is based on a panel presentation at a meeting of the HR Network at the American Management Association headquarters in Manhattan. The HR Network is co-sponsored by The Five O'Clock Club and the AMA, and is a vendor-free venue for HR professionals to meet informally and hear discussions of important issues of the day.

The panelists were:

- Jose Irizarry, Vice President, Worldwide Compensation Consulting and GMSA for American Express
- Gangadei Deonarine, Executive Director, Compensation & Benefits for Estée Lauder
- Diane Lerner, senior executive compensation consultant, Watson Wyatt
- Alan Sklover, Partner, Sklover & Donath, LLC

Policy to Fit the Times

In the 1954 Broadway musical, *The Pajama Game*—recently revived in New York City—the workers at the Sleep Tite pajama factory stage a work slowdown to pressure management for a 7½ cent raise. In the song, “Seven and a Half Cents,” they calculate how much more money will be in their pay envelopes over the next five, ten and twenty years.

Getting ahead on money requires mastering games of finesse and strategy.

The story and the sentiment seem quaint now, but this bit of memorabilia from the Eisenhower years provides insights into the mindset of workers a half century ago: employees expected to stay in their jobs for a long time, and they assumed that hard work would be rewarded *gradually*. Few people these days, however—from the hourly factory worker to the CEO—expect to get ahead by staying with a job or a company for twenty years. With the average job lasting only about 4.5 years, most assume that getting ahead on money will require jumping to greener pastures, and mastering games of finesse and strategy. Employees are more than willing to play this game, and corporations know that managers and HR professionals must learn the complexities of *executive compensation*.

A simplistic definition of *executive compensation* would be “what executives get paid,” but the term is now used more comprehensively to mean the



Panelist Alan Sklover, Partner, Sklover & Donath, LLC, a law firm that represents and counsels executives on how to negotiate with their employers.

executive compensation policy. And in the *policy* sense, executive compensation is understood to be a component of the over-all business strategy: How can it be formulated in such a way to help the bottom line and advance the positioning and image of the organization?

Executive compensation policy is a component of an organization's over-all business strategy.

We can identify at least three purposes of such policy:

- **Getting the best people to do the job**, which, in today's global economy, is no small achievement. A few years ago we began hearing talk about the “war for talent”—and it might have seemed a trendy term, but that war remains a fact of life. As one specialist has stated: “The war for talent is not going away. Companies are looking for



Our prestigious panel on Executive Compensation addressed over 100 HR executives.

people who not only have a global mindset, but who may have to travel or relocate at the drop of a hat.

“Organizations need executives who can manage in challenging and uncertain times—and be able to inspire others in such environments. They need people who are not only comfortable with technology, but who embrace it. Anyway you cut it, these people are in short supply, and the need for such talent will only increase. You need such people to compete in the global economy.” Executive compensation policy must enable an organization to be competitive in the scramble for talent.

- **Rewarding and motivating those who are already on board.** Everybody is hired to meet specific objectives. There are goals, tasks and assignments to be achieved. Is the executive compensation package designed to pull people toward these goals and reward achievements and productivity along the way? This assumes that there will be standards of measurement—the metrics—by which to measure performance, and these can be defined and specified as components of executive compensation policy.

- **Retaining the brightest and the best.** If you’ve hired the right people, who have chosen your company over competitor organizations in the industry; or if you’ve trained and nurtured people so that they become coveted in the marketplace—then, clearly, you want to be able to keep them. It will be especially costly to find replacements.

Metrics for measuring performance can be defined as components of the executive compensation policy.

Reward and Punishment as Incentives

While this need for an effective compensation policy is widely acknowledged, developing the specifics and put-

ting them into practice has usually been more difficult than imagined. Perhaps because managers and policy writers often fail to understand basic truths about human motivation, the difference between rewards and punishments can be overlooked. Rather than focusing on the benefits that can lead employees to say, “Wow, that’s fantastic,” thus prompting them to work harder *and* feel greater loyalty to the boss and the company, managers have commonly worked on the assumption that inflicting pain—or promising to inflict pain—can result in desired behavior. Usually it has the opposite effect.

In some corporate environments, there’s a lot of nervousness around the time bonus checks are handed out. “Who’s going to leave once the checks have cleared?,” is the guessing game. But, as one authority has observed, “If the executive compensation program is working, you would not be worrying about who is leaving when the checks clear.” In fact, retention policies commonly don’t have enough depth in terms of sweet incentives; many have actually become no more than a catalogue of the painful things that will happen if an executive leaves. The policies have become heavily weighted with *threats*: delayed vesting, for example, which was supposedly conceived as an incentive for getting people to stay longer (but why would employees view *delayed vesting* as a reward?); the requirement for 50 to 75 days notice before leaving a job—which may *appear* to be protection for the company, but which can never work in practice; non-compete agreements, which likewise appear to be protective, but which are, in truth, problematic. *Disincentive* measures usually don’t make executives feel wonderful about working for an organization.

So Where Do We Go from Here?

To bring executive compensation programs more in line with the best interests of both employers and employ-



Diane Lerner, Senior Executive Compensation Consultant, Watson Wyatt.

ees, the formula of the three Cs may provide a sound template.

1. Commitment

Commitment in this context means trying to overcome the atmosphere created by at-will employment laws. In many states, employment is strictly at the will of the employer; bluntly put, the boss can fire you on a whim. That may strike some of us as a farfetched—are organizations really so much at the mercy of personalities?—but when a new COO arrives and wants to clean house, or bring in his or her team, the dismissal can look very much like a whim. Of course, the employer is in jeopardy if discrimination on the basis of race, gender or other factors can be proved. But in the absence of that,



Gangadei Deonarine Executive Director, Competition and Benefits for Estée Lauder.

there is no social contact guaranteeing employment. Americans are usually aware that an entitlement attitude isn't appropriate.

Hence, sound executive compensation policy should seek to overcome this atmosphere and convey to employees the idea of *employer reliability*. That is, the policy message should be: "Our corporate policy favors keeping employees as long as possible, *and* keeping them happy." Trying to find the best talent in a very competitive global market, *without* conveying the sense of commitment, is, as one expert puts it, "a race to oblivion."

Retention policies commonly are loaded with threats instead of sweet incentives.

2. Contracts

Perhaps one of the most common laments of employees who have been in their jobs for a while is that "things didn't turn out the way they were supposed to." Responsibilities and assignments may have been added or taken away, departments reorganized, bosses and co-workers changed; or expectations have not been met in terms of reviews, promotions, raises and bonuses. Frequently, job offers are made and accepted over a handshake, and bosses and employees have differing memories of what was agreed to during several hours of inter-



Jose Irizarry, Vice President, Worldwide Compensation Consulting and GMSA for American Express.

viewing. Formal offer letters may do little more than describe a job in broad-brush strokes. Positive impressions about *reliability* can be enhanced by the use of *contracts*. "Identify your brightest and best," advises one expert, "and do not be fearful of that horrible word 'contract'—but do not put threats in the contracts!"

3. Consideration

Does it sound too soft in the business world to speak of *consideration*, in the sense of *being considerate of others*? Another "c" word is usually thought to be the fundamental principle of business, namely *competition*, but being considerate or even compassionate can be good for business as well. One con-



HR executives were informed about the importance of the three Cs -- commitment, contracts and consideration.

What Human Resources Executives Say About the HR Network Breakfast Seminars!

Thank you for providing this morning's program. It stimulated several ideas and confirmed my thinking on others. The handouts are extremely useful. When I returned to the office we had an impromptu meeting of our executive team, where I described the topic and talked about the key points. We had a good discussion—all thanks to this morning's program.

Each of your panel members contributed excellent ideas, enthusiastically and sincerely. It was an excellent morning.

The session was excellent, one of the best. I make a habit of attending a wide variety of events and yours is by far the best in terms of organization, speakers, content and attendees. It is one of the NY Business community's best kept secrets.

What Is the HR Network, and Why Does It Offer Breakfast Seminars?

The HR Network Breakfast was founded in 2003 by The Five O'Clock Club to provide a learning forum for HR professionals—to help them do their jobs better and advance them in their careers.

This is a way for The Five O'Clock Club to give back to our customers and to serve the HR community, which has shown increasing appreciation for our innovative out-placement services.

We work hard to present six substantive HR Network Breakfast Seminars every year, so that HR professionals can take away information to give them a competitive advantage.

And, by the way, *we never allow vendors to attend*, so HR officers can focus as well on getting to know each other.

tract specialist commented: “Instead of the increasing use of threats and legalities—a trend that has been driven by bad experience and attorneys—it would probably be better to look to the Golden Rule. Imagine what would motivate *you* and make you want to make commitments in return.” Yet another “c” word can guide policy as well: *clarity*, as one leader has put it: “There are increasing demands for clarity, pay for performance, transparency and consistency between corporate interests and individual interests.”

Disincentive measures usually don't make executives feel wonderful about working for an organization.

Big Ticket Violations

Even the advocates of executive contracts, however, caution that it takes a lot of thought and hard work to craft them appropriately, so that the best interests of everyone are protected. One major danger zone, for example, is executive severance. Perhaps the poster child for a bad severance policy would be Michael Ovitz, whose multimillion-dollar severance claims (\$38 million in cash and \$100 million in stock), after only 14 months with Disney, were litigated for a decade. As one industry consultant commented: “If you have a big mistake embedded in a contract, your executive comp policy may end up on the front

page of the *Wall Street Journal* or the *New York Times*.”

Employers should convey a sense of their commitment and reliability in the executive compensation policy.

Enormous severance deals are commonly resented and ridiculed by the public, but company investors actually feel the pain. One survey of 55 institutional investors, representing about \$800 billion in assets, revealed that fully 75 percent were of the opinion that executive severance, at the levels commonly seen today, “was not shareholder friendly.” In other words, the big payouts to executives who, in many cases, haven't lived up to expectations, mean less money in the pockets of investors. One consultant observed: “You clearly aren't going to run your company based only on what your institutional investors think, but it is important to understand that they really are not happy with multi-million dollar payouts, particularly when people are terminated.”

The Need for Due Diligence

Because of the media we've all become familiar with outrageous severance arrangements, and there's been a lot of press as well about outrageous executive salaries and bonuses. The first



Kate Wendleton enthusiastically moderated the panel and fielded questions.

thing that comes to mind is the power of the Old Boys' Network, which enables the wealthy to protect the wealthy. We wonder if all sense of proportion and fairness has been abandoned. The main lesson to be drawn, however, is not that there's something wrong with executive contracts. Rather, we need to make sure that somebody is *minding the contracts*. We need to make sure that there are checks and balances. Appropriate contracts depend on due diligence, common sense and a commitment to fairness.

The complexities involved are daunting, and can be glimpsed by considering an example. Giving a generous severance package to an executive who *failed to do the job* is obviously bad business—and looks like cronyism. But many executives want to be protected in



Key topics of interest included being considerate of employees and following the Golden Rule in the workplace.



Adrienne Hickey, Editorial Director, AMACOM, and our AMA host.

case they're doing a *great* job, and things *still* don't work out. Hence, contracts commonly stipulate severance if there is "resignation for good reason." One of the good reasons,

for example, is that corporate headquarters moves to another state. Or another good reason may be reduction in pay—perhaps because of new management, a merger, or poor company performance. But what if pay was reduced because *bonuses* were down? As was mentioned earlier, there can be a lot of nail biting when bonus checks have cleared. Should resignations in the wake of low bonuses be considered for good reason or not? Who needs to be protected most in such situations—the company or the employee?

Positive impressions about organizational reliability can be enhanced by the use of contracts.

Minding Contracts: the Role of HR

If "winning the talent war" has emerged as a common concern for HR professionals in the battle to keep their organizations competitive, "earning a place at the table" has become just as much a concern in looking out for their *own* careers. Any HR officer who wants to have an impact on the bottom line should ask, "What more can I do to make myself and my role indispensable—so that the CEO and CFO *want* to consult me on strategic issues?"

Compensation and payroll traditionally have been HR functions, so it's logical for HR to move into compensation at the *strategic* level. Thus, HR professionals should take the initiative

and the lead on this front—and in the *minding of the contracts*.

Is there indeed a kind of power vacuum here? Not that this is a realm lacking in experts—there are the attorneys. Review of contracts is not a coveted assignment, but effort here by HR can reap major rewards. One leader observed, "There are so many details in the contracts that can create problems. These documents are so *boring*—they are so dry that people just don't pay attention. It really is a struggle. As HR professionals we need to focus on the details and advise our companies about what they're really getting into. Is *that* what they really want? We can save our organizations a lot of embarrassment and trouble down the road."

There are several areas in which scrutiny can be applied. When one company buys another, for example, there may be long-standing employee contracts to consider, usually with compensation commitments. Or contracts made one or two decades in the past that were based on conditions or circumstances that no longer exist. As one HR consultant reports, "My experience typically has been trying to fix contracts made many years ago that have blown up in our faces and created tremendous problems—so there's a lot of troubleshooting."

It's logical for HR to move into compensation on the strategic level.

Clear Thinking and Balance

HR can also simply help with clear thinking, which, when it comes to contracts, is another way of saying: *read the fine print*. "We can help our companies understand the implications of what they're agreeing to," suggests an HR specialist. "If you decide to give something to somebody because that's what it takes to recruit the person, fine. But if you really didn't *realize* what you were getting into, or what precedents

you are setting, that's not so fine."

The byword in establishing strategic executive compensation policy remains *balance*. The need to offer attractive packages to the brightest and best clearly can drive policy, but there is another master to be served as well. Contracts should be devoid of threats, but they should emphasize company expectations. "The key thing," according to one HR expert, "is to get a balance between the protection that is being offered to executives, and the protection that the company is getting." For example, the contract can include provisions that the executive will work full-time, and will check with the company before going onto boards—so that she or she will not be "over-boarded" and distracted from the job. The company can also specify rules about confidentiality and define some kind of fair-play non-compete agreements. So many non-competes turn out to be unenforceable because the employer asks for far more than is reasonable. But HR can bring common sense to bear on what is reasonable and enforceable, and thus help to create realistic non-competes.

Paying Well for Defined Deliverables

Executive compensation policy should be linked closely with performance and results. Careful attention should be paid to the *measuring* of results. This is a clear summons for the involvement of HR, which has traditionally coordinated performance reviews. There has been much talk in recent times about the importance of metrics, and *especially* when executive compensation is contractually defined, performance should be as well. One HR executive states the case well: "Are you crystal clear on the *performance* metrics that are required for this level of compensation? The role of HR is to be the eyes and ears of the company in helping managers to see if performance is meeting expectations." ●