Exercising Compensation Committee Discretion within Privately Held Companies

Compensation committees within privately held companies have greater means to exercise discretion than their public company counterparts. This is primarily due to accounting rules that restrict public companies from taking tax deductions on portions of compensation that are not explicitly performance-based.[1] The ability to apply discretion to compensation decisions is an advantage for private companies in that it permits directors to use their collective judgment in exercising both committee, and overall fiduciary responsibilities, without tax consequences. The form, process, and frequency through which private company compensation committees exercise discretion vary widely. Presented below is a discussion on the means through which committees typically exercise discretion and the factors influencing how it is applied.

How Committees Exercise Discretion

Compensation committees exercise discretion through three primary means:

1. **Pure Discretionary Awards / Plans:** Some privately held organizations have no formal incentive plans with prescribed objectives and corresponding reward opportunities. Payments to executives are determined subjectively based on performance against overall business plan objectives while considering any relevant company and/or overall market factors. These circumstances typically require a high degree of trust between the Committee and management

2. **Ad hoc / Supplemental Awards:** These discretionary awards are made independent of existing incentive plan opportunities. Awards most often fall into two categories:

[1] Section 162(m) states that for covered employees, compensation above $1M is tax deductible only to the extent it is performance-based and can be calculated through a predetermined formula by an independent third party. Discretionary increases to award levels eliminate the tax deduction on compensation over $1M; negative discretion may be applied with no impact on the tax deduction.

- *Excellence Awards*: Made to recognize extraordinary contributions to overall company success (e.g., M&A activity, new product development, key customer / contract wins etc.)
- *Retention Awards:* Made to handcuff an executive to the business as the award vests over a specific period of time

3. **Adjustments to Either Incentive Pools/Payments or Goals:** These are discretionary decisions made within the confines of existing formal incentive plans. Committees may choose to adjust the pool of available dollars, individual payments to executives, or the underlying goals within the plan, that in turn affect payouts. This is the most common form of discretion employed

Factors Influencing Discretion

The following factors influence the prevalence of discretion among compensation committees:

- **Size and Complexity:** Smaller companies tend to rely more on discretion than larger more complex organizations

- **Ownership Structure:** Family owned and operated, or organizations led by a dominant founding personality, tend to rely on discretion more so than those businesses run by professional managers

- **Stretch in Performance Objectives and Corresponding Payout Potential**: Organizations employing stretch goals with a high degree of upside payout potential tend not to use discretion as much as organizations with more achievable goals and steadier payouts. The governing principle is that in return for premium pay opportunities, the organization expects results, and is less likely to modify goals or payouts for unforeseen circumstances. Conversely, organizations with more conservative goals and predictable payouts, yet limited upside earnings potential, are more likely to apply discretion

- **Maturity and Formality in Governance Practices**: Organizations with developed governance models are either less likely to employ compensation discretion, or require structure around how they exercise discretion, than organizations with less mature governance procedures. Model corporate governance practice dictates that committees define policies and boundaries for the use of discretion in the charter, compensation philosophy, and/or incentive plan documents

Defining Parameters for Exercising Discretion

Forward thinking compensation committees anticipate how and when to use discretion in their decision-making, and develop formal guidelines or “rules-of-engagement.” These guidelines clearly articulate what is within the committees’ purview, thereby avoiding the trap of having similar discussions at multiple board meetings. Guidelines also increase the consistency, quality, and speed of compensation decisions. Below is a list of parameters and questions to be answered that may help committees define perspectives on exercising discretion:

- **Where Discretion Is Appropriate:** Defines the programs and circumstances where discretion may be applied
  - *In what programs can we apply discretion? (i.e., annual plan, long-term plan, ad hoc awards, etc.)*
  - *To what extent will we permit both positive and negative discretion to funded pools and/or individual awards?*
  - *In what circumstances can we adjust goals? What circumstances will we not adjust goals? Common areas addressed include accounting rule changes, currency exchange rates, M&A activity, one-time and restructuring charges, taxes, capital expenditures (foreseen vs. unforeseen), interest rates, etc.*
  - *Does discretion apply similarly to all senior executives? (e.g., does discretion apply to the CEO in the same way as other executives?)*

- **Degree of Discretion:** Defines boundaries to the amount of discretion applied
  - *Are there limits to any downside or upside adjustments?*
  - *Do these limits apply to all executives in the same way?*

- **Process and Timing:** Defines how and when to consider exercising discretion
  - *Who initiates the process for considering discretion?*
  - *Who makes the business case?*
  - *What type of analysis is needed and expected?*
  - *At what committee meetings do we entertain discussion / make decisions?*

- **Approval Process:** Defines who is involved in the decision making process
  - *What is the role of the compensation committee? What is the role of the full board?*
  - *What is the role of the CEO with regard to other senior executives?*
  - *What is the process when discretion affects the CEO?*

Conclusion

There is no single “correct” way for private company compensation committees to exercise discretion. Solutions should take into account the company’s unique culture around rewards, governance model, ownership structure, and shareholder expectations. To help committees navigate these complex decisions, it is helpful to have a pre-defined set of guidelines or rules-of-engagement that articulate when it is appropriate to exercise discretion and the process surrounding it.