

# SENIOR CONSULTANT

The Voice of the Investment Management Consultant

## Independence Day: The Critical Need for Unbiased Advice

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Over the last decade, the stock market and business environment have been such that, in spite of good intentions and accountability checkpoints, an increasing number of board members, compensation committees, consultants and executives made decisions that have been called into question. A corporate governance revolution has emerged as a result of the revelation of impurities in the compensation system and other areas relating to financial responsibility.

One of the most important and conclusive revelations being reinforced is that boards of directors need to be held accountable for their actions, or lack thereof. Recent legislative enactments, guidelines and rulings echo this concern and are being imposed by Congress, NYSE, NASDAQ, IRS and most recently, the Delaware courts. Specifically:

- **Congress.** The Sarbanes-Oxley Act signed in 2002 formalized personal liability on the directors and corporate officers of publicly traded companies by forcing them to sign attestation forms as to the accuracy of the process and results of financial reporting. Violations may result in a personal fine of up to five years in prison and/or \$10 million in fines which will likely not be covered by D&O insurance.
- The **NYSE** and **NASDAQ** redefined rules: what constitutes an outside director, how an independent board should be comprised and how executive compensation should be determined.
- The **IRS** launched an unprecedented audit of 24 public companies on eight specific executive compensation and benefit components, and has since extended its focus to include privately held companies. Additionally, Nonqualified Deferred Compensation compliance has been targeted as the #1 item for the IRS to review.<sup>1</sup>
- **Delaware Courts.** Most recently, the Delaware Court of Chancery made a decision that ran completely counter to historical rulings that had not held

directors personally liable for breaching their fiduciary duty in making executive compensation decisions. The Court ruled in *The Walt Disney Co. Derivative Litigation* (825 A.2d 275) that, “where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its shareholders, the director’s actions are either ‘not in good faith’ or ‘involve intentional misconduct’.”<sup>2</sup>

### Disturbing Research

Additionally, there has been unsettling research published in mid-2004 regarding the ineffectiveness of compensation committees. In the academic study entitled “Board Composition and Corporate Fraud,” the researchers draw 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.”<sup>3</sup>

While it is difficult for academics to explain the irony of the conclusions drawn from their empirical research, advisors sitting inside the boardroom can shed some light; many compensation committee members admit to lacking training in this increasingly complex yet critical function.

The compensation field and its related inputs, processes and results are becoming a battleground of liability. The potential exposure for board members has increased greatly – and suddenly, pointing to the criti-

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cal need for advice that is truly independent of bias.

## The Changing Role of Independence

As the need increases for an independent opinion on reasonable and competitive financial practices, the definition of independence comes into question – and rightly so. This question goes to the very core of selecting consultants who can ultimately elevate the overall process within corporate America and the reputation and results surrounding financial recordkeeping.

### Historical Definition

Historically, independent opinion in the compensation consulting industry has been loosely defined. The one-stop shop where large HR consultancies and accounting/audit firms provided many of the independent reviews has long been commonplace. It only seemed to reason that, if a firm was adept at independently reviewing a company's financial statements, it should have no problem reviewing the reasonableness of compensation provided to executives. However, there is a sizable hiccup within this natural extension of services because accounting audit and executive compensation audit can conflict with one another.

The new definition of independence is as much about having technical expertise as it is about rendering opinions and recommendations without a conflict of interests. In many of today's consulting firms, the conflicts are numerous because of the vast number of other services the consulting firm offers. For example, the more "revenue streams" a company can offer a consulting firm, the more likely it will be difficult to give any candid advice that might hamper other business opportunities. Any peripheral business opportunities that even tempt a consultant to water down advice could dilute a consultant's independence.

Independence is currently being put to the test while companies try to establish processes to help them avoid the very appearance of conflict. The following fence posts provide an evaluation checklist whereby an ethical, inde-

pendent consultant can be selected to provide valuable answers and solutions to the oftentimes complex arena of fiduciary responsibility. Specifically, as it relates to independence in this new day, boards, managers and committees hiring outside consulting should look for the following:

- **Opinions without a conflict of interests.** Many of today's consultants have other services outside of executive compensation and benefits that they are waiting to introduce or are currently providing to their compensation clients. While one set of consultants may "stand their ground" in the interest of ethics, there is still the temptation for good consultants to give bad advice or to compromise their recommendations to protect larger service lines on behalf of their

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firm. For example, it is not uncommon for a large HR consultancy to have one partner providing a client's payroll services (i.e., \$500k outsourcing revenue per year) and another partner representing that same client's executive compensation services (\$50k consulting revenue per year). If a sticky executive issue comes up, there could be a strong temptation to cater to the executive rather than risk the loss of other business. While this conflict of interest may not play out in the majority of such situations, it is important to recognize that, by tempting good people to do the wrong thing, independence could be compromised.

- **Independence attestations.** If directors and key officers of a company have to sign attestations forms, it should only follow that an independent consultant should sign an attestation form as to the independence of the process, findings and recommendations.

- **Independent process.** The governing bodies such as the IRS and FBI have recently emphasized that process is as important as results. Companies should check references as part of the process in selecting an advisor. Consultants should be asked if they have had to return fees due to poor process and whether they are involved in any lawsuit for having a conflict of interest.
- **Avoid dueling consultants.** Currently, many companies are considering or are engaging two consultants – one for the board and one for the executives. This practice begs the question: Are two consultants better than one? Even consultants themselves, in an effort to increase sales, may recommend hiring two consultants.

However, the ramifications of such a scenario would lead to each firm trying to represent their own interests resulting in (1) a series of negotiations and "opposing sides" as well as (2) consulting fees that would be more than twice the normal rate needed. One independent and ethical compensation consultant engaged by the board will serve the best interest of the company, not the individual. However, if management believes two are necessary, then it may prove wise – especially for the shareholders – to detail the expectations of deliverables, the process, reporting relationships, etc.

- **Provide consultants a direct link to the Board Committee.** While it is important that an independent consultant interview both management and board committee members to determine goals, objectives, company background, culture, ..., ultimately the consultant should be engaged by the committee and report its findings accordingly. In fact, management and executive compensation committees for some of the leading companies across the U.S. are joining forces to conduct the search for the right consultant. This action reinforces the point that independent advice on executive issues is important to both groups, and it's a good way to avoid division.
- **Transfer knowledge.** A truly independent consultant will not facilitate an addiction to future consulting services. Independent consultants will be more concerned with

delivering reasonable compensation solutions while educating both board members and management along the way. Providing insight into the processes and framework is another safeguard for establishing appropriateness within a pay system designed to attract, retain and motivate key performers.

- **Conduct an Executive Session.** While most preliminary findings and recommendations are made directly to the compensation committee in the presence of management, oftentimes it is necessary for the compensation committee to ask candid questions to the independent consultant in an executive session. Additionally, this may also allow the committee to be further educated.
- **Provide Reports in Advance.** Gone are the days where a consultant provides a report the day of a board meeting and then requires a stamp of approval from the board. This “fly by the seat of the pants” approach is far from an independent process and runs counter to the educational approach necessary for raising the critical questions.
- **Provide Expertise.** Being technically adept is not only critical in the boardroom but also in the courtroom. Figure 1, The Reasonable and Optics Quadrant Test™, is one way boards, executives and their independent advisors can push out the gray in deciphering the very tough issues.

### New “Independence Day”

When it comes to CEOs, as G. Richard Wagoner, Jr., chairman and CEO of General Motors recently said, “Everything is under a magnifying glass.” Legislators and other key regulatory entities are nipping at the heels of executive pay. The national media has positioned corporate ethics in the crosshairs. Even the academic community is rendering an opinion – all of which has ushered in the need for a new type of “Independence Day” for executives and boards. Independent consulting

facilitates competitive and reasonable compensation practices, but more importantly, provides peace of mind by reducing the tremendous risk and liability that board members, executives and companies are facing as a whole. Truly independent opinions result from independent processes, the removal of bias (from related service lines or temptations to sell other services), direct communication links and technical prowess in this increasingly specialized field. With personal liability issues intensifying now more than ever, executives, shareholders, board members and compensation committee members need sound, independent advice worthy of their trust. ■

### Footnotes

1. Executive Compensation & Taxation Coordinator. Executive Compensation Alert. August 1, 2004.
2. The Corporate Counsel. The New Compensation Committee Responsibilities – A Roadmap for Meeting the New Standards and Avoiding Personal Liability. May-June 2004.
3. Uzun, Hattice, Samuel H. Szewczyk and Raj Varma. “Board Compensation and Corporate Fraud”, AIMR.

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