

# *Best Practices for Compensation Committees*

## *How to Exercise “Good Business Judgment”*

“Good business judgment” is the standard that boards are being held to in court case after court case. As a director, how do you know you are applying good business judgment? What are the best practices used by leading boards? We have worked with several compensation committees who have defined and developed best practices which fall into four areas: *Process*, *Principles*, *Pay*, and *Performance*. Some of the most actionable of these best practices are specific analyses that fall into the *Pay* and *Performance* categories. These analyses include:

- ***Total Cost of Management*** – What is the total cost for the top 10–25 executives in the senior management team (including base pay, incentives, equity, benefits, and perquisites)?
- ***Historical Perspective*** – What was the Total Cost of Management over the last 3-5 years?
- ***Historical Pay-to-Performance Sensitivity*** – How has the Total Cost of Management varied with performance over time?
- ***Future Pay Sensitivity*** – How much will the Total Cost of Management vary with performance? How well will increases and decreases in performance correlate with increases and decreases in pay?
- ***Historical Equity Incentive Analyses*** – How much equity have we granted management over the last 5-10 years (amount and value)? How much have they exercised, sold, pocketed? How much do they still hold in stock and options?
- ***Wealth Effect*** – How much are executives holding in stock and options and how much do they make or lose when the stock price goes up or down by \$1 or \$5?
- ***Pay for Performance*** – Is the company’s pay positioning appropriate for the current performance level? If pay is at the 75<sup>th</sup> percentile, then performance must be too. (This seems obvious, but many companies don't do it.)
- ***Retention Analysis*** – What do executives lose if they leave? How deep are our hooks? How strong and enforceable are our non-competes?
- ***Hidden Costs*** – What are the potential financial impacts of the current SERP's, severance, and deferred compensation plans? What are the estimated total costs in the event of a change in control, including gross-ups. Better to see the gross ups now than be grossed out when they hit the front page.



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