Ten Ways to Restore Investor Confidence in Compensation

What boards can do to ease shareholder anger over pay packages

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Outrage over executive compensation has hit a boiling point. And it may get worse before it gets better.

New proxy disclosure rules approved by the Securities and Exchange Commission last July are shedding a harsh light on the breadth of corporate chiefs' oversized packages. The overhaul requires companies to provide a total compensation figure for each of their top five officers.

WHO MADE THE BIGGEST BUCKS?

- Read about the five highest-paid CEOs[1]
- Chart: CEO compensation at companies with best and worst shareholder return

A CLOSER LOOK

- CEO Compensation Scorecard:[2] A sortable table of pay and perks
- Perfect Payday:[3] A look at companies under scrutiny for past stock-option grants and practices

The new rules also give investors a better handle on perquisites, pensions, deferred compensation and stock-option grants – aw ards that previously were buried in the fine print of public filings, or not disclosed at all.

The revelations, combined with the extensive scandal over backdated stock options, make board pay panels a bigger target for investors' ire. Activist investors are increasingly trying to block the re-election of directors involved in controversial compensation awards. Through April 4, investors also had submitted 281 shareholder resolutions related to executive pay -- far more than the 173 proposed for all of 2006, according to Institutional Shareholder Services, a Rockville, Md., firm that advises institutional investors.

Board members typically blame their inability to control runaway rewards on competitive pressures -- especially when the boards are recruiting new management. "Most compensation committees want to do it right," says Norman Augustine, a retired Lockheed Martin Corp. CEO who heads such panels at **ConocoPhillips** and Procter & Gamble Co. "The difficult question is, 'What is the right thing?' "

Here are 10 tips for boards that might produce executive-pay plans acceptable to disgruntled stockholders. The suggestions come from activists, compensation experts and a handful of daring directors:

1. Make sure the board's pay consultants don't also work for management.

Last October, 13 institutional investors sent a letter to the 25 biggest companies in the Standard & Poor's 500-stock index, asking pay-panel chairmen to disclose whether their companies had other business relationships with their executive-pay advisers. The letter outlined steps to avoid such conflicts of interest. Consultancies that counsel boards about pay for the top brass occasionally earn fatter sums by running benefit programs for management.

WALL STREET JOURNAL PODCAST

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Most of the 23 companies that responded complied in part with the shareholders' requests, though not all have adopted written policies stating intentions to avoid such conflicts of interest. The letter "was the primary reason" **Morgan Stanley** directors replaced **Hewitt Associates** Inc. as their consultant, says a spokesman for the New York financial-services firm. Hewitt, which declined to comment, also advised Morgan Stanley management about pensions. The Morgan Stanley pay panel pledged to consider for approval any work that its next consultant does for management when fees exceed $25,000.

Several other businesses, including **Verizon Communications** Inc. and **Wal-Mart Stores** Inc., face shareholder proposals this year on whether they should reveal ties between their board's pay adviser and management. The new proxy rules don't require disclosure of the relationships.

2. During outside CEO hunts, set limits on the projected compensation, hire a savvy negotiator and find a back-up candidate.

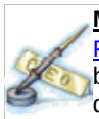
Too often, critics say, boards desperate for fresh leadership blindly agree to star prospects' exorbitant demands. This picture is starting to change.

Setting a pay range at the outset of **Gateway** Inc.'s 2006 search for a new chief executive "gave us a channel marker of what's reasonable," says Joe Parham, compensation panel chairman. "We wanted to do a course correction."

Last September, directors of the computer maker filled the top spot with J. Edward Coleman, a former Arrow Electronics Inc. executive. His package fell in the middle of the directors' desired range, Mr. Parham says. Among other things, the new CEO received about 2.2 million options valued at $1.95 million. His predecessor, Wayne R. Inouye, got 10 million options in 2004, the year he joined.

Boeing Co. directors retained Robert Stucker, a Chicago attorney who usually represents executives, to help them hammer out an accord with W. James McNerney before Mr. McNerney assumed command in summer 2005. Board members "wanted somebody who was the expert," someone close to the situation says.

Mr. McNerney accepted less-generous severance than he was eligible for at 3M Co., his prior employer -- where Mr. Stucker had represented him. Mr. Stucker, chairman of the Chicago-based law firm Vedder Price, says negotiating on boards' behalf during CEO contract talks accounts for 20% of his practice, double the proportion five years ago. Mr. Stucker declines to comment on whether his prior representation of Mr. McNerney posed a conflict of interest during his subsequent dealings with the Boeing board on Mr. McNerney's pay.



MORE FROM THE REPORT . . .

Facing greater disclosure[7], boards are cutting back on CEO extras from chauffeur service to deferred compensation. Plus, if a private-equity firm buys[8] your company, what does it mean for your compensation?

• See the complete CEO Compensation report[9].

3. Skip severance for anyone with a sizable stock stake and deferred-compensation account.

"Severance is completely unnecessary" for wealthy officials, says Michael S. Kesner, a principal in Deloitte Consulting's executive-compensation practice. Investors shouldn't "provide the executive's great-great-grandchildren with a payday," he adds.

CEOs themselves sometimes initiate such moves. That was true at **Home Depot** Inc., says an informed individual, where Frank Blake, the new chief executive, insisted on a more modest pay package than his predecessor, Robert Nardelli. In addition to spurning a guaranteed bonus, supplemental pension and restricted shares, Mr. Blake now lacks the guaranteed severance he had before he advanced from executive vice president.

Mr. Blake's deal "is a vast improvement over the Nardelli package. But it took shareholders three years of complaining to get Home Depot directors to hear us," says Richard Ferlauto, director of pension and benefit policy for the American Federation of State, County and Municipal Employees union, in Washington, D.C.

William A. Osborn, chairman and CEO of **Northern Trust** Corp. since 1995, recently terminated his employment-security agreement. The accord would have given him a lump sum equal to three years of salary and bonus -- plus five years to exercise his options -- if he lost his job within two years of a change in control at the Chicago bank-holding concern.

Thanks to his seniority and longevity, "I have significant equity ownership in Northern Trust and am retirement-eligible," the 59-year-old banker wrote in a Feb. 20 letter to the company. As of Jan. 1, he owned about 2.2 million shares and options exercisable within 60 days. "An employment security agreement for me is unnecessary," his letter added.

4. Retreat from "pay for failure" by making it easier to fire for cause.

Investor advocates have long complained about extravagant departure deals for unsuccessful CEOs. An officer terminated because directors believe he committed serious misdeeds usually loses exit payments. But ousters for cause can be costly. In September, three former CEOs won millions after challenging boards that fired them.

A few companies have devised new reasons to fire their leaders for cause. Thus, **Walt Disney** Co. directors can terminate CEO Robert Iger for cause if he refuses to give testimony or cooperate with an investigation "into his or the company's business practices," his October 2005 contract states.

The trend hasn't spread yet because "boards want to keep the CEO happy," concedes Jerry W. Levin, chairman of Sharper Image Corp. "That's why shareholder activism over this is a good thing."

5. Take a skeptical view of "peer group" comparisons.

Under the new disclosure rules, proxies must describe and name peer companies that boards use to gauge pay competitiveness while creating compensation plans. The problem: Management frequently persuades board pay panels to pick competitors that will justify juicier deals.

Winners & Losers

For 350 major U.S. corporations, the median total shareholder return equaled 15.1% in 2006, while their leaders' total direct compensation rose to a median of $6,548,805. The chiefs of the best performers nevertheless reaped far fewer rewards from their labors than did the heads of businesses with the poorest returns for investors. Each listing under worst returns is followed by a comment from the company.

CHIEF EXECUTIVE/COMPANY	FISCAL 2006 TSR	TDC	PCT. CHANGE IN TDC
▲ **BEST RETURNS**			
L. Patrick Hassey/Allegheny Technologies	152.9%	$6,310,945	12.6%
Sam K. Duncan/OfficeMax	98.8%	$5,291,587	N.A.
Patricia A. Woertz/Archer-Daniels-Midland	95.6%	$7,998,654*	N.A.
Martin Richenhagen/AGCO	86.8%	$5,550,371	579.6%
Robert P. Ingle/Ingles Markets	83.2%	$100,000	0.0%
▼ **WORST RETURNS**			
Hector de J. Ruiz/Advanced Micro Devices	-33.3%	$12,442,773	15.6%
"Over the last five years, shareholder returns were significantly greater than the industry's."			
Ian J. McCarthy/Beazer Homes USA	-32.9%	$30,206,642	180.3%
A spokeswoman didn't return calls for comment.			
Donald J. Tomnitz/D.R. Horton	-32.8%	$13,569,069	3.4%
"Fiscal 2006 net income exceeded $1.2 billion, second highest in company's history."			
Ara K. Hovnanian/Hovnanian Enterprises	-31.4%	$12,999,684	-55.4%
"CEO's compensation, which declined by more than 50%, is directly tied to the company's performance."			
William C. Griffiths/Champion Enterprises	-31.3%	$1,819,000	-35.8%
"Despite financial results similar to 2005, returns declined alongside housing peers."			

*Based on partial-year data. N.A.: A valid comparison is not available, typically because the chief executive is relatively new. TDC stands for total direct compensation.

Source: Analysis of latest proxy statements for 350 major U.S. companies by Mercer Human Resource Consulting. The New York firm uses a revised definition to calculate total direct compensation. It now covers salary, bonus, and other annual incentives as well as the value of restricted stock, stock options and other long-term incentive awards at the time they were granted. Total shareholder return, or TSR, is the sum of stock-price appreciation plus reinvestment of dividends.

Consider **Eli Lilly** & Co. The pharmaceutical maker's latest proxy statement says directors judge its pay practices against eight other drug manufacturers, including **Johnson & Johnson**, because "Lilly must compete with these companies for talent."

But J&J is much larger and more complicated than Lilly. "When you compare [Lilly's] CEO to that company's, all that does is ratchet up the pay for someone with a less

complex job," says Denise Nappier, Connecticut's state treasurer. She oversees a $24 billion pension fund for public workers.

A Lilly spokesman, Mark Taylor, responds that Lilly uses top-tier pharmaceutical companies like J&J as benchmarks "to make sure we are aligned in offering competitive packages."

6. Kill unjustifiable perquisites.

A limited retreat is under way for perks. Companies have trimmed extras ranging from personal flights on the corporate jet to financial counseling.

Next year, **Gannett** Co. "will no longer provide its senior executives with any allowance for home security systems or club membership fees," the newspaper publisher's latest proxy says. But in certain cases, directors have enlarged other forms of remuneration to make up for lost perks.

Boards fear the hazards of publicizing perks amid the ruckus over executive rewards. The new proxy rules require revealing perks of $10,000 or more apiece. Prior rules limited such disclosures to those valued above $50,000.

7. Link all long-term incentives to performance goals.

Without such ties, executives at poorly performing businesses can make money exercising their options amid a rising stock market.

General Electric Co. earned kudos in 2003 when it replaced options and restricted shares for Chief Executive Jeffrey R. Immelt with "performance share units." The units pay out based on cash flow and stock performance. GE shares generally have underperformed the S&P 500 index since Mr. Immelt took the helm in September 2001.

But few companies have emulated GE. Directors say, " 'It's a good idea, but we don't see other people doing it,' " notes Paul Hodgson, senior research associate for Corporate Library, a Portland, Maine, governance-research firm. Ten companies have received investor resolutions this year recommending linking a substantial amount of equity compensation, such as options and restricted shares, to performance.

8. Divulge precise measures that shape payouts for performance-based awards, and set hurdles high.

Despite the new proxy rules, businesses still may conceal performance goals for competitive reasons. Many do.

Investors should be able to figure out whether generous bonuses reflect good performance or poorly set targets, says Lucian Bebchuk, a Harvard Law School professor and co-author of the book "Pay Without Performance."

Fuller disclosure would produce "more stringent hurdles," says Michael McCauley, corporate-governance director for Florida's State Board of Administration, which manages about $135 billion of public-employee pension assets.

9. Conduct regular checkups about pay practices.

Boards are trying different approaches. Gateway's pay panel will decide this month whether to request an annual internal audit of option grants and similar long-term awards, Mr. Parham says. "I think it's a great idea" that might someday involve external auditors, too, he adds.

ConocoPhillips directors will consider rotating their pay consultant every five years. "The benefit clearly is that you will get a fresh look," says Mr. Augustine, chairman of the ConocoPhillips pay panel.

Other boards are seeking second opinions about their pay plans and their advisers from rival consultancies. Scott Olsen, head of PricewaterhouseCoopers' reward practice, says he does this about six times a year, up from "never" five years ago.

10. Give investors a voice about executive-pay packages, a right that exists in four countries.

So far in 2007, shareholders have submitted proposals at 64 companies seeking an advisory vote on executive pay. Confronted with such a resolution, **Aflac** Inc. agreed to give investors a nonbinding vote on pay starting in 2009. **AT&T** Inc. and **Northrop Grumman** Corp. tried unsuccessfully to block the proposals from their proxy ballots this year.

U.S. Rep. Barney Frank, the Massachusetts Democrat and new chairman of the House Financial Services Committee, introduced a bill last month requiring annual advisory votes. The measure passed that committee late last month, and heads now for a full House vote.

"Say-on-pay" proponents hope investor censure -- or the threat of it -- will encourage directors to trim excessive awards and better link pay with performance. An advisory vote "tamps down the potential for CEO greed," says AFSCME's Mr. Ferlauto. "Shareholders will have to replace compensation committees that don't heed these votes."

--Ms. Lublin, the management news editor for The Wall Street Journal in New York, served as contributing editor for this report.

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