Money Talks

Corporate Counsel
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If CEOs are getting paid too much for the wrong reasons, what can – or should – boards do about it? Four experts weigh in on fixing executive pay.

IN the past couple of years, executive pay has become like the weather. Everyone complains about it. But no one does anything about it.

At Corporate Governance Advisor, we decided to try to take the discussion beyond the complaint stage. Are chief executive officers really being paid too much for doing too little? And if so, how can boards and companies do a better job of designing effective compensation for today's CEOs?

To find out, earlier this year we pulled together a group of experts who know their way around a boardroom: Betsy Atkins, CEO of venture capital investor Baja Corporation and a director of Reynolds American Inc., Chico's FAS, Inc., UTStarcom, Inc., and Polycom, Inc.; Paul Brountas, senior counsel at Wilmer Cutler Pickering Hale and Dorr and author of Boardroom Excellence (Wiley, 2004); Richard Koppes, of counsel at Jones Day, a director of Apria Healthcare Group Inc. and Valeant Pharmaceuticals International, and former general counsel of the California Public Employees Retirement System; and Michael Katzke, a partner at Wachtell, Lipton, Rosen & Katz who specializes in executive compensation.

As talking points, we asked panelists to consider some recent proposals for fixing executive compensation. These included the increased disclosure requirements that the Securities and Exchange Commission is currently considering, the heightened role for shareholders advocated by Lucian Bebchuk and Jesse Fried in their book, Pay Without Performance, and the reforms suggested to the New York Stock Exchange, Inc., by Winston & Strawn's Dan Webb in his investigation of the compensation paid to former NYSE CEO Richard Grasso.

In the discussion that ensued--which has been slightly edited for clarity--none of our panelists had any problem coming up with strong opinions. Different panelists advocated slightly different solutions. But one thing that everyone agreed on: Fairer, more effective executive compensation starts with an active and engaged board of directors.

Emily Barker, Corporate Counsel:

Does [executive pay] need fixing?

Paul Brountas: Richard Findley, the chair of Canada's Center for Corporate & Public Governance, characterized executive compensation as the mad cow disease of America's boardrooms, which is moving from corporation to corporation, [like] contamination. He wrote it a couple of years ago. I think it's still true.

[In January] we had a merger announced in the Boston area. Procter & Gamble is going to acquire Gillette, and the [Gillette] CEO, [James] Kilts, a very good CEO, is going to walk away with about $180 million, I think [in stock, options, bonuses, and other benefits]. I have to say to myself, do you think you would have turned this job down if he'd only gotten $18 million rather than the $180 million package? Or maybe $28 million?

So sometimes you wonder about the incentive. Is this good for the company, or is it good for me, Mr. CEO?

I think in many of these companies the directors aren't doing their job, and that is providing the oversight and monitoring the compensation, knowing what's going on and assuring that high pay is good, but it is [also] tied to high performance.

Michael Katzke: I also think that a lot of work really [has] an individual board-by-individual board and person-by-person aspect to it. [At Wachtell] we've been involved with a board where they fired a CEO, and then they hired a new CEO right after that. I was on conference calls at 3 in the morning with one of the board members, who had the task of running this firing. He wanted to know every nickel being spent. It was a CEO termination, and as you all know, CEOs often wind up with a $5 million or $10 million package. They really wanted to make sure that this person did not get more than either he was entitled to, or really more than what might be called reasonable. And they kept it down.

I [also] think there needs to be more of a movement to having executives hold [company shares] for a five- or ten-year horizon, and I think along with that, I would prefer to see more strength put into stock ownership guidelines than we're seeing right now. I think a lot of companies have them, but then they start counting shares [that executives] could receive through restricted stock grants or options exercises, as opposed to having executives really put a little bit more teeth into their ownership of their company.

Richard Koppes: I come from the long-term [investor] community, and over the ten years I was at CalPERS, we had many meetings with management who had very little stock . . . and these people thought of this as their company. I have fond memories of names which you would recognize of CEOs pounding, "How dare you challenge us? How dare you question us? This is my company, my company." And, you know, my role was often to say, "You know, excuse me, Mr. CEO, you own only 500,000 or a million shares. We own 3 million. And you know, we've noticed you've been selling your shares for a long time."

I just think [a stock ownership requirement] promotes a different mind-set with management. What is the CEO telling you if he or she wants the freedom to sell a lot of their stock?

Barker: One of the suggestions actually that's raised in Pay Without Performance is that there should be more regulation of this type of equity compensation. For example, requiring executives to disclose in advance if they're going to sell stock, when they're going to sell it, how much they're going to sell.

Betsy Atkins: I think that's very, very reasonable. I think that's fair and reasonable because it

immunizes the company from the hindsight class action suits that say, "Oh, you sold. You pumped and dumped."

Brountas: Something that I've been struggling with for years, and that is that chapter [in Pay With-out Performance which] talks about the directors negotiating [CEO compensation at arm's length]. I have found that it is very difficult for many directors to be truly independent directors, despite the fact that they meet Nasdaq and New York Stock Exchange requirements. Directors don't want to disagree. There's a sense of collegiality in board meetings.

Koppes: Well, you don't want to say no.

Brountas: You don't want to say no, and you don't want to take somebody on in a meeting and say, "You're wrong."

What you need is independent-thinking directors [when it comes to] paying performance and judging people. I think that should be stressed somehow.

Atkins: Well, that's driven from the CEO. The whole dynamic in the board and the conversation that happens in the boardroom is driven from the chairman and the CEO. What gets put on the agenda? What is the rhythm of the meeting? Is there time for discussion? Is there time for dialogue? Do they encourage disparate views?

Katzke: I think actually the Disney case, [the shareholder litigation over severance paid to former Disney president Michael Ovitz, has] served a purpose, in that I'm finding boards are really more now focused on actually paying attention and listening . . . and we're making more of a point to make sure [directors] actually understand what the numbers are, what they were proving. And we are getting more questions, as far as what's going on.

We're also seeing a lot of . . . the dual comp consultant practices, where the board will have its own comp consultant, and management will have a consultant.

Atkins: Do you think it's working?

Katzke: We [advised on a merger recently], and I guess [management] had [compensation consultant] William Mercer, . . . and the board had [compensation consultant] Fred Cook representing them, and I thought it was overdone, frankly. I think a good board that asked a lot of questions would have gotten to the same place.

Atkins: I think that there's been a change on a lot of comp committees I'm on. We now are going back out in the market, we're interviewing comp consultants, just like you interview the auditors. We are selecting them together with management, but their engagement letter comes from the comp committee.

Koppes: Are you finding those consultants to be . . . truly independent? I mean, they are not basically working a great deal already for management of some kind? How do you find consultants who have the board mind-set? Because that really does need to be different, if you're

going to be engaging in a negotiation, which is what this should really be about.

Atkins: I'm not advocating the two consultant model. I think there are special circumstances where it makes sense. . . . I do find comp consultants [responsive] to your point, Rich, if you give them the strong guidance that says, we're looking very carefully at the group of companies you want to benchmark us against as peers.

So, for example . . . at Chico's [FAS, Inc.], where I'm a board member. This is one of the top-performing retail specialty stores. [We don't] compare ourselves to all the specialty retail stores like [Limited Brands, Inc.'s] The Limited or Victoria's Secret or AnnTaylor Stores Corporation, [which are] low-growth, low-performing specialty retail stores. So it's not fair to peg us against that, when for the last six years we've been listed in Forbes as one of the fastest-growing companies. So we identified a set of peers that were high-growth companies and made our benchmark tougher. The comp consultants will respond to what you define.

Brountas: I read some of the Dan Webb report [on the investigation into the compensation of NYSE president Grasso]. How can all these very smart people who are members of the board of the New York Stock Exchange--prominent, intelligent, obviously well versed in corporate governance--not know what the hell is going on? I mean, it's just mind-boggling that decisions were made without relating [all the different] compensation pieces.

Koppes: I think there's been this kind of divine right that has grown up [among CEOs] that "We are owed this. We all have to be in the top part." The board didn't question it, and many of them didn't [know]. I think the good news of what's happened in the last few years, whether it's brought on by the plaintiff's part or the media, is that boards are doing their job. You know, corporate governance by embarrassment is a good pressure to have. People view this as a job, and they understand their role of oversight, and they're beginning to say no and challenge [management]. Boards are becoming a problem for CEOs.

Barker: What about this idea of [Lucian] Bebchuk's to try to align directors and shareholders more closely? He argues that directors should be more "dependent" upon shareholders. He's [saying that] shareholders should be allowed to nominate directors if they like . . . or even that shareholders should be allowed to vote directly on provisions in the charter.

Brountas: Well, I think his choice of words is unfortunate. I don't know how you ever become dependent on shareholders. Are you supposed to be communicating with them every day? I don't know how shareholders can make the decisions that Pepsi [management] has to make every day. They're just not qualified to make these decisions. So they should be voting for somebody who they trust who can make the decisions.

Koppes: If you've got a good solid independent active board, then frankly the shareholders need to back off. It's impossible for them to know and to act instead of the directors or to be voting on everything. Shareholders don't know, they're not there.

Katzke: Do you think as an investor or a former CalPERS person that the proxy disclosure of compensation is adequate?

Koppes: No, I think that's an area where we could do a lot more.

Katzke: [We] have the performance graph off buried somewhere in the proxy, and then have a table which shows how much the individuals get paid, and then have a comp committee report which, if you could ever figure out what they said, might give you what sort of percentile [comparing the CEO's pay to his] peer group. It doesn't really work because people can't piece it together.

I think it would be helpful to have something that says [the company] performed at the tenth percentile the last three years, and this fellow alone is being paid at the twenty-fifth percentile. Just something that would allow shareholders to understand whether a company that's doing well is paying well, or conversely it's paying well and they're doing poorly.

Koppes: And to make sure that the directors knew what they were agreeing to, because so many of our embarrassments seem to be directors who say, "Well, gosh, I really didn't know . . . what the severance package really was."

Barker: If the SEC required companies to make public disclosure of total CEO compensation, would that help the board members themselves better understand how much compensation they're granting?

Atkins: I think that's very fair. I think that you raise a great point. What is the total compensation? What are all the elements? What's the retirement piece? What's the pension piece? What are all the perks? I think that the disclosure would be a discipline that would help. I'm fearful of more regulatory solutions. The unintended consequences of more regulation. Another Sarbanes-Oxley Act of executive compensation.

Brountas: One other thing, everybody talks about setting the tone at the top and ethics and culture and so forth in companies, and I've been trying to figure out how that plays into compensation. Maybe it doesn't. But it certainly seems to me that the board has some sort of responsibility in making sure that there's a culture within the company that rewards people when they deserve to be rewarded [and] gets rid of them when they don't perform.

Everybody talks about the compensation committee establishing a compensation philosophy. How have you been doing that? Does that mean that [you] want to be at the top tier of compensation? Is that a philosophy?

Atkins: That is a philosophy to some companies. Do we want to pay in the middle? Do we want to pay in the seventy-fifth quartile? Where do we think we need to be? And they establish it based on a few things. First of all, for example, in Silicon Valley . . . if you're not paying in a certain quartile, if you're paying in the bottom quarter relative to your peers, it's going to be hard to attract certain types of technologists.

So your philosophy is driven by your competitive dynamic, or what you're trying to do with your compensation. Are you a company that's having a hard time attracting and competing for talent

in Silicon Valley? Are you a company in a place like Detroit, where whoever is there probably doesn't have all that many job options? If you're an executive at GM, where else are you going to go but Ford?

Are you going to have heavily weighted options? Well, in Silicon Valley you are, but at Ford Motor maybe it's a more restricted stock and pension plan. Your competitive pressures to find people and pay people are going to be different. The comp philosophy that you refer to is driven somewhat by industry. And even in technology, it's not all the same for technology, right? The way that you compensate at Intel and Microsoft is radically different than how you compensate [at] the very small-cap start-up, where it can be your leverage but there's a chance that somebody is going to become a multimillionaire.

Koppes: Have all your committees had that kind of discussion?

Atkins: We probably revisit our philosophy a couple of times during the course of the year to think, has something changed in our competitive situation? In our industry? Is there a shift now in where we are as a company in our maturity base? You know, if we're shifting from being a high-growth company toward being a value company, then that's going to drive our philosophy differently.

Barker: If you had to . . . come up with one do and one don't for compensation committees, what would they be?

Katzke: Make sure that they appreciate what they're getting into and really understand what the costs are. They should not be in a situation where they're not willing to ask questions.

We [counseled one client in] a $2 billion merger a year or so ago, and I was surprised because the board a) they didn't ask many questions on the merger and b) we were putting in new [compensation] arrangements for the target executives, and they asked even less questions about those. To really just sort of turn your eye away and not really pay attention to what's going on is to me a) a very bad thing for the company and b) it's going to potentially [lead to] a situation like Disney, where you've lost the protection of the business judgment rule, and now you really, as a board member, are in trouble.

Brountas: Well, I think it's prevalent now that you pay high pay for high performance. That means that the board really does have to know what's going on, because there are so many elements that go into performance. That means transparency, so that when you report to your shareholders they know why these [executives] are receiving it.

When the company isn't doing well, [executives shouldn't] get paid for performance, but they do get paid pretty well. And if they do too badly, then they get fired.

Atkins: I would say, do act like an owner. Make sure you understand what the compensation is in total. And don't just go with what is the market compensation. Look at the specific performance of how your company is doing relative to others in its sector.

Don't just go by "The whole pharma compensation index goes up at X percent." It's how did your pharma company do relative to the index.

Koppes: Understand that as the comp committee, if you're doing your job, that you're really . . . hopefully at somewhat of an arm's-length negotiation with management with the CEO, and that you're going to have to sometimes say no. And that's not going to be popular. So it's not a popular place . . . the comp committee. In fact, I think being the chair of the comp committee now is the hardest job on any board, if they're doing their job.

I guess the don't is, don't give into temper tantrums. In other words, as [corporate governance activist] Nell Minow is famous for saying, recognize that you have to be the adult.

You're the parent, and sometimes [you have to] say no.