Reining Back the Company Gravy Train

Management Today
By Peter Montagnon
February 7, 2005

This book's cure for the corporate habit of rewarding failure is a shift in the balance of power. Review by Peter Montagnon.

It's nice work if you can lose it. In the two years that Jill Barad was chief executive of Mattel, its share price halved, wiping out dollars 2.5 billion in shareholder value. But when she left, she received dollars 50 million, including forgiveness of a dollars 4.2 million loan and a contribution of dollars 3.3 million towards her tax bill.

Reward for failure on this scale is so absurd as to be laughable. Sadly, Barad is not alone. The bubble of the late 1990s has produced case after case of excess, which, unless corrected, ultimately risks damage to the reputation of capitalism itself. So it is timely to find a book that analyses the problem and proposes solutions.

The basic tenet of Pay Without Performance is that the system of executive compensation has failed. Boards are supposed to determine the compensation of management at arms' length from those that receive it. But the structure of boards leaves them prone to management influence. The solution, say the authors, is to make boards more subject to shareholder influence.

This is a significant conclusion because it raises an important question about governance. Boards that yield to pressure from management over pay will hardly be able to provide the right sort of checks and balances in other areas. Compensation is not then the only problem. History shows that value is at risk in companies where the management has an undue influence.

According to Bebchuk and Fried, the steps taken in the US to deal with these problems have still not freed boards from management influence. If that means the problem of executive compensation remains unsolved, the implication is that for all the efforts of the SEC and others, the risk of another generation of Enrons remains.

Bebchuk and Fried note that studies indicate a correlation between managerial power and pay. Remuneration is less closely linked to performance where boards are large and the power of directors is diluted, where anti-takeover devices are in place, or where there is no large shareholder block.

Much compensation comes without performance conditions and the amount is often camouflaged. In 2001, for example, executives of Verizon Communications received bonuses reflecting net income of dollars 389 million, even though this figure was based solely on a decision to increase the projected future returns of the company's pension fund.

One of the biggest problems has been with options. These produced windfall gains for executives on the back of a general stock market rise, but were rarely subject to performance conditions. Sometimes, options would also be granted to executives just before an announcement that lifted the share price.

Some answers are already provided by UK market practice. Here the timing of option grants is carefully distanced from corporate announcements, and options normally vest only after a three-year performance period. Since performance hurdles are often based on total shareholder return relative to competitors, there are fewer unjustified windfalls.

Yet Bebchuk and Fried are probably right to argue that the answer lies not in tweaking the rules around pay itself but in a more radical shift in the balance of power on US boards. Although US companies must now have a majority of independent directors, this means little when even the most independent directors ultimately remain dependent on the CEO for their seat on the board.

The authors are also right to dismiss current SEC proposals to allow shareholders to nominate directors as too weak. They would click in only after confidence in a particular director has been lost, and the process by which shareholders can assert their rights is expensive and cumbersome.

The truth may be that the system itself is imperfect because it expects executives, who work as agents, to be aggressive in the pursuit of value for owners and modest in their own aspirations. The task is to find the balance in the relationship between managers, directors and shareholders that provides the best chance of sustained long-term value-creation.

This book has important messages about where that balance should lie, not just with regard to executive compensation but to governance in general.

Pay Without Performance; Lucian Bebchuk and Jesse Fried; Harvard University Press pounds 16.95; MT price pounds 13.95; To order, visit www.mtmagazine.co.uk

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