INTRODUCTION

The Battle over Executive Compensation

Two perceptions of corporate executive pay now compete for acceptance in the United States. The first views executive compensation as a reasonably well-executed pay-for-performance model, characterized by high pay for high performance and less pay for lower performance. The successful application of this model has helped create an economic juggernaut, resulting in trillions of dollars of wealth for shareholders and substantial income and net worth for millions of corporate employees and their families. Consistent with basic microeconomic theory, high executive pay simply reflects the strong demand for top talent.

The other perception sees a failed pay-for-performance model with immorally high and rising executive pay, unrelated to corporate performance, and enormous wealth for executives who benefit from a "rising tide" in the stock market. Executives essentially set their own pay by wielding power over boards of directors that have not fulfilled their duty to balance the interests of executives with those of stakeholders. Executive pay – which has enriched management at the expense of shareholders, employees, customers, and their communities – is an embarrassment to our country and has done more economic harm than good, leading to business scandals, the demoralization of employees, and unacceptable levels of income inequality.

This second view broadly challenges the credibility of the entire corporate community. Fed most notably by a series of financial scandals, the popular press, the business press, and a group of powerful public organizations have whipped the perception of a failed pay model into a full-blown mythology of a corporate America ruled by executive greed.

For years, headlines have seized on anecdotal accounts of outrageous amounts earned by executives at failing companies and the financial tragedy that strikes shareholders and employees when executives line their own pockets at the expense of the organization. Images of lavish executive lifestyles are now engraved in the popular consciousness and propel public support for political responses that include new regulatory measures and demands for greater shareholder control over executive compensation. Fresh accusations of executives paid for nonperformance appear regularly.

One of the focal points for these attacks is stock options – once the cornerstone of the executive pay-for-performance model. Interestingly and ironically, stock options were part of the redesign of executive pay programs that occurred more than a decade ago in response to claims that executive pay should be more closely linked to corporate performance.

We are the first to acknowledge that a poorly constructed and executed pay-for-performance model can damage productivity, employee morale, and social objectives. But, like most mythologies, the current conception of executive compensation distorts or exaggerates actual events. The mythology has too easily found larger-than-life examples of personal gain and sumptuous lifestyles with no link to superior corporate performance.

Unfortunately, outliers exist – companies where executive pay is high and where severance arrangements or supplemental pensions create large payouts for mediocre or poor performance. Within the workings of the free market that broadly characterize the U.S. economy, these outliers are called out in the press, and their executives are ousted for poor performance.

But our research, stated throughout this book, shows that most companies have substantial amounts of pay-for-performance, with realized executive pay fluctuating with company performance. To the extent that the current mythology leads to a rejection of the pay-for-performance model and restrictions on the risk-and-reward structure for setting executive compensation, U.S. corporate performance will suffer. If boards are pressured into reducing executive pay, we will see more turnover and less talent in the executive suite as the top job candidates move on to other professions.

In fact, the most prominent proponents of the current mythology – institutional shareholders and unions – will be among those that suffer most as executive talent declines, earnings shrink, share prices drop, and jobs are destroyed. Worse yet, companies may attempt to circumvent plans that engage shareholders. For example, they may move away from stock options to cash incentives to avoid the need for shareholder approval. This may reduce the alignment between management and shareholders and subvert the principal–agent relationship, which critics say is poorly executed.

While we readily join those who criticize boards that reward executives who do not produce, we know that this is not the case at the vast majority of U.S. corporations. Our experience has demonstrated clearly that the pay-for-performance model is not only viable but essential to the continued success of U.S. companies and the U.S. economy.

Executive Compensation in the U.S. Corporate Model

The stakes involved in the outcome of the argument are huge. The debate about executive compensation must take place in the broader context of the U.S. corporate model, which generates wealth for shareholders, a good income for millions of Americans, and retirement benefits and health care protections for employees and their dependents.

The U.S. corporate model also protects the economy from devastating cyclical swings. The U.S. economy is volatile, but stock market corrections and economic recessions are far shallower than they were in the past because the corporate model rewards flexibility and efficiency. Executives are paid to keep their companies lean and survive the downturns. Because companies are well managed going into a recession, they are able to pull out quickly and with less long-term job loss than we see abroad.

There are many reasons for the strength of the U.S. corporate model – its organizational flexibility and creativity, high levels of research and development, and technological prowess – but its success is closely connected to its unique approach to human capital, an approach based on relatively unregulated labor markets, high labor mobility, and a century-long reliance on various forms of incentive pay.

Executive compensation is determined by the labor market for managerial talent and by a pay-for-performance system that extends from the executive suite down to the factory floor and has contributed to high productivity rates in the United States for more than a century. Some argue that the labor market for executives is no longer efficient and that the pay-for-performance model no longer applies to CEOs, but this is not the case. CEOs are routinely dismissed or subjected to sharp pay cuts when they fail to produce.

Running a corporation involves making major decisions about expansions and divestitures, job creation and layoffs. Although some people consider it unseemly to reward executives who cause others to lose their jobs, the resulting efficiencies create growth and employment and secure the long-term survival and success of the whole system. When executives are not rewarded for making the tough decisions, companies do not perform as well.

Those who argue that we should abandon these executive pay practices deny the dynamic nature of the corporate model and the economy it supports. It is not a coincidence that the Dow Jones Industrial Average, which stood at 5,000 in 1996, is now well above 13,000. While U.S. executive pay practices do not entirely explain this rise, there is little doubt that it would not have occurred without them – and no evidence that the rise would have been even larger if the sums paid to executives had instead been paid to shareholders or reinvested.

The U.S. corporate model and the executive pay practices that drive it have created investment returns for millions of shareholders and funded pension and retirement savings plans now worth trillions of dollars. Over their careers, the top five executives at U.S. companies receive, on average, 2 percent to 3 percent of the value generated by the corporations they manage. The small savings that might occur by reducing executive pay would be swamped by the resulting decline in productivity, profitability, stock market returns, and the overall value of the corporation. Whether corporate success is measured in stock price performance, productivity, or employment, it starts at the top of the corporate structure.

U.S. executives are universally recognized as the best in the world. While there are few examples of U.S. companies importing international executives to boost corporate performance, many foreign companies have hired U.S. executives to improve earnings and efficiency. In fact, we have never encountered a case where a U.S. board has imported a CEO from abroad to cut compensation costs at the executive level. Such a move would run counter to board members' primary responsibilities: to ensure continuity of management and financial success. Compensation committees, for good reason, are unwilling to take such a risk.

The Goals of Executive Compensation

The debate about executive pay comes down to one's view of the executive labor market. Is it working properly – with risks and rewards, intense negotiations, and executives fired for failure – or is it a rigged system in which executives stack boards with their cronies and get paid huge amounts of money regardless of whether they succeed or fail?

A long list of pressures, including resistance from institutional investors, accounting and tax changes, enhanced proxy disclosure requirements, federal legislation, and media scrutiny, are forcing companies to rethink the design and delivery of their executive compensation programs, especially their stock-based incentives. But these pressures are having a decided, and many would argue adverse, impact on other employees. The current storm over executive pay is more likely to damage the far larger world of nonexecutive employees, who could lose their stock-based plans, now under attack.

The key is a proper mix of risks and rewards. Base pay provides a stable, competitive income. Benefits attract and retain talent in a tight labor market. Annual incentives motivate short-term behaviors and actions that drive long-term value creation. Long-term incentives (LTIs), in the form of equity, encourage employees to maximize long-term shareholder value. Pensions, SERPs, and deferred compensation plans promote long-term retention and company affiliation and long-term capital accumulation. Severance plans allow executives to take the risks necessary to seek maximum shareholder value, even if it means jeopardizing their own jobs. The compensation package must address both the need for income and security and the opportunity to accumulate assets.

Executive pay programs must also be aligned with employee pay programs so that efforts are synchronized throughout the organization. They must send signals about the company's strategic imperatives to other stakeholders – especially shareholders – and ensure the implementation of those imperatives. If a company is losing market share or operating in a stagnant industry, for example, the pay program should reward executives for profitability but also, perhaps more important, for revenue growth.

Pay programs must motivate executives to make the capital investments and business decisions that earn a greater return than the cost of that capital. They must motivate executives to divest units that are not earning more than they cost, even if that means shrinking an organization that the executive has helped build. Shareholders, too, must earn a return in excess of the cost of human capital. Investing in a top executive involves up-front costs, and the return on that investment can be evaluated only over time.

Although we contend that the basic executive pay model is sound, specific improvements will allow it to continue to succeed: real stock ownership among executives, the right mix of long-term incentives, more modest severance and perquisites, and compensation committee practices and procedures that reflect good corporate governance.

Our Approach

By looking at the recent history of U.S. executive pay, investigating the extent to which the pay-for-performance model has governed executive pay levels, and assessing the success of this model in creating value for shareholders and robust job growth for U.S. workers, we hope to initiate a thoughtful discussion of what is working well in executive compensation and what could be improved.

OUR VIEWS

Although we demonstrate that executive compensation is closely tied to corporate performance, some aspects of executive pay are deeply flawed. We agree with the critics, for example, that the excessive use of stock options may negatively affect corporate performance. We also agree that more disclosure – especially with respect to supplemental retirement plans, deferred compensation, and severance payouts – is necessary. With the recent introduction of new proxy disclosure rules, the SEC has taken a substantial step in improving the disclosure of these elements.

Institutional investors, a potentially powerful influence on executive compensation, have serious criticisms of the current executive compensation model. Their concerns must be addressed where appropriate. Our goal is to provide solutions to specific problems and examine the best techniques for sustaining an effective pay-for-performance model.

The prologue shows the challenges facing a compensation committee chair. We begin in Chapter 1 with a detailed review of the myths surrounding executive pay and the evidence that refutes those myths. Chapter 2 discusses managerial power, which critics claim has undermined the pay-for-performance model, and the various aspects of executive compensation that critics see as manifestations of that power. Chapter 3 focuses on the external pressures that now surround executive pay. Chapter 4 traces the decline of the stock option as the primary vehicle for performance-based rewards.

Chapter 5 looks at new directions in stock-based incentives and long-term incentive programs. Chapter 6 discusses executive stock ownership as a solution to the executive compensation crisis. Chapter 7 covers director compensation in the context of increased director responsibilities and liability. Chapter 8 sets forth best practices for compensation committees and governance issues related to executive pay. Chapter 9 looks at stock programs designed for the broader employee population, the fate of those programs in the new regulatory environment, and alternative incentive plan designs. Chapter 10 compares executive compensation plans abroad with plans in the United States.

We close with an epilogue that returns the reader to the compensation committee meeting described in the prologue and reviews the committee's work to resolve the problems raised there. Appendix A describes the legal and regulatory requirements for executive compensation plans. Appendix B outlines the regulatory and institutional mandates that now affect executive compensation. Appendix C lists a number of academic studies relevant to the pay-for-performance model discussed here.

As always, we welcome any criticisms that contribute to the attempt to distinguish myth from reality in executive compensation and create the conditions for a constructive discussion of its future.

1 The Myths and Realities of Pay-for-Performance

> The work of those who criticize CEO pay, although appealing, simply does not "prove" that any particular CEO is overpaid, much less that an entire class of CEOs is overpaid. What is lacking in such work is some indication of what the CEOs would earn if the market for their services were more efficient. In the absence of evidence that the "overpaid" individuals would have been willing to accept less for their services, or that CEOs occupy some sort of monopoly position regarding executive services, it is difficult to accept the proposition as proven.
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> Mark J. Loewenstein, professor, University of Colorado School of Law

> The perception among reporters and other [critics] that the corner suite is a sinecure with huge rewards and little accountability bears no resemblance to present reality. Fully half of the Fortune 1,000 companies have replaced their man at the top since 2000.
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> "Off with Their Heads," editorial, *Wall Street Journal*, August 1, 2006

The full-blown mythology of a corporate America ruled by executive greed and excess consists of two related components: a failed pay-for-performance model and managerial power. The myth of the failed pay model hinges on the idea that the link between executive compensation and corporate performance never truly existed and therefore does not determine executive pay levels. The myth of excessive managerial power accepts the idea of a failed model and puts in its service the image of unchecked executives dominating subservient boards as the explanation for decisions resulting in excessive executive pay.

Our findings indicate that pay levels are highly sensitive to fluctuations in corporate performance. The research also shows that the U.S.

executive labor market is dynamic and sensitive to changes in the economy and in corporate performance. These sensitivities play a role in the U.S. economy's overall health.

The myth of the failed pay-for-performance model finds its touchstones in real examples of companies where executives have collected huge sums in cash compensation and stock options while shareholder returns declined. In some instances, CEOs have been richly rewarded for mediocre or even poor performance. But instances where CEOs became wealthy and the company shareholders made tens of billions of dollars have also been lumped into the failed model.

The myth of managerial power satisfies the need for a simple explanation for the failed pay-for-performance model and meshes with recent reports of corrupt governance practices and ineffective boards. Cases of overstated profits – or outright fraud – have fueled the idea that performance measures can be manipulated to justify higher pay while boards remain silent. The perceived ability of executives to time the grant or exercise of their stock options and collect additional pay through covert means has made the situation even worse.

The powerful combination of these two myths appears in statements from institutional investors, trade unions, and the media. The California Public Employees' Retirement System (CalPERS, the nation's largest public pension fund) provides a typical example in its November 15, 2004, press release announcing its new campaign "to reign [*sic*] in abusive compensation practices in corporate America and hold directors and compensation committees more accountable for their actions."

The AFL-CIO's Web site embraces the same myths:

> Each year, shocking new examples of CEO pay greed are made public. Investors are concerned not just about the growing size of executive compensation packages, but the fact that CEO pay levels show little apparent relationship to corporate profits, stock prices or executive performance. How do CEOs do it? For years, executives have relied on their shareholders to be passive absentee owners. CEOs have rigged their own compensation packages by packing their boards with conflicted or negligent directors.[1]

The Realities of Pay-for-Performance

Even if the critics are somewhat correct about some of the flaws in executive pay – too high, too many stock options, too much managerial influence and manipulation, too little disclosure, too generous pensions and severance – they are wrong about pay-for-performance, which trumps the other concerns. As explained in this book, high levels of pay opportunity have turned out to be a great investment for shareholders as well as for the executives. In the worst case, enormous shareholder wealth has been created despite those problems. In the best case, some of those factors allowed U.S. corporations to attract and motivate perhaps the greatest managerial generation in economic history.

The myth that executive pay is not tied to corporate performance includes several components: CEOs receive high pay even at companies with lackluster returns to shareholders; CEO pay rises when performance is strong but does not fall when performance declines; and stock options are ineffective rewards and a poor investment for the company.

Watson Wyatt conducts extensive research on the impact of executive pay and stock options on executive, corporate, and overall economic behavior. In evaluating thousands of companies annually for 10 to 15 years – yielding nearly 20,000 "company-years" of data – not only Watson Wyatt but dozens of economists have come to the same conclusion. For most companies, there is substantial pay-for-performance sensitivity. Simply put, high performance generates high pay, and low performance generates low pay.

MYTH 1: Executives are paid far more than they are worth in relation to the value they create for their companies.

REALITY 1: Executives generally receive only a small portion of the substantial value they help create for their companies and their shareholders.

There is no doubt that U.S. CEOs are well paid. As Figure 1.1 shows, the median CEO at the 1,500 largest U.S. companies had total direct compensation (TDC) opportunity (TDC = salary + bonus + present value of new long-term incentives) of approximately $3.2 million in 2005. As Figure 1.2 shows, CEOs' total pay opportunity increased by only 2.9 percent, a reduced growth rate from prior years. The amount these CEOs actually receive depends on stock performance plus other financial metrics that underlie their incentive programs. But as media and other pay critics often note, CEOs' actual pay is also high relative to that of other employees. A 2005 *BusinessWeek* article, "A Payday for Performance," lists 12 executives with more than $160 million in unexercised stock option profits.[2]

In reality, CEO pay is a very small part of a company's overall cost structure. Total CEO pay in 2004 was less than 0.09 percent of sales,