MYTHS AND REALITIES OF EXECUTIVE PAY

The executive pay model used widely in the United States is essential both to the continued success of companies and to the U.S. economy itself. The successful application of this model, which is built on the foundation of pay-for-performance, 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. High executive pay simply reflects the strong demand for top talent and can be evaluated with consideration of the performance that leads to high pay. Yet, myths of a failed model still abound, perpetuated by occasional excesses, recent corporate scandals, and controversy over the use of stock options. This book documents the realities of executive compensation by investigating the extent to which the pay-for-performance model governs executive pay levels. It also assesses the relative success of this model in creating value for shareholders and robust job growth for U.S. employees and provides detailed, real-world guidance for designing and executing effective executive compensation plans. Based on extensive empirical research and decades of direct experience in the field, *Myths and Realities of Executive Pay* settles the debate about executive compensation and the role it plays in the broader U.S. economy.

Ira T. Kay, Ph.D., global practice director of executive compensation consulting at Watson Wyatt Worldwide, headquartered in Washington, DC, is a nationally recognized expert on executive compensation. He has helped U.S. public, private, and international companies develop annual and long-term incentive plans to increase shareholder value. Dr. Kay has written and spoken extensively on executive compensation issues and conducted research on executive pay, stock ownership, and stock options. He is coauthor of the book *The Human Capital Edge* and is the author of *CEO Pay and Shareholder Value: Helping the U.S. Win the Global Economic War* and *Value at the Top: Solutions to the Executive Compensation Crisis*. Dr. Kay has published articles in the *Harvard Business Review*, *McKinsey Quarterly*, *Journal of Deferred Compensation*, and *Across the Board*. He has also presented analysis of executive compensation issues before the Federal Reserve Board, the Securities and Exchange Commission, the Financial Accounting Standards Board, and a U.S. Senate subcommittee. He is frequently quoted in the major business press and speaks globally on executive compensation issues.

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Contents

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978-0-521-87195-2 — Myths and Realities of Executive Pay
Ira Kay , Steven Van Putten
Frontmatter
More Information

Acknowledgments

The myths of ever-rising executive pay, unchecked management power, and a failed pay-for-performance model, perpetuated by the media, have reached a visceral crescendo. We have reached a critical juncture in the future of executive pay. We present a different and successful reality of executive pay comprising pay-for-performance, an efficient labor market, and an effective corporate governance model. This reality is based on extensive primary and secondary research combined with dozens of years of experience consulting to successful corporations. In our effort to separate fact from fiction and thus dispel the myths surrounding executive compensation, we are greatly indebted to our colleagues and clients, who have allowed us to test many of our hypotheses in real-world situations.

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PROLOGUE

The Compensation Committee Meets

May 23, 2006

The chair of the compensation committee scans next week's committee meeting agenda. The first several items are perfunctory – approval of minutes from the prior meeting, new-hire and promotional stock option awards, and an update on a succession-planning project. No surprises there. But the last two agenda items leap off the page: *status of employee stock purchase plan (ESPP) and broad-based option awards*, and *CEO employment agreement renewal*.

These are not unexpected. Several months ago, one of the outside directors called the chair to discuss the ESPP and broad-based option awards, raising a concern that the company was not getting much bang for its buck; that it was incurring significant expense and dilution for these stock-based awards that appeared to have little perceived value among employees.

In effect, the outside director was asking the committee to revisit the preceding year's decision to continue providing broad-based stock option awards and an ESPP – a decision that was agreed to by both management and the committee. That stay-the-course decision had been made in the face of mandatory stock option and ESPP expensing that would go into effect in January 2006. At the time, the decision made sense. The company's stock was trading near an all-time high, employee morale was strong, and the company was having little difficulty attracting and retaining top talent. With the company's broad-based equity programs apparently a key contributor to its success, the committee and senior management were disinclined to make any rash changes.

But during the year, events had occurred that, in retrospect, called into question the appropriateness of the strategy. The company's stock price had languished as a result of macroeconomic factors that adversely affected the company's industry. The fact that the company's flat stock price reflected better performance than that of its peers offered little solace to employees whose stock options were now just treading water.

The situation for option holders was compounded by the company's decision to institute a fairly healthy dividend, which gave shareholders a tax-effective return but provided option holders with no extra value. In addition, at the board of directors' annual off-site meeting, the CEO had described a short-term strategy that would necessitate several capital investments, the benefits of which would likely not be reflected in the stock price in the near term.

At the same time, through its outside compensation consultant, the committee learned that the competitive landscape was indeed changing. In a recent presentation to the committee, the consultant had noted that many peer companies had begun to deemphasize stock options by introducing alternative programs for senior levels of management and by reducing participation and/or shifting to vehicles offering a greater line of sight between actions and rewards at lower employee levels.

The chair understands that these factors merit a reappraisal. But she is concerned that dramatic changes could subvert several key objectives: fostering a culture of share ownership, promoting long-term retention and perspective, and maintaining alignment with shareholders. She also worries that a transition away from stock options to full-value shares could negatively affect the company's emphasis on pay-for-performance.

On top of that, and even more visible, is the ironic juxtaposition with the last agenda item – the renewal of the CEO's employment agreement.

Three years ago, to lure the CEO to the then-underperforming company, the board of directors had constructed an impressive pay package. In addition to competitive cash and equity compensation arrangements, the three-year employment agreement provided a large sign-on restricted-stock award, credited years of service under the company's supplemental executive retirement plan (SERP), and provided a severance benefit equal to three times the combined base salary and annual bonus.

In the event the CEO was let go in connection with a change in control and his severance and related benefits constituted an excess parachute payment (as defined under sections 4999 and 280G of the Internal Revenue Code), he would be entitled to a gross-up payment to reimburse him for any excise taxes incurred. After reviewing detailed peer practices, the compensation committee was comfortable that the package was appropriately competitive.

Three years later, the board thinks the CEO has earned every penny of his compensation package and that shareholders, in turn, have earned an above-market return on their investment in the new CEO. The CEO's unrelenting focus on controlling costs and realizing growth through new distribution channels has spurred the company to its best performance on record, despite a recently sluggish stock price.

Not surprisingly, rumors have been circulating that several companies in need of a well-regarded turnaround expert have placed this CEO at the top of their lists. For his part, the CEO enjoys working for the company, and he and his family want to stay in the area. He has communicated his wish to remain with the company and is interested in entering into a new agreement that would secure his services for the duration of his career. The board wants the same thing, but external pressures are constricting its ability to craft a new, attractive employment deal.

First, the company was recently sued by two separate shareholders who claim that the CEO received excessive compensation. The chair knows that the lawsuit is frivolous and thinks it stemmed from the committee's efforts to improve the transparency of executive compensation disclosure a year before being required to do so by the Securities and Exchange Commission. In the company's recently filed proxy statement, the compensation committee included a table showing the CEO's total remuneration, including the annualized value of benefits and perquisites. Because the CEO was a mid-career hire, the annualized SERP value, including the credited years of service, was an eye-popping number. The lawsuit specifically notes the elements of compensation, including the SERP and the sign-on restricted-stock award, that are not directly related to performance.

To compound matters, in the same proxy statement, two large institutional shareholders submitted separate executive pay resolutions, the first to limit severance benefits to no more than one times the combined salary and bonus and the second to require shareholder approval of the SERP. While the chair knows that these proposals are nonbinding, she is sensitive to the scrutiny the company will receive if they pass and the company subsequently files a Form 8-K disclosing the terms of a new CEO employment agreement.

It is apparent to the chair that there are multiple stakeholder perspectives on these issues and that most are in conflict. Therefore, she has asked that the final two agenda items be structured as review and discussion items rather than approval items. She has also asked the head of human resources to survey a cross section of employees about the current equity programs compared with other forms of remuneration. And she has asked the compensation consultant to collect and interpret data on peer practices.

A week before the meeting, the chair and the committee members receive the requested materials and the agenda. The challenge for the chair will be to channel the discussion toward achieving an outcome that benefits all stakeholders and, at the same time, reflects good corporate governance practices that will withstand public scrutiny.

May 30, 2006

At the meeting, the chair quickly dispenses with the initial items on the agenda. Diving right into the item on the employee stock option awards and ESPP, she asks the senior vice president of human resources to discuss the results of the employee survey. The SVP notes several pervasive themes: that the ESPP is viewed as an attractive benefit and that most employees value options for the recognition – and the affinity to the company – they provide. Like shares acquired through the ESPP, options are generally cashed in as soon as they vest.

One finding from the survey that concerns, but does not surprise, the SVP is the wide disparity in views based on demographics and employee level. Older employees in general prefer the security of restricted stock or cash to the upside potential of options more than younger employees do. However, the more senior the position, the greater the value the individual places on stock options. The SVP is concerned that changes to the current programs could create internal strife.

The compensation consultant then provides an overview of the changing competitive landscape. An increasing number of peer companies are shifting away from stock options, as evidenced by declining annual share usage rates and award sizes. At the executive level, companies are making up for reduced option award levels by introducing long-term performance plans, denominated in cash or shares. Although less clear from publicly disclosed data, it appears that companies are limiting stock option award eligibility for lower-level employees and that several are shifting to restricted stock with award levels that are differentiated on the basis of individual performance.

The chair asks the consultant to work with the SVP and his team to develop alternative approaches and evaluate long-term incentives (LTIs). She says that the committee expects a specific recommendation with supporting LTI rationale.

At this point, the chair excuses senior management, and the committee goes into executive session to discuss the CEO's employment agreement. She tells the committee members that the CEO has said he is looking for more security that will in effect lock him in with the company for the rest of his career. He has mentioned the possibility of an additional restricted-stock award and an enhancement to his supplemental retirement benefit.

One of the committee members objects, saying that maintaining links to performance is the key objective and that the prior restricted-stock and SERP credits were used as part of an employment inducement strategy.

The chair asks the consultant to develop alternative approaches and to work with her directly on the issue. With the meeting adjourned, she turns to the consultant and asks how executive compensation became so complicated so fast. "It's an interesting story," he says, "and the myths often overshadow the realities."