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Executive Compensation Best Practices

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Many investors are shocked by the size of CEO compensation, particularly in situations in which the CEO was seemingly the beneficiary of good luck. In the case of Exxon, the good luck was the increase in worldwide oil prices, which the media presumed was not the result of CEO efforts.

It was reported that Lee Raymond, the retired Chairman of Exxon, was paid $51.1 million in 2005, the equivalent of $141,000 a day, nearly $6,000 an hour. It was also reported that Exxon gave Lee Raymond one of the most generous retirement packages in history, nearly $400 million, including pension, stock options, and other perks, such as a $1 million consulting contract, two years of home security, personal security, a car and driver, and use of an Exxon corporate jet for professional purposes. Exxon defended Raymond's compensation, noting that during the twelve years that he ran the company, Exxon became the world's largest oil company and its stock price went up 500% (as of April 2006).

Given the time pressures and other constraints media reporters placed on Exxon's public relations personnel, this may have been as good a response as possible under the circumstances. However, the Exxon defense was unconvincing to skeptics because it failed to articulate an acceptable CEO compensation theory. For example, Exxon could have stated, if true, that Lee Raymond developed a strategy to expand the company's oil production and reserves, thereby positioning Exxon to benefit from the rise in oil prices, or that Mr. Raymond's compensation was developed after an extensive competitive analysis. Merely stating that the Exxon shareholders also benefited from the rise in oil prices was not a completely satisfactory explanation for the large amounts paid to Mr. Raymond.

Moreover, given what happened to former CEO of Home Depot Mr. Robert Nardelli, it is possible that Mr. Raymond would have been fired had the stock price fallen during his tenure, even though due to events also beyond his control.

Those who believe that good luck should not be the basis for increasing CEO compensation should ask themselves whether bad luck should also be ignored. If a CEO is to be rewarded for events beyond the CEO's control that increase the profits and stock price of the company, then, arguably, the CEO should likewise be punished for events beyond the CEO's control that adversely affect the profits and stock price of the company. If it is not feasible to punish the CEO for events beyond his or her control, then, arguably, the CEO should not be paid more than what is competitively required to retain the CEO even if very favorable events occur over which the CEO had no control, which increase the company's profits and stock price.

The counter-argument is that CEOs are being held responsible for increasing the price of the stock and are being punished for failing to do so even if their operational performance was beyond reproach. According to a Booz Allen Hamilton study[1], almost 1 in 3 CEOs were forced out of office in 2006, compared to 1 in 8 in 1995.

One example would be Robert Nardelli of Home Depot who was terminated based upon the failure of the Home Depot stock to appreciate, even though he was successful in significantly increasing the profits of Home Depot.

Professors Bebchuk and Fried[2] make a similar argument with regard to stock option and other equity-based compensation. They argue that executives should not be rewarded for increases in stock prices that are no greater than indexes for the market in general and, therefore, stock options and other equity grants should only reward the executive for increases in value over and above increases in these stock market indexes.[3] By rewarding executives only for stock price increases that are arguably due to their effort, the executive does not profit from events beyond his or her control.

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Warren E. Buffett on Executive Compensation

The concept of rewarding or punishing CEOs for events beyond their control has caught the attention of Warren E. Buffett. The following are excerpts of Mr. Buffett's engaging views on executive compensation[4]:

> "When we use [CEO] incentives – and these can be large – they are always tied to the operating results for which a given CEO has authority. We issue no lottery tickets that carry payoffs unrelated to business performance. *If a CEO bats .300, he gets paid for being a .300 hitter, even if circumstances outside of his control cause Berkshire to perform poorly. And if he bats .150, he doesn't get a payoff just because the successes of others have enabled Berkshire to prosper mightily.* An example: We now own $61 billion of equities at Berkshire, whose value can easily rise or fall by 10% in a given year. Why in the world should the pay of our operating executives be affected by such $6 billion swings, however important the gain or loss may be for shareholders?... [Emphasis Supplied]

CEO Compensation Theories

There are two rival theories for the rise in CEO compensation. The first theory blames lax corporate governance by directors of public companies, many of whom are selected by and beholden to the CEO. This is the Warren Buffett theory.

The second theory ascribes the increase to economic factors, including globalization and technology and other macroeconomic factors that have increased the productivity of a select few superstars. For example, a paper by Professors Xavier Gabaix, (Massachusetts Institute of Technology) and Agustin Landier, (New York University) dated May 8, 2006 entitled "Why Has CEO Pay Increased So Much?" states that a "large part of the rise in CEO compensation in the U.S. economy is explained without assuming managerial entrenchment, mishandling of options, or theft."[5]

> "Historically, in the U.S. at least, the rise of CEO compensation coincided with an increase in market capitalization of the largest firms. Between 1980 and 2000, the average asset value of the largest 500 firms increased by a factor of 6 (i.e. a 500% increase). The model predicts that CEO pay should increase by a factor of 6. The result is driven by the scarcity of CEOs, competitive forces, and the six-fold increase in stock market valuations. Incentive concerns or managerial entrenchment play strictly no role in this model of CEO compensation. In our view, the rise in CEO compensation is a simple mirror of the rise in the value of large U.S. companies since the 1980s."

In 1981, Professor Sherwin Rosen of the University of Chicago wrote a paper entitled "The Economics of Superstars" which he characterized as follows: "The phenomenon of Superstars, wherein relatively small numbers of people earn enormous amounts of money and dominate the activities in which they engage, seems to be increasingly important in the modern world."[6]

Professor Rosen cites examples of a small number of popular comedians who can earn extraordinary sums as a result of the capacity of television to reach popular masses. He found two common elements in all of the so-called Superstars: "First, a close connection between personal reward and a size of one's own market; and second, a strong tendency for both market size and reward to be skewed toward the most talented people in the activity."

Professor David H. Autor (Massachusetts Institute of Technology) cites advances in communications technology, including the Internet, for the proposition that there are "winner take all markets," (i.e., allowing individuals with extraordinary talent to serve substantial markets almost single-handedly) and that communications technologies may displace lesser talents, redistributing a larger share of the rewards to a smaller number of superstars.[7]

A January 9, 2007 blog by Stephen Kaplan of the University of Chicago[8] entitled "Are CEOs of U.S. Public Companies Really Overpaid?" makes some of the following points in defense of CEO compensation:

> The CEO job at large public companies is less secure today than it has been over the last 35 years, with CEO turnover at Fortune 500 companies running at over 16% per year since 1998 versus 10% per year in the 1970s, with CEO job retention of an average of six years today versus ten years in the 1970s.
>
> CEO turnover and pay at Fortune 500 companies is strongly linked to stock performance relative to the industry, citing the public dismissals of Hank McKinnell of Pfizer and Robert Nardelli of Home Depot, each of whom served over six years and presided over poor stock performance relative to their industries, and the fact that CEOs in the top compensation decile were with firms that outperformed their industries over the previous three years by more than 50%, while CEOs in the bottom compensation decile were with firms that underperformed their industries by more than 25%.

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There are elements of truth in each of the rival theories. The dramatic increases in CEO compensation are both the result of economic factors, such as globalization which creates potential "superstar markets," and a failure of compensation committees of boards of directors to consistently use "best practices" in formulating and approving CEO compensation.

Tying Performance to the Strategic Plan

Best Practice:

Each company should have a year-to-year budget and a long-term strategic plan, and reward the executive for accomplishing the goals of both.

Any good CEO compensation package must provide incentives to satisfy both its year-to-year budget and its long-term strategic plan. Most companies have a budget and reward the CEO for achieving or exceeding the budget or punish the CEO for missing that budget. However, many companies do not have a long-term strategic plan.

It is difficult to establish goals for the CEO in the absence of a clear and well articulated long-term strategic plan. Indeed, the CEO compensation package must, in part, tie into the strategic plan as well as the annual budget.

For example, assume that a multilocation retailer has an annual budget that contemplates an increase in revenues of 10% per year and an increase in profits of 12% per year. The long-term strategic plan of this retailer may contemplate doubling the number of retail stores over the next five years. Assume that in a given year, the CEO meets the year-to-year budget but fails to open any new stores. In this situation, the CEO should receive a bonus for achieving the annual budget, but no bonus based upon the strategic plan goal in the absence of compelling reasons why no progress was made in achieving the long-term strategic plan.

Executive performance goals cannot be created in isolation. Every company should have a strategic plan and be certain that the articulated goals for the CEO assist in the accomplishment of the goals of that plan.

Unintended Consequences

Unintended consequences are the bane of the law, contractual provisions, and financial metrics.

Compensation metrics are also subject to unintended consequences and gaming and in many cases reward or punish the executive for events over which the executive has no control. For example, a performance metric keyed to earnings per share is subject to each of the following problems:

Earnings per share may rise or fall because of changes in world-wide commodity prices for raw materials, thereby making this metric unsuitable as a measurement of executive performance.

Earnings per share may increase because management reduces its research and development expenditures, or, alternatively, earnings per share fall because the company must engage in needed research and development for long-term strategic reasons.

Changes in accounting principles or their application cause earnings per share to decrease or, alternatively, cause earnings per share to increase.

Significant management bonuses based upon earnings per share have caused management to "cook the books." For example, according to a Securities and Exchange Commission (SEC) complaint, the senior management of Huntington Bancshares, Inc., in order to achieve earnings per share targets that determined bonuses and to meet Wall Street expectations, allegedly engaged in a number of misstatements. The misstatements included up-front recognition of loan and lease origination fees that were required by accounting rules to be deferred and amortized over the term of the loan or lease; improper capitalization of commission expenses and deferral of pension costs that were required to be recognized in the period incurred; misstated reserves; improper deferral of income; and misclassification of nonoperating income as operating income. As a result, Huntington Bancshares, Inc. paid a penalty of $7.5 million and suffered public embarrassment.[9]

Firm Expansion and CEO Pay

Revenue size is often viewed as an indication of the complexity of an organization and this is a major factor in establishing the market for CEO compensation. The significance of revenue size differs from industry to industry. Some believe that revenue growth, which is one of the financial statement measurements less subject to manipulation, is a good metric to use in establishing executive compensation.

However, even revenue growth is subject to manipulation, as we have seen from the so-called "channel-stuffing" cases in which large amounts of inventory are shipped at the end of a quarter to enhance revenue even though there is no requirement to pay for it. Revenue growth can also be affected by mergers and acquisitions and thus revenue can become distorted as a performance metric.

The following is an abstract from a paper by Professors Bebchuk and Grinstein, November 2005, in which they

ascribe significant CEO compensation growth to firm size (presumably revenue growth or market capitalization):

> "We study the extent to which decisions to expand firm size are associated with increases in subsequent CEO compensation. Controlling for past stock performance, we find a positive correlation between CEO compensation and the CEO's past decisions to increase firm size. This correlation is economically meaningful; for example, other things being equal, CEO's who in the preceding three years were in the top quartile in terms of expanding by increasing the number of shares outstanding receive compensation that is higher by one-third than the compensation of CEOs belonging to the bottom quartile…We find an asymmetry between size increases and decreases: while size increases are followed by higher CEO pay, size decreases are not followed by a pay reduction…*The association we find between expansion decisions and subsequent CEO pay could provide CEOs with incentives to expand firm size.*" [Emphasis Supplied]

Equity-Based Compensation

Best Practice:

The percentage of equity-based compensation to the executive's total compensation package should not be so large as to cause the executive to unduly focus on the price of the company's stock, but should be large enough to compete on a risk-adjusted basis with compensation packages potentially offered by private equity funds.

In establishing the percentage of equity compensation of the CEO and other senior executives, public companies should take into account the potential competition from all areas, including private equity funds for talented management groups.

It is appropriate for the compensation committee to try to align the interests of the executive with the interests of shareholders by providing stock options, stock appreciation rights, stock grants, and other forms of equity compensation. However, if the percentage of the total compensation package represented by such equity compensation becomes overly large, the executive may tend to focus more on increasing the stock price than on improving operational performance. Despite this potential disadvantage of a large percentage of equity compensation, the percentage of equity compensation should always be competitive with other opportunities available to the management group. The compensation committee should at least consider the equity incentives that may be provided by private equity funds which may wish to recruit the management team, possibly as part of an acquisition of the company.

Best Practice:

Compensation committees must properly balance the total compensation package of executives between short-term and long-term performance goals, with a greater percentage being applied to long-term goals.

Moody's Investors Service, Inc. is particularly sensitive to the degree of emphasis on long-term performance goals. They have stated as follows: "In evaluating executive pay, we differentiate between short-term (base salary, annual bonuses and other annual pay) from long-term pay (LTIPs and equity-based pay) so as to determine how pay encourages long-term decision-making."[10]

The Exxon Mobil Corporation has a unique annual stock bonus plan which attempts to combine both short-term and long-term objectives. Only half of the annual bonus award is paid in the year of grant. Payment of the balance of the annual bonus is delayed until a specified level of cumulative earnings per share is achieved. If the cumulative earnings per share do not reach the specified dollar requirement within three years, the delayed portion of the bonus is correspondingly reduced.

A New Role for CEOs

The corporate governance movement has created new demands on CEOs and placed them in the role of politicians as well as managers. During the twentieth century, CEOs were judged primarily upon their operating results and lesser emphasis was given to stock price performance and adherence to high corporate governance standards. In the post-Enron era, CEOs must pay attention not only to operating performance, but also to stock price performance, to satisfying the demands of other constituencies including employees, customers, and the communities in which they operate, and to practicing good corporate governance. Today's CEO must be able to convincingly explain to securities analysts the company's long-term strategy and is being held responsible for increasing stock prices over which they may have only little control.

Boards of directors must be sensitive to these new pressures on CEOs in establishing compensation strategies. Direction must be provided by the board to the CEO as to the emphasis that should be given to stockholder demands for increasing stock prices, particularly short-term stock price trends. The board must decide how much emphasis to place on long-term performance, as opposed to short-term performance, in the compensation packages of CEOs.

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Notes

[1] Lucier, Weeler and Habbel, *The Era of the Inclusive Leader* (May 22, 2007), *available at* www.boozeallen.com.

[2] *Pay Without Performance*, Harvard University Press, 2004.

[3] A similar argument for indexing stock option exercise prices was made by Alfred Rappaport in an article titled "New Thinking on How to Link Executive Pay with Performance," which appears in the Harvard Business Review on Compensation (2001).

[4] 2006 Annual Report of Berkshire Hathaway Inc.

[5] Gabaix, Xavier and Landier, Augustin, *Why Has CEO Pay Increased So Much?* (May 8, 2006). MIT Department of Economics Working Paper No. 06-13.

[6] Sherwin Rosen, *Economics of Superstars*, 52 The American Scholar, No. 4 (Autumn 1983).

[7] *Wiring the Labor Market*, 15 J. of Economics Perspectives, No. 1 (Winter 2001).

[8] The Harvard Law School Corporate Governance Blog.

[9] U.S. Securities and Exchange Commission, Litigation Rel. No. 19243 (June 2005), www.sec.gov/litigation/litreleases/lr19243.htm. Click on SEC Complaint in this matter; Securities Exchange Act Release No. 51781 (June 2, 2005).

[10] A User's Guide to the SEC's New Rules for Reporting Executive Pay, April 2007, p. 4.

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