Executive Compensation:
More Bang for your Buck

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Introduction

Executive compensation is of growing concern today. In the wakes of corporate scandals such as Enron and WorldCom, executives are being scrutinized more than ever and companies want assurance that executives will live up to their large payment packages. Recently, there has been a disconnect between executive payment packages and the company's desired mission which executives are supposed to work towards. Due to the SEC's increased disclosure requirements, index stock options are now a very real solution to aligning executive compensation and company objectives. Compensation Committees, a unit of the board of directors, are the crucial factor to the success of such an initiative. Their governance and disclosure of the payment process can assure that CEO's are paid fairly and are working towards the stated company mission.

Ethical Framework

I will explain my argument using duty ethics as well as a fairness and justice approach to executive compensation. The fundamental understanding of justice was derived by Aristotle more than two thousand years ago and is still widely accepted today: “equals should be treated equally and unequals unequally.”[1] In other words “individuals should be treated the same, unless they differ in ways that are relevant to the situation in which they are involved.”[2] For example, if two people that are working for a company are doing work that is equivalent in terms of the amount of work and the mental capacity that the work requires, than I think we would all agree that it would be unjust to pay one of these workers more than the other. This idea is the ethical basis upon which I am basing my argument for a change in the governance and issuance of executive compensation.

There are three different kinds of justice which are very important to executive compensation and in cases where compensation is unjust and/or unfair different forms of justice are being used to compensate for unjust actions.

- The first type of justice is called distributive justice and this is what all employee compensation is based on; distributive justice is the extent to which our corporations ensure that benefits and burdens are distributed among employees in ways that are both fair and just. This means that an individual is paid based upon the physical and mental capacity their job requires.[3]
- A second important form of justice is retributive justice. Retributive justice refers to the extent to which punishments are

fair and just. For example, the punishment for an underperforming CEO would be job termination and a loss of severance pay.[4]

- The third kind of justice is known as compensatory justice, which means that people are fairly compensated for their injuries. In the case of executive pay the only way to compensate stockholders who have been hurt by underperforming executives is to change the pay scale to better align managerial and owner goals.[5]

CEO Expectations

To understand why current CEO compensation is so unjust we must define what company's expect from a CEO. Also, it must be made clear that the problem is not the amount of money that CEOs are being paid, but rather the ways in which the money is awarded to CEOs. CEO's are hired for a variety of reasons: for a specific goal such as to increase new product development, further penetrate an existing market, or to save the company from a previous underperforming CEO. So, CEOs can be viewed as multi-headed monsters, the CEO is the big head and it is their job to listen to all of the other heads and use their information in making wise judgments that guide the body of the beast where to go: down the sunny trail with rabbits and deer next to a river or down the dark alley filled with scary eyes and eerie noises.

Unfortunately it is not this simple; there are many voices to listen to and even more roads that a CEO can choose to take. But the intangible abilities of successful CEOs to make sound decisions and guide their prospective companies down the right paths is the risk reward scenario in which CEO's are deserving of very high compensation.[6] One task always remains the same when it comes to performance; provide long term growth and sustainability. Who says that this is the one task that exists throughout all corporations? The stockholders are the members that say this and it is their funds that make public corporations possible, executives are managing the company for these shareholders and as such should have their best interests in mind. Short term gains that will cause long term problems are never viewed as the right direction of the company by the stockholders, but this is exactly what many executive compensation packages promote. Executive compensation needs to be changed so that CEO's are paid based upon the execution of their duties: which primarily is to provide long term growth and sustainability which will result in a rising stock price.

Three Elements of Bad Executive Compensation

Three elements that we must confront in regards to executive compensation to realign payment with performance are large base pay, severance packages, and misuse of stock options that have become standard practice. These three elements promote poor performance and are always unwarranted. The problem is that companies are paying CEO's based on the wrong measures. A person's base pay is for their day to day work it is time spent in the office writing memos, talking to clients, working with different departments, attending meetings etc. These are tasks that all executives do and although they do require a level of expertise they are inherently no different from person to person. Therefore, since I have defined base pay as that which pays for routine duties there should be no reason for the Chief executive officer to receive substantially more than any other executive in the company.

Severance packages have lost sight of their original intent. Severance packages are pay and benefits for employees who have been fired or have resigned from a company. So why would your employer negotiate your severance package with you after you have quit or been fired? “You’re selling a release, an end to the possibility of a legal proceeding and expense for the company. You’re promising to go quietly. The employer benefits by avoiding possible damage to workforce morale and the time and expense of disruptive litigation.”[7] This seems to contradict the circumstances under which many CEO’s are being fired and are being paid large severance packages. A major part of this problem that contributes to the negotiation of out of proportion severance packages as part of the contract terms is a company’s desire to hire out of house. Companies often times hire very well known former CEO’s of other successful companies that are able to bargain for a much more extensive payment package (including a severance package) when in fact they should be promoting management and giving current executives an opportunity to run the company that they have been working for, for many years. There are many good reasons why company’s should do this: first someone who has already worked for a company for a number of years knows the industry very well and understands the competition very well, second someone who has already been working for the company understands the company’s culture, and third promoting management gives the company a lot more leverage. Management wants the opportunity to prove that they can successfully manage the company. Therefore, they are willing to work for a lot less money; they don’t have the negotiating power that a CEO from another company has.[8]

The third element to discuss is the misuse of stock options. When used properly stock options can be a great way to pay-for-performance, unfortunately in the past there has not been proper governance and disclosure of this information for stock options to be used as intended. Stock options are granted by the board of directors to executives and are a guaranteed number of stock shares at a set price and time that an executive can option to receive at some point in the future. Stock option back dating is a very common misuse of stock options. It is when executives back date the time for when the option was granted so if the stock price was significantly lower than the grant date.[9] This is of course is illegal because it is diluting the returns that shareholders make on stock gains. It is clear that all three of these forms of compensation are unwarranted and it makes you wonder how such blatant disregards for company resources can go unnoticed, the answer is a lack of transparency and communication to the stockholders. The board of directors oversees and must sign off on all final stock options before they are paid out to executives. If the board of directors were doing its job there wouldn't be the backdating scandals that there are in the corporate world today. Unfortunately, in cases where there have been admissions of stock option back dating "The decision-making process has been to bypass the compensation committees completely. In other words, they have simply been asked to rubber-stamp decisions that have already been made by management."[10]

These committees, which are a selection of the board of directors, are failing their duties; the problem is that the board is selected by a nominating committee that usually includes the CEO who is often the chairman of the company as well as current board members. These directors already have a comfortable relationship with the CEO and hence are less likely to elect a truly independent director who would be brave enough to stand up against management and stock option back dating.

Many times the CEO is also a board member of another company so there are many mutual favors being conceded by CEOs on different boards, the you scratch my back and I'll scratch yours mentality. Furthermore, shareholders are not given the direct privilege of nominating a director and voting on directors. The current system is under what is known as a plurality standard, this means that shareholders are allowed to vote on the slate of candidates that management has assembled. However; "There's seldom a contest, and, under the plurality standard, if a director gets one vote and a million and a half other votes are withheld against that director, it doesn't matter-that director is elected with one vote."[11] To solve this problem the SEC must make all information available to stockholders. Providing clear and precise information of compensation terms that owners can understand would regulate the issuance of stock options and prevent backdating.

Why Performance Based Pay?

Why should a CEO's payment be based on performance? Some people say that executives should be paid entirely by salary. This however, is not true because the only companies that pay their top executive by salary are private companies. However; this is entirely different since the majority of private companies cannot afford to pay the CEO through private stock only because they have a very small number of shares and the returns generated from stock gains would not provide a sufficient income. Also private companies do not have public money to pay out of proportion sums to their executives and therefore executive payment is regulated through economic means. Outside of private companies virtually every other professional level job is paid based upon performance: lawyers are paid by billable hours, doctors by clients treated, athletes by competitions won (individual sports such as golf and tennis; other sports such as basketball and baseball are private enterprises in which it is up to the team owners to negotiate player contracts which are based on performance).

Public Corporations are the only businesses that make it more enticing for CEO's to seek short term gains that produce stock price spikes and then walk away with multimillion dollar severance packages; so by intentionally harming the corporation CEO's are paid millions of dollars. "How can anyone justify Home Depot's (HD) former CEO Bob Nardelli receiving a $200 million termination settlement after declines in market share and shareholder value?"[12] The answer to this is you can't. When CEO's like Bob Nardelli are given these outrageous severance packages, employees are fired to account for these funds, investor confidence is ruined, which in turn sends sends the stock price plummeting as investors sell their stake in the company and remaining owners have lost a large amount of money and continue to be hurt by smaller dividend returns which they may rely on as a means of income. If a CEO's job is to provide long term growth and sustainability for investors then surely protecting the jobs of the company's employees who are often shareholders and are one of the few sustainable advantages a business can have are equally important to a company.

The Problem with Stock Options

As I have stated, stock options used as performance based payment methods can realign shareholder and management goals and they can also greatly improve executive performance. Stock options are granted by the board of directors. They are the right to a given number of shares at the current market price when the option is granted. So, executives make money on these options when the stock price rises and then after a certain time period they are able to exercise the option and can sell the stock for a profit.[13] Unfortunately, these options are often misused by executives with the knowledge of the board of directors.

> "The bull market of the 1990s brought substantial value to stock options, but when the market began a downturn, investor value dropped substantially. Although investor value dropped with share prices, the average CEO total compensation in American companies was higher in 2002 than in 1999. In other words, executive-owners continued to benefit from huge pay packages while investor-owners suffered from the downturn in the value of their stock portfolios. At least some decrease in portfolio values was a direct result of the market's reaction to the financial scandals created by the executive-owners of corporations."[14]

This is the result of back dating stock options which is the major issue why so many people are against them as a means of executive pay. It is the board of directors job to govern these options and unfortunately they allow backdating to happen which is why it is so important for the compensation committee to be completely separate from management. Back dating stock options occurs when executives adjust the option grant date to a previous time when the stock price was lower to create a better gain for them. This practice is illegal and in no way benefits the company although boards of directors have often argued that this practice is necessary to retain valuable employees.

> "Boards of directors have defended the re-pricing of executive stock options by stating that it helps retain executives who are essential to company performance. The authors believe that the issue that must be addressed in the face of this logic is how essential such executives actually are if they were the people in charge during the market decline. There is some evidence that the performance and retention rationales behind repricing are flawed."[15]

The logic behind the acceptance for back dating stock options is greatly flawed and this problem stems from the connection between the board of directors and management, they must be separate units to function properly. "Second, three separate studies indicated that over the two-year period after repricing, CEO turnover was approximately twice as high for repricing firms compared to a matched group of firms that did not reprice"[16]

Compensation Committee Responsibilities

The compensation committee is made up of members of the board of directors. As members of the board of directors it is important that this unit be completely independent of management so that the group is able to create an unbiased compensation plan that is fair to both executives and stockholders. Since the inception of the SEC's new executive compensation disclosure rules there have been several positive effects on compensation committees.

- First of all many committees have been engaging in preparing the compensation discussion and analysis, which explains the rationale for each pay element which holds the committee accountable for unjust pay.[17]

- Second this analysis has provided detailed information on pay levels allowing for better assessment of a company's pay-for-performance strategy[18]
- Last the in depth preparation that is required in disclosure statements will help these committees to better understand executive payment programs and will enable index stock options to be used properly and effectively.[19]

Furthermore, to improve disclosure, investor confidence and to control pay-for-performance measures compensation committees must:

- Share disclosure targets; this measure will increase investor confidence and ensure that the compensation committees are living up to their responsibilities.[20]
- Explain how incentive payouts are determined and,[21]
- Last is to make sure that all of these disclosure statements are in plain English. These documents do investors no good and appear deceptive if the people it is meant to benefit can't understand the document.[22]

Index Stock Options

With improved compensation committee oversight and better disclosure to investors these committees are now able to implement pay-for-performance methods that before were not governed sufficiently to work effectively. The method of performance based pay that I am talking about is index stock options. Index stock options are when

> "The board of directors selects a group of companies, such as industry rivals, to serve as a benchmarking peer group. The option-issuing company indexes or ties the exercise price to the benchmark group. In theory, economic and industry factors should affect similar companies in similar fashion. Thus, if share prices for the benchmark group rise by an average of 10% in a given year, then the option-issuing company's shares should rise comparably. If instead the company's shares rise 15%, then an assumption can be made that the executives provided a positive 5% controllable organizational impact and, as such, deserve additional performance-based pay. Indexed options cannot be exercised at a profit unless the issuing company's stock price either outperforms, or falls less steeply than, its peer comparison companies."[23]

This is the most just way to compensate executives for the additional benefits they provide and best aligns executive and company goals because it prevents managing for self interests because of improved compensation committee oversight and disclosure. Furthermore, tying the stock option to a industry index means that executives have to work harder to assure that their company has the best strategy possible so that they are able to reap the benefits of this form of pay-for-performance.[24]

As with any type of performance based pay it can always be manipulated, the key is to make sure that compensation committees have proper oversight and disclose all relevant information to ensure that payment measures like index stock options are used properly and effectively. Index stock options are the most effective form of pay-for-performance because it prevents managing for self interests by tying the option to an industry index. Executives must manage to the best of their abilities and outperform competitors to reap the benefits of these options. Also, other aspects of executive pay such as severance packages and out of proportion base salary must be diminished to better motivate today's executives. These are people who are motivated by money and as such it is crucial that the members that govern executives (Board of Directors: compensation committees) must make sure that the payment packages are set up in a way that promotes executives to manage for company interests.

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