



CEO Pay: A Window into Corporate Governance

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Once again, proxy season has revealed some eye-popping numbers in executive compensation packages, generating heat from shareholders, labor organizations and some analysts who contend the links between CEO pay and performance are frayed.

Among the most-talked about compensation reports this year is the \$1.6 billion option package for UnitedHealth Group CEO William McGuire at a time when more than 40 million Americans lack health insurance. Former Exxon CEO Lee Raymond retired with a \$400 million package as consumers face soaring gasoline prices.



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AFL-CIO members hired a plane to fly over Pfizer's annual meeting in Lincoln, Neb., in April with a banner reading: "Give it back Hank!" -- a reference to CEO Hank McKinnell's \$83 million pension plan set to take effect in 2008. McKinnell has already earned \$65 million since he became CEO in January 2001. At the time of the meeting, Pfizer shares had dropped 46% in value under McKinnell's watch.

"The press loves this time of year when it can jump in and find a really big number, but I don't think you're going to see any big increases in CEO pay this year," says Wharton accounting professor [Wayne Guay](#). "Over the last 10 years, pay has generally gone up each year -- some years more than others. This year there's not anything unusual."

According to a survey prepared by Mercer Human Resource Consulting for *The Wall Street Journal*, total direct compensation for CEOs at 350 top corporations grew 16% in 2005. That was down from a 41% increase in 2004, but well over the 3.2% hike in wages and benefits for U.S. workers overall last year.

Median direct compensation, including salaries, bonuses, restricted stock grants, and gains from option exercises and other long-term incentive payments, was \$6 million. Pay for CEOs at the 10 businesses with the highest shareholder returns grew by 51.3% to more than \$10.2 million. The 10 CEOs whose shareholders took the biggest hit last year suffered a 72.5% drop in compensation to less than \$1.6 million, according to *The Journal*.

Wharton accounting professor [Scott Richardson](#) says investors are increasingly paying attention to compensation as a window into the broader make-up of the firm. "I view compensation as part of the governance structure -- how stakeholders in the firm make sure they don't get screwed over by management." He notes that the strongest link to executive pay is the size of the firm, with larger firms offering their CEOs higher pay packages.

Disclosure is key, he stresses, using Lee Raymond's Exxon retirement package as an example. That type of package is "fine as long as [boards and executives] contract up front, as long as it's disclosed to stakeholders and as long as the stakeholders have a right to question the pay structure." He says Raymond's terms were known at least four years ago, before skyrocketing oil prices made the price of his options increasingly valuable. "It's a lucky outcome for him, but that's the way it goes," says Richardson, pointing out that swings in long-term compensation can be particularly volatile in commodity-based

businesses with less price elasticity.

Conflicts of Interest

Outside consultants play a critical role in determining compensation, says Wharton management professor [Martin Conyon](#), noting that a compensation committee made up of independent directors usually sets CEO pay. As outsiders, these directors rely on expert advice from professional firms that track salary trends at peer companies.

While management is not involved in these discussions, the system can create an opportunity for conflict-of-interest problems because executives use the same firms to assist in developing strategies in other areas, such as human resources planning or pension design, he says. "One can imagine a scenario where the consultants would err on the high side on executive pay because they don't want to lose this other lucrative business. If you lowball the CEO's pay this year, your probability of being hired next year is jeopardized."

Conyon suggests that the problem would be solved if companies disclose which firms they use for compensation consulting. The argument against disclosure is that firms want to protect the privacy of their own consultants. "To my mind, this is a weak argument," says Conyon. He notes that in 2003, British corporate law was amended to require that companies name compensation advisors in their annual reports.

Conyon is not necessarily opposed to companies using the same consultant for compensation work and other parts of the business because there could be efficiencies in doing so. He also notes that most large consulting firms generally are careful to avoid conflicts in order to protect their reputation, particularly following the accounting firm scandals at Enron and other companies. "The approach to take is the one that creates greater transparency," he says. "Put the case before the investors to evaluate."

Conyon also disputes assertions that consultants contribute to an inevitable march upwards in CEO compensation. Others have argued that consultants create an institutional creep in salaries by the way they group companies for comparison and determine the market rate of pay.

Preliminary research on British companies using the data disclosed since 2003 indicates no difference in pay levels among firms that use outside consultants and those that do not, Conyon says. "Once one controls for legitimate factors such as the size of the firm, the sector and the risks in the sector, then there is no relationship between pay and the presence of the compensation consultant."

However, Conyon adds, there does appear to be slight evidence indicating firms that hire the same consultants for compensation work and services in other parts of the business pay CEOs more than companies that do not use the same consultant for compensation advice and other work.

Poorly-designed Plans

Linking CEO pay to performance, typically shareholder return, has been building for nearly 30 years, but remains controversial.

A study in April by The Corporate Library -- a governance analysis firm headquartered in Portland, Maine -- titled, *Pay for Failure: The Compensation Committees Responsible*, found 11 companies that over the past five years paid out \$865 million to CEOs who lost a total of \$640 billion in shareholder value. Those on the list are: AT&T, BellSouth, Hewlett-Packard, Home Depot, Lucent Technologies, Merck, Pfizer, Safeway, Time Warner, Verizon Communications and Wal-Mart Stores.

Each of the companies paid its CEO more than \$15 million in the last two available fiscal years, had a

negative return to stockholders over the last five years, and underperformed peers. "There has been more concern over the past few years about the link between pay and performance," says Paul Hodgson, senior research associate at The Corporate Library.

In the past two to three years, Hodgson adds, companies have begun to replace often-controversial stock option programs with restricted stock in their compensation plans. "The problem is that many of the restricted share schemes being used are not designed well. There are too many companies out there that are adopting off-the-shelf versions of the plans without considering what they might do to adapt to their own company's circumstances."

The most common metric, he says, is total stockholder return, but that does not take into account how well the company is doing when judged against its peers. On the other hand, companies that base their payouts totally on performance relative to their peers could wind up rewarding executives whose firms lose money for shareholders, he says.

Companies are about evenly divided between those that use a relative standard and those that focus on an absolute target, according to Hodgson, who says performance-based pay packages would be more effective if they were based on a mix of the two.

Guay says high demand for talented executives is the most important determinant driving up CEO pay and contends that it is worth every penny it takes to hire the best person possible to lead a complex global company. "Finding an individual to run these companies is extremely difficult," he says. "When you are talking about a \$50 billion company, if the difference between the best CEO and the second-best CEO changes the value by half a percentage point, the [best CEO] will have justified his pay for his entire career."

Meanwhile, new SEC accounting rules will add more disclosure to the value of total compensation packages, particularly option grants, which have been critical to performance-based pay for years. Guay says the new rules will also shed new light on retirement pay. "The one piece of compensation and benefits that will get more disclosure is related to retirement benefits. Those weren't transparent and are really not included in any of the surveys you see in the press."

The system could be improved with more disclosure about the nature of the incentives underlying compensation, Guay adds. "Whether the CEOs are overpaid or not is a minor issue. The bigger issue is, do these CEOs have incentives to do a good job?" A CEO who is motivated to achieve the right goals can add to his or her portfolio for hitting those targets. But if the targets are designed right, investors will reap even more in improved share price, Guay says.

Performance-linked pay is also key for those who set the CEO's pay -- corporate directors. This spring Coca-Cola said it would eliminate directors' pay unless the company hits financial targets. Coke will stop paying current directors cash and instead will issue "equity-share units" valued at \$175,000. The directors can trade those in for cash in 2009, only if the company posts compounded annual growth of 8% in earnings per share in 2006, 2007 and 2008.

"It used to be that 20 years ago, the director got a flat fee. What's changed is there is more performance pay for directors," says Richardson. "You want the monitors of the firm to be encouraging decisions that are in the long-term interest of shareholders. I think having performance pay for directors makes some sense."

Novel Approaches

When United Healthcare's McGuire passed well beyond the \$1 billion mark with his options package, that raised eyebrows, says Shirley Westcott, managing director of policy at Proxy Governance, an independent proxy advisory firm in Vienna, Va. "When you see high compensation packages and really

high severance and pension pay, it makes the average investor think, 'Wow. That's nowhere near what I'm ever going to make.' The numbers are just so astronomical," says Westcott.

The SEC is investigating the timing of McGuire's stock option grants to determine whether they were priced on dips in the share price in order to inflate the value of his holdings. UnitedHealth directors have since voted to stop awarding new stock options to McGuire and some other senior executives, and halted free personal use of the corporate jet.

Meanwhile, some companies have placed a cap on severance payouts, mostly at the demand of shareholders through resolutions. In December, Coke adopted a new policy requiring that its stockholders approve any future executive severance agreements that amount to at least 2.99 times the recipient's annual salary and bonus.

Hewlett-Packard also has a cap, but union pension funds argue the company violated its own policy when it gave former CEO Carly Fiorina a retirement package valued at up to \$42 million. "These are companies that have had a very bad history of making high severance payments. Stockholders have said to them, 'That's enough,'" says Hodgson, who contends that companies skirt caps on cash retirement packages by rewarding retiring executives with restricted stock that vests immediately and is essentially the same as cash.

Another tricky area is change-of-control provisions in which executives can reap windfalls if their company is acquired, says Westcott. "The difficulty with some change-of-control payments is they can be written in executive contracts well in advance of the merger or they are hammered out in the merger negotiations."

According to Westcott, this year's proxy season has generated some novel shareholder initiatives. She points to proposals to allow shareholders to vote on director compensation and compensation committee reports, which she notes is common practice in the U.K., Australia and other markets overseas.

Still, Hodgson says whopping payouts don't mean all that much to the bottom lines of major corporations. For example, he points out that Raymond's \$400 million package comes from a company with a market value approaching \$400 billion. "It's really just a blip. That's not enough to agitate the institutional investors who have made so much money that they are not really concerned about it. The economic argument, not [the ethical issue], is the only argument as far as they are concerned."

Westcott suggests that one potential curb on outsized CEO pay may be CEOs themselves. "A lot of the ratcheting up is from the CEO seeing what the other guy gets paid, and what all his peers get, and saying, 'I deserve that too.'" The process could work in reverse if CEOs see others turning down pay after their basic material needs are met, she suggests.

Westcott notes that Apple Computer CEO Steve Jobs has been paid a salary of \$1 a year, although he is estimated to be worth more than \$3 billion as a founder of Apple and Pixar Animation Studios.

Jack L. Stahl, Revlon's CEO, handed over his \$373,190 bonus to reward employees in 2005. Bill Ford, CEO of the troubled automaker founded by his great-grandfather, told shareholders this spring he would not take a salary or bonus -- for the second year in a row -- until he can turn the company around. "It's partly to ensure good will," says Westcott, "and partly recognition that when a company does poorly, it doesn't look good for the CEO to be making millions."

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