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How To Fail And Pocket $ 100 Million

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Pay Without Performance: The Unfulfilled Promise of Executive Compensation
By Lucian Bebchuk and Jesse Fried
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This book is a critical account of executive remuneration practice in the US and its implications for corporate governance. The analysis is, however, largely applicable to the UK. On both sides of the Atlantic, the total remuneration packages of chief executive officers increased substantially in the late 1990s. In fact, according to figures published in The Sunday Times in March 2005, between 1997 and 2003 they grew much faster in Britain than in the US. Compensation in the UK increased by 77 per cent over this period, whereas the increase in the US over the same period was only 5.6 per cent. This difference reflected a catching up process this side of the Atlantic. In 2003, the average annual package from 1,495 US firms was Pounds 2,830,000, compared with Pounds 1,691,000 for 176 UK firms.

The size of CEO remuneration packages has attracted a great deal of critical comment, but the nature of the criticism has varied. One critique starts from a moral or fairness perspective, and it takes the view that paying top executives hundreds of times more than rank-and-file employees is inherently unjust. In this context, it is worth noting that in the successful Basque cooperative Mondragon the ratio of the highest to the lowest pay is 4.5:1.

Another viewpoint is that these high salaries and bonuses are unnecessary - and that top executives, already relatively well-off, are adequately motivated by the drive for achievement and esteem and do not need such outstandingly high monetary rewards. Clearly there is no shortage of university vice-chancellors despite the fact that remuneration does not come anywhere near the levels paid to top executives in other industries.

The position taken by the authors, however, and the theme of the book, is that executives are influenced by financial incentives but that the system breaks down in failing to ensure a sufficient correlation between pay and performance. They are particularly critical of a system that allows failed CEOs to receive huge payouts in the form of compensation for premature termination of their contracts. The most recent cases in the US involved huge pay-off sums - $ 42 million (Pounds 22 million) in the case of Carly Fiorina, ousted from Hewlett-Packard, and more than $ 100 million in the case of James Kilts's departure from Gillette. Such levels of compensation have not been seen in the UK. In 2004, J. Sainsbury was strongly criticised for awarding a Pounds 2.3 million bonus to Sir Peter Davis despite the company's poor performance during his period of office.

When large sums are paid to departing CEOs, they do not indicate outbursts of generosity by boards of directors. They reflect rather the astuteness of CEOs' legal advisers when hiring takes place and contracts are drawn up.

When a company runs into difficulties a frequent approach is to fire the current CEO and to bring in a "white knight" from outside to turn the company round. Headhunters are hired, and in due course a suitable candidate with a record of success is identified. The directors fall over themselves in their haste to recruit the company's potential saviour and, in the process, are only too happy to accept the contract drawn up by the incoming CEO's lawyers.

They do not worry about what might happen if the new CEO fails to deliver, being absolutely sure that they have made the right choice and that the outcome will be a rapid recovery in the firm's fortunes. However, when they finally come round to the view that the new CEO is not up to the job, they find that, under the terms of the contract, they can avoid paying massive compensation only if they can

prove just cause. In the grey area of company performance, this is virtually impossible.

The solution to the problem, therefore, is not for shareholders'

representatives and their representatives to howl with outrage when the compensation is paid out, but carefully to scrutinise carefully the contractual terms under which top executives are employed, paying particular attention to the length of such contracts and the way in which remuneration is linked to company performance.

According to a recent survey by Mercer Human Resource Consulting, pressure by the institutions in the UK is beginning to be effective. Pay increases for executive directors and senior executives have remained static from 2003, with bonus payments decreasing. The survey found that salary increases in 2004 had not changed from the previous year, with a median salary increase of 6 per cent. Median bonuses were down to 39 per cent of base pay from 49 per cent.

One reason for this has been better consultation with institutional shareholders. In consequence, no FTSE 100 company had its remuneration report voted down in 2004.

As an example of a significant change, Royal Dutch/Shell recently introduced more stringent remuneration policies for executives, as it continues to try to win back investor confidence after the oil reserves scandal of 2004. The company announced that it had decided to end stock option grants. The Anglo-Dutch group also said it would change the long-term incentive plans for executive directors and amend their deferred bonus plan. The amount a director can get from these plans will, in future, depend on how Shell fares against its rivals, such as ExxonMobil, BP, Total and ChevronTexaco. If Shell comes fourth or fifth in this group in terms of its total shareholder return, executives will not receive any bonus shares under the long-term incentive plan and will not qualify for extra shares in the deferred bonus plan.

As Lucian Bebchuk and Jesse Fried point out, the issue of pay for performance is part of the wider problem of corporate governance. Although part of the solution lies with shareholder activism, the other part lies with the role and effective power of independent directors; recent governance reforms on both sides of the Atlantic have been important factors in ensuring a degree of moderation. Their proposed solutions focus on ways of making board directors more independent of the executive management team and on reducing board's insulation from shareholders. They are lawyers by discipline, academics by profession and Americans by nationality. This combination means that the book is a difficult read and is overlengthy in relation to its thesis and supporting evidence.

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