Blame the Board of Directors

Governance experts take on Lucian Bebchuk's arguments about shareholder power and CEO pay.


Out of Control?

The last issue of *Across the Board* featured an extensive interview with Harvard's Lucian Bebchuk, co-author of *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, which raises uncomfortable issues and asks difficult questions about the way directors oversee—or fail to oversee—the operations of the companies for which they're responsible. In particular, Bebchuk takes on CEO pay, lambasting the "official view" that it's set by market forces or by arm's-length negotiation between CEOs and compensation committees.

Why do directors fail to perform? Bebchuk argues that they have little incentive to keep an eye on management or a lid on executive compensation—with predictable results. He proposes giving shareholders more access to the corporate ballot.

We went to some of North America's top corporate-governance experts to get their takes on Bebchuk's provocative arguments, and on the issues he raises in our interview and in *Pay Without Performance*. It's not surprising to find that, while everyone appreciates his efforts to bring accountability to governance, his views are hardly universally held.

—Matthew Budman

Thomas W. Joo:

I agree that the "official view" is undermined by reality—though I can't imagine who doesn't agree, other than perhaps CEOs and directors themselves. The question is: Why don't market forces control compensation? One non-market reason that should be explored is the unlimited tax deductibility of "performance-based" compensation. To the extent that tax policy encourages executive compensation to be contingent rather than fixed, we should expect executives to negotiate for larger and larger gross packages to offset the risk of nonpayment.

On another of Lucian Bebchuk's points: I agree that directors should face real competitive elections. The SEC's director-nomination proposal seems to have died, but I was never a big fan of it, because it imposed a one-size-fits-all nomination rule on all corporations. Wouldn't it make more sense to allow shareholders to propose new nomination procedures within their own companies? The AFSCME Pension Plan attempted to do so in 2002 but was shut down by the SEC's interpretation of Rule 14a-8(i)(8). The rule allows management to exclude a shareholder proposal that "relates to an election for membership on the company's board." The SEC has interpreted this to allow exclusion of any proposals "that may result in contested elections of directors." Yes, you read that correctly. Even if the shareholder-nomination proposal had passed, the SEC would have prevented shareholders from pressing for any alternative methods of increasing ballot access. Now that the SEC proposal has apparently failed, we have no reform—and no prospects for company-by-company innovation.

PROFESSOR JOO teaches at U.C. Davis School of Law and is editor of Corporate Governance: Law, Theory, and Policy.

Caroline Oliver:

Lucian Bebchuk understands the difference between the board and management—that the board's proper function is to exercise ownership and management's proper function is to run things. Thus he rightly asserts that when it comes to executive compensation, it is critical that there be the closest possible alignment between the interests of directors and the interests of shareholders. This is not to say that directors are mere ciphers—it is to say that their leadership is about seeking to interpret and forward shareholders' interests as fully as possible.

Bebchuk also highlights the crucial difference between shareholders and other stakeholders. Shareholders are the source of the board's authority. Stakeholders' interests must be taken account of—but only to the extent necessary to serve shareholders' best interests, which may mean to a far greater extent than they are taken account of today.

MS. OLIVER is co-author of, most recently, Corporate Boards That Create Value: Governing Company Performance From the Boardroom.

Ralph D. Ward:

As a writer on corporate governance, I have three common responses to the work of other governance thinkers: (1) Tell me something I don't already know, (2) I disagree, and, rarest and most valuable, (3) Wow, someone else noticed that! Lucian Bebchuk prompts the last with his comments on the ineffectiveness of positive incentives for board performance. Quite simply, what economic reason does a director have to do a good job? Board pay for performance faces many social and regulatory hurdles—and can backfire. Loading directors (and executives) with equity was a hallmark of the scandals at Tyco, Enron, and WorldCom. Rather than assure sound oversight, it drove everyone to prop the stock price up by any means necessary.

Negative reinforcement—board penalties for poor oversight—is more popular, especially in the recent reform frenzy. However, penalties prove highly erratic in practice. Though the January shareholder settlements by Enron and WorldCom directors forced them to pay damages out of pocket, the settlements—even if upheld—will prove relatively painless for the directors, their only real boardroom message being that "this reform stuff has gone too damn far."

MR. WARD is publisher of the Boardroom Insider *newsletter and author of* Saving the Corporate Board: Why Boards Fail and How to Fix Them.

Jay Lorsch:

Lucian Bebchuk and Jesse Fried identify many of the causes of the current compensation crisis. My major concern with *Pay Without Performance* is that the authors do a much better job of identifying the causes of the problem than they do of providing solutions. Those concerned with the board's role in compensation matters should take the authors' diagnosis seriously and work to come up with remedies.

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However, I take exception to a few aspects of the diagnosis: first, that directors have no incentive to do a good job, and that their performance reflects it. Certainly, I am not comfortable with the performance of many boards and compensation committees, but the problem is not a lack of incentives. Directors have plenty of incentives to do the right thing, including the desire to be seen as effective and to protect their reputations.

Second, while I agree that shareholders should be given more influence in the governance of their companies, this is easier said than done. Given that shareholders are a dynamic and changing lot—and that many institutional shareholders would rather follow the Wall Street Rule than become involved in governance matters, including compensation—how do we get shareholders to take a stand? It is a great idea in principle, but difficult in practice.

PROFESSOR LORSCH teaches at Harvard Business School and is co-author of, most recently, Back to the Drawing Board: Designing Corporate Boards for a Complex World.

Jannice Moore:

I agree with Lucian Bebchuk that there is a flaw in the system of incentives, but I would take the issue of the "system" further. Most boards have no "system" of governance. They have a collection of "practices"—in some cases "best practices"—but even a collection of best practices does not make a system.

What is needed is a conceptually coherent "operating system" designed to encompass the board's entire role. Such a system would ensure that the board, as the agent of the shareholders, knows the shareholders' expectations and, grounded in that knowledge, explicitly states its expectations for management performance. Further, the system would clearly identify boundaries of prudence and ethics within which the CEO is expected to operate. It would also include a rigorous method of monitoring the CEO's performance against those stated expectations, thus allowing CEO compensation to be directly connected to performance. While the board may trust the CEO to do a good job, accountable governance requires application of the Russian proverb that Ronald Reagan made famous: *doveryay, no proveryay*—“trust, but verify.” Such a system does exist: the Policy Governance Model developed by John Carver. Approaching the board’s job, and its connection to shareholders, in a systematic way such as this model offers would be a powerful antidote to the “out of control” pay without performance that Bebchuk describes.

MS. MOORE is chair of the International Policy Governance Association and president of The Governance Coach.

Steven Lydenberg:

The short-term thinking of boards of directors lies at the heart of today’s problems with CEO compensation. Lucian Bebchuk rightly singles out the creation of “long-term shareholder value” as a worthy goal toward which boards should strive in constructing compensation incentives. A recent study by Henderson Global Investors and the U.K.’s Universities Superannuation Scheme, *Getting What You Pay For: Linking Executive Remuneration to Responsible Long-Term Corporate Success*, amplifies this point. The study argues that the means used to create this value—including such extra-financial factors as customer satisfaction, employee issues, the environment, and health and safety—are as important as the end: stock price, earnings per share.

In addition, Bebchuk makes a crucial point in observing that only when shareholders gain increased powers to remove board members not representing their long-term interests will the problems of “gratuitous” CEO compensation disappear. For this reason, current stirrings in the U.S. corporate-governance world to allow a direct yes/no vote on board nominees also have the potential to right a system gone askew.

MR. LYDENBERG is chief investment officer of Domini Social Investments and author of Corporations and the Public Interest: Guiding the Invisible Hand.

Dan Dalton:

Appropriate compensation for directors is a vexing question, as is its relationship with the compensation of senior officers. First, directors set their own compensation. This, in itself, is a moral hazard. Beyond that, any contingent compensation approach imposes an exacerbated hazard for directors. Any time that additional compensation for officers directly informs additional compensation for directors, there is a problem.

Consider traditional stock options or their contemporary correspondent, performance-based or time-accelerated restricted stock. In his book *Enterprise Risk Management*, James Lam recounts that, “If you go into a company and see smart people doing stupid things, 9 times out of 10 they are being paid to do so.” Exactly. Some people confronted with contingent rewards may be seduced to cross the metaphorical line to secure those rewards. In principle, a wise board can ameliorate this problem by insisting that senior management pursue these rewards with reason. When board members jointly benefit from unimpeded, untoward behavior, however, this is far less easily done.

Accordingly, perhaps boards’ compensation should not include contingent arrangements. Pay them well, even very well, but not contingently. Even so, I wonder: At what point is directors’ compensation high enough to compromise their independence?

PROFESSOR DALTON is Harold A. Poling Chair of Strategic Management at Indiana University’s Kelley School of Business.

Michelle Leder:

Because I read SEC filings every day for my blog, I know just how spot-on Lucian Bebchuk and Jesse Fried’s *Pay Without Performance* really is. When I first began doing this nearly two years ago, I used to be amazed at the huge paydays for executives, many of whom had done a mediocre job at best. Ditto for former executives who often receive lavish golden parachutes or multiyear consulting contracts, despite being shown the door.

What continues to amaze me is the wide array of names that companies come up with to describe some of this compensation. In the filings, it’s not uncommon to see such terms as “special signing bonus,” “effective time bonus,” or my personal favorite, a “death retention bonus,” which pays someone for staying at a company despite the fact that he’s six feet under the ground. It’s also fairly common for directors to have substantial business dealings with the company whose board they’re sitting on. And no matter how impartial a director thinks he is, when he’s collecting $200,000 a year from the company, his point of view is going to be colored.

MS. LEDER writes the blog www.footnoted.org and is author of Financial Fine Print: Uncovering a Company’s True Value.

Charles Elson:

I have argued for many years that the problem of overcompensation comes primarily from the directors themselves. It’s the result of a lack of negotiation between the board and management over pay. And this failure comes from the board being nominated and dominated by the management themselves. The solution, then, is to stimulate active board negotiation. Here’s where I disagree with

The problem of overcompensation comes primarily from the directors themselves.

Lucian Bebchuk: Because of diffused institutional ownership, it's difficult for shareholders to act in concert. It can't be just one institution pressing for change—they have to band together, and that's easier said than done. And while shareholder pressure on boards is a good and helpful thing, it cannot be solely relied upon to resolve the compensation crisis.

The solution, as I've long argued, is to give the directors themselves a personal incentive to negotiate effectively with management over pay. And that can be accomplished by creating a directorship completely independent of management, who does not fear replacement by management over disagreements on pay, and most important of all, directors with substantial equity holdings in the companies on whose boards they sit. Directors should be required to purchase significant amounts of company stock upon election to the board and paid director fees primarily in restricted stock. Combined with increased shareholder pressure on boards—as Bebchuk has argued—this will ultimately solve the problem.

Professor Elson is chair of the John L. Weinberg Center for Corporate Governance at the University of Delaware's Lerner College of Business & Economics.

Carolyn Brancato:

In 2003, the Conference Board Commission on Public Trust and Private Enterprise blamed runaway compensation for the financial debacles of Enron, WorldCom, and others. In the decade since the 1993 162(m) tax legislation was passed (making compensation in excess of $1 million not deductible unless related to performance), options had exploded as a way to link compensation to executive performance. While options focused executives on creating shareholder value, they provided a reason to cook the books. The process was aided by a system of compensation consultants who worked for management and not the board.

The Commission recommended that directors serving on compensation committees be entirely independent and hire their own consultants, who would analyze pay for performance from the "ground up" and avoid the Lake Wobegon syndrome of having to pay all CEOs in the 75th percentile of compensation (a mathematical impossibility). Companies, and the system, are adjusting to the new playing field.

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Lucian Bebchuk's call for increased shareholder power to discipline directors to provide reasonable pay for performance is, like the system of the 1990s, out of balance. Sure, some large institutional investors, like TIAA-CREF, state that compensation is a "window into the boardroom" and that you can tell most of what you need to know about a company's corporate governance by examining its compensation plan. But many other investors do not have the time or money to monitor compensation as carefully as TIAA-CREF does.

While investors cannot now elect directors as easily as they can in the United Kingdom, many investors lack the information to understand how individual directors contribute or don't contribute to generating shareholder value. The system still works on the principle that directors exercise their fiduciary duties of care, loyalty, and good faith to do what is right for long-term corporate viability. And there's legal accountability: Directors are pushed to do the right thing by the Delaware courts and by out-of-court shareholder settlements. Moreover, investors already have quite a lot of power over companies—the revised New York Stock Exchange rules require them to approve equity-based compensation plans. This is a major hook, and boards are increasingly looking for shareholder approval in designing compensation plans that either provide more meaningful pay for performance or "claw back" compensation when performance turns out to be less than originally reported (e.g., Fannie Mae). The trick is for boards, executives, and investors to get a good balance to get the pay-for-performance (or lack-of-pay-for-non-performance) incentives right. The elements are all there; to keep the whole system in proper balance, what we need is continued director education, refinement of the mechanisms, transparency, and corporate/investor dialogue.

Ms. Brancato is director of the Directors' Institute and the Global Corporate Governance Research Center at The Conference Board.

Marleen O'Connor:

I disagree that giving stakeholders power will diminish shareholder power. Given that the beneficiaries of institutional investors are your average working folk, increasing the employee voice is important to promoting sustainable shareholder value. The AFL-CIO, for instance, is developing a worker-owner view of the firm.

I have written on promoting voluntary disclosure guidelines for human-resource values. Since most share value is based on human capital, the current system of financial disclosure, which concentrates on physical capital, is inadequate to meet the needs of investors. This information could be important to employees as well as shareholders.

Finally, I encourage corporate social responsibility for work/family balance. We should consider the family as stakeholder, focusing on economic measures that consider the well-being of children rather than strictly GDP and short-term stock prices. Since U.S. capitalism relies on small unions, small government, and large corporations, corporations have an important role to play in promoting our future human capital.

Thus, shareholder and employee/family interests do not conflict—indeed, they are important aspects of looking at our quality of life. We need measures to make corporate executives responsible to these concerns.

PROFESSOR O'CONNOR teaches corporate law and law and economics at Stetson University College of Law.

Paul W. MacAvoy:

What Lucian Bebchuk calls the *incorrect* "official view"—that "executive-pay arrangements are the result of arm's-length bargaining between executives trying to get the best deal for themselves and boards trying to get the best deal for shareholders"—is in fact the current reality. This is how it works: After private discussions with the compensation consultant and, separately, the CEO, the compensation committee reviews and adjusts the annual executive-compensation package. In most cases, adjustments of the CEO's package are designed to reward or penalize the CEO and his team for meeting or failing to meet performance targets, and they are effective in eleven out of twelve multi-billion-dollar corporations.

When I chaired this committee at Alumax Corp., I had to deal with a CEO who was extremely sensitive about how his package compared to those of CEOs of other mining companies, and he warned me of Alumax's adverse results if he were "too low." He complained widely that he was burdened with a compensation-committee chairman who made less than he did. In response, I negotiated mercilessly, but after the exercise was over, we again were good colleagues who enjoyed a scotch and soda together. (He *had* to be nice to me—I could be even more stubborn next time.) It was all very professional; personal relationships were seldom disrupted by package cuts, a characteristic of boards with which Bebchuk does not seem to be familiar.

This is not to imply that I and other compensation-committee chairs did not make mistakes in the 1990s. Bebchuk seems to imply systemic malfunction—board inattention to incentives and to results as to whether compensation packages were too high or too low. That is an inaccurate characterization of change in the compensation process in the last decade. Influenced by Harvard Business School professors who wrote that it was not how much you paid but "how," many corporations shifted from cash bonuses to options. But this move took place just before the bubble in share prices, which caused the accumulated wealth positions of managers with five years of options to be worth upon cashout ten times more than the compensation committee had intended. Bebchuk is correct that compensation was unhinged from performance, but it wasn't because compensation committees weren't trying to link them.

> **More pay for better board performance is a thicket of brambles.**

The members of compensation and audit committees are to some extent independent of management, with responsibility for the integrity of the financial statements and for the performance of management. The question is: What is "to some extent"? I agree that it varies from case to case—when the compensation chair is the CEO's wife's cousin, the extent is not very much; when the chair is an academician seeking to make agency theory work, the result is to put the manager exactly on the risk-return frontier.

But Bebchuk's proposals to motivate the board to motivate management are not compelling. He focuses on the threat of removal and replacement of directors by shareholder vote. I reserve my enthusiasm for that process's efficiency. When it becomes apparent that a board member—say, a movie star—doesn't belong on a board, a majority vote of shareholders should be sufficient to remove her. You don't need to have shareholders specify the replacement (another movie star, perhaps) who doesn't fit in that chair. Bebchuk seems to want a reserve seat on the board for Fidelity because it holds five million shares. Three of the fourteen boards I have been on had the big gorilla sitting there, and in my experience, the gorilla focuses on what is in the interests of her employer (Fidelity) rather than the interests of the generic shareholder. And when the new director has been installed as a result of a hostile proxy battle, that person never is truly accepted.

How, then, to incentivize the board to increase the "degree" to which it serves the interests of shareholders? Fear of dismissal from the board is unlikely to work—most of the hundreds of directors I have known consider resigning every time the share price declines, because the hassle is not worth it. As Bebchuk implies, more pay for better board performance is a thicket of brambles: Who is to decide pay level, and how do you measure performance of the monitoring function? He discounts the now-widespread movement in the state courts to make directors legally liable for egregious errors in monitoring and rewarding management.

In recent years, state courts have begun to require that directors must incur liability for poor corporate performance that could have been avoided. There is concern, however, that directors will disappear. My impression is that there is no shortage of others to take these slots.

PROFESSOR MACAVOY is Williams Brothers Professor Emeritus of Management Studies at Yale School of Management and co-author of, most recently, The Recurrent Crisis in Corporate Governance.