HANK BOERNER

EXECUTIVE COMPENSATION FOR SENIOR MANAGERS

In ancient Greece, the philosopher Aristotle is said to have urged that no citizen of the first western democracy be paid more than seven times the wages of the lowest paid citizen.

Twenty three centuries later, the founders of Ben & Jerry's, the ice cream manufacturing firm "with a social conscience," took this suggestion seriously and established the 7-to-1 ratio within their young firm. Senior executives' pay levels were not to exceed seven times that of their lowest wage level employees. Social responsibility advocates and some journalists cheered; few companies actually followed the example. (In 2000, the founders, Ben Cohen and Jerry Greenfield, sold their company to Unilever for $326 million and Mr. Cohen received $39 million for his interests.)

CEO compensation has become a complex and contentious issue in the United States and the focus of individual and institutional shareholders, many shareholder advocates, and the media. The issue will have serious financial, investing, societal, and business implications. There are signs the issue could also become a concern beyond U.S. borders. Even if it does not, within the United States executive compensation will remain an important topic for broad public debate.

This column will briefly explore the recent past in the U.S. executive compensation issue, the dimensions of the issue today, and some possible future trends. CEO pay is a lightning-rod issue that institutional investors are clearly focused on, and that could cause serious disagreements between shareholders and corporate boards and managers in the months ahead.

Emergence of corporate pay schemes

Modern corporations evolved in the United States throughout the early years of the twentieth century. At some companies, families remained in charge, with little or no public ownership. Therefore, they could reward themselves (and a chosen few) quite handsomely. Family owner-managers of large industrial firms were the new American aristocracy. Then, as more companies became publicly owned, the fruits of the enterprise were more broadly shared.

In the years immediately after World War II, large U.S. corporations established complex"grade and step" salary protocols, with senior managers included. As with many corporate practices, administrative systems in large corporations mimicked military systems (such as established pay grades for privates up to sergeants and lieutenants up to generals). The U.S. military provided many examples and lessons for the post-World War II corporate managers, many of whom were trained by the Army and Navy.

This grade and step approach was especially important in certain regulated industries—e.g., telephone, electric, airlines—where appearances were important; it would not do to have the CEO and other executives receiving unseemly compensation for managing a company that was perceived to be serving the public under strict government supervision.

Under these programs, the differences between average CEO and senior executive pay and rank and file salary levels were not great throughout much of the postwar era.

Large corporations continue the practice; General Electric (GE), for example, until recently maintained 29 salary grades, according to management recruiters Johnson Smith & Knisley (JS&K). GE now has just six grades—and what JS&K refers to as "broadbanding practices," a trend to do away with the traditional promotion raise and the very concept of the corporate ladder. In its place are annual cash bonuses for managers, similar to those paid to senior executives, and variable pay, which are now offered by 60 percent of large companies. GE continues to stress the importance of pay for performance.

CEO compensation became a high profile and often contentious issue throughout the 1980s and especially as the 1990s began. At the annual meetings in 1991, for example, compensation levels were clearly a focus of shareholder ire.

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Modern corporate governance is said to have evolved partly in the early 1990s battles over CEO performance, where executive compensation practices were either a direct or indirect issue for shareholders at large, underperforming companies such as IBM, GM, American Express, Eastman Kodak, Westinghouse, and others.

Major players shaping the public dialogue included compensation experts Ira Kay and Graef Crystal, United Shareholders' Ralph Whitworth, corporate governance pioneer Robert Monks (LENS Fund), and the California Public Employees' Retirement System's (CalPERS) CEO Dale Hanson and General Counsel Richard Koppes.

Public sector officials and the investing public became involved in the issue as first the business press and then the mass media focused on CEO pay. In April 1992, *Time* magazine asked Americans, "How Is Your Pay" and pointed out that American CEOs had "risk-free pay, with the average pay level being 160 times that of blue-collar workers." (The CEOs of the top 200 companies received an average of $2.8 million in 1989.) Many publications—such as *Business Week, Fortune,* and *The New York Times*—continue to publish lists of CEO pay regularly. (The executive pay to blue-collar pay ratio often exceeds 400 to 1 today.)

Time published the examples of compensation packages in the 1980s that to the editors seemed to be off the charts: Chrysler's Lee Iacocca received $20 million in 1986; Toys "R" Us' Chairman Charles Lazarus received $60 million in 1988; Time-Warner's Chairman Steve Ross received $78 million in 1990; and Walt Disney Co's CEO Michael Eisner received $40 million in 1988. The apocryphal tale told is that every other CEO asked their boards to review their packages and immediately hire a compensation expert to help "correct" deficiencies in compensation programs.

Pay for performance messages

As public criticism of high payouts mounted, however, some companies also began to take action to address public opinion. At Walt Disney, Mr. Eisner agreed to a base salary of $750,000 (from 1991 to 1998); any additional pay would come from a portion of the profits above certain agreed-to levels. No one could foresee the dramatic rise in share prices that was just over the horizon. By 1996, Mr. Eisner had cash income of $8.7 million and stock options worth more than $180 million! Mr. Eisner could thank the dramatic rise in Disney share prices for the inflation of his options value. Early investors could also thank the CEO for dramatically increasing the value of their holdings by mid-decade.

At pharmaceutical manufacturer Becton Dickinson, CEO Raymond Gilmartin said he would receive more money only if the company's stock outperformed the Standard & Poors (S&P) 500 index by a certain amount. In the 1990s, the granting of generous options began with such arrangements as pay for performance, which became the watchwords for CEOs and boards. Public focus on the issue waxed and waned, except for a hardy band of determined shareholder activists who did not care about share price increases if they felt CEOs were overcompensated and persisted in keeping the issue alive. But often they were lonely voices as the Dow Jones steadily increased by thousand-point marks and NASDAQ approached the 5,000 mark.

THE PAY-FOR-PERFORMANCE TREND WAS FIRMLY ESTABLISHED BY THE EARLY 1990S.

The symbolic $1 million salary mark

CEO compensation also approached a symbolic mark of its own: the $ 1 million salary level (in the early 1990s). In May 1991, the *San Francisco Chronicle* reported that while net income was falling at 33 of the region's top 100 public companies, CEO compensation rose in 1990 to just under $1 million, and 37 CEO's actually made more than $1 million. Among them was John Sculley of Apple who was recruited from Pepsico to turn Apple around, and was paid $2.2 million. He also cashed in options worth $14.5 million.

The pay-for-performance trend was firmly established by the early 1990s and became a reliable mantra for CEOs, boards, and compensation consultants to defend generous options grants. And while the million dollar salary threshold may appear to be quite quaint today, given recent CEO pay levels, at the time a very real public opinion barrier was about to be broken by pacesetting companies. Once passed, the next symbolic benchmarks grew to the tens and even hundreds of millions of dollars when options were included.

At *Business Week*, corporate governance editor John Byrne (later to co-author "Jack" with GE's Jack Welch) in May 1991 asked readers, "How Much is Enough?" and cited the pay of Reebok's Chairman Paul Fireman (which was $13.1 million in 1986, rising to $14.8 million by 1990). As Byrne characterized the situation, "Each year, the numbers are mind-numbing. They're enough to scramble your calculator. Executive pay seems out of control." There was much more controversy to come throughout the 1990s as well as great increases in CEO compensation.

Accounting for options?

Two important developments occurred in the early 1990s:

1. The Financial Accounting Standards Board (FASB) began a rulemaking initiative to address executive compensation; and
2. The federal government limited the deductibility of CEO compensation.

The heads of many companies, including well-known CEO personalities in California's Silicon Valley, opposed any new accounting rules that would limit the wealth-building power of stock options. Political pressure was applied and the FASB eventually abandoned the rule—but not the issue.

The federal government imposed a $1 million salary cap for corporate tax deductions (the treatment of executive compensation as a deductible expense was basically limited to $1 million cash salary, a political compromise at the time). Generous use of stock options quickly became a major element of CEO and senior management compensation (and was especially important in CEO recruiting). Some strike prices were set very low, with no relation to the market valuation; at other times, if share price fell, options were re-priced.

Shareholders did object to these practices; Warren Buffett of Berkshire Hathaway asked "If options aren't expenses to the corporation, what are they? They certainly are expenses to the shareholder, as they dilute holdings." But government or accounting rule-makers took no action. The market soared to new highs throughout the 1990s.

Periodically, the media headlined CEO pay issues—especially as CEOs came to be paid in the tens and even hundreds of millions of dollars as options were cashed in or outright grants were made.

Overall, the issue waxed and waned with the public during the heady days of the 1994-2000 bull market. As share prices rose, generous compensation packages for senior managers, and some members of boards, were overlooked by both institutional and individual investors. However, not *all* investors looked the other way. Shareholder activists maintained their focus on CEO pay schemes and regularly raised the issue in proxy resolutions, at annual meetings, in meetings with management and boards, at investor meetings, in news interviews, and by other means.

The public debate was tilting in favor of executives and boards as dramatic share price increases attracted many new investors to the equities markets. The arguments were made in favor of generous stock option packages and salary packages.

Opponents of excessive CEO pay argue that:

- We should recognize that stock options have a downside risk (a potential fall in value) that may encourage excessive risk-taking by executives; and
- Most CEOs held less than one percent interest in their companies (in 1992 anyway).

Fast forward: the end of the bull market

In spring 2000, the major indexes stalled and began to fall. The Dow Jones had climbed from 3,000 to 11,500 in the decade, and would slide over two years to just above 7,500. The NASDAQ would lose three-quarters of its value over three years, the worst decline in a major stock index since the Great Depression.

THE CURRENT DEBATE OVER EXECUTIVE COMPENSATION WILL AFFECT VIRTUALLY ALL PUBLICLY OWNED CORPORATIONS.

A number of formerly high valuation companies—like Enron, Quest, and WorldCom—lost all or almost all of their market valuation in a very short period of time. The amount of money that CEOs of these companies received became a topic of public discussion and much media coverage. The collapse of WorldCom, and the revelations of executive compensation practices, for example, is often cited as a major impetus for passage of the Sarbanes-Oxley package of legislation.

Exaggerating the pain for shareholders was the exiting of CEOs of more than a few poorly performing or bankrupt companies with very high compensation "goodbye" packages, re-igniting the public debate over pay for performance. Investors were demanding someone pay for their losses, and wanted some departed managers to suffer "pain for poor performance." (Sarbanes-Oxley provisions today require forfeiture of such compensation by officers and directors under certain conditions.)

In the new era of corporate accountability, the current debate over executive compensation will affect virtually all publicly owned corporations. One major influence on the issue will be the New York Stock Exchange's (NYSE's) amended listed company rules, which were approved in June by the Securities and Exchange Commission (SEC).

Shareholder approval of equity plans for NYSE-listed companies

The NYSE standard for listed companies has been that shareholder approval is required of all plans in which officers or directors may participate; broad-based plans and one-time employment inducements are exempt. Brokers may vote customer shares without instruction as long as the proposal is not contested and does not cover more than 5 percent of the outstanding stock.

A new rule is being incorporated: Shareholder approval is required for the adoption or material change in any equity compensation plan. Certain grants are exempt but must be approved by the compensation committee or a majority of independent directors. Existing plans are not required to be retroactively approved, but any material modifications will require shareholder approval. Listed companies are not allowed to permit proxy votes on equity plans unless the beneficial owner of the shares has given voting instructions (to those voting their shares, such as brokers).

Similar moves at NASDAQ exchange

The NASDAQ exchange's listing standard has been: "Shareholder approval of stock option or purchase plans is required if director or officers of the listed company may acquire stock." The new rule is: "Shareholder will be required for the adoption of all stock option and purchase plans and material modification of plans. Inducement grants to new employees will be exempt if the grants were approved by an independent compensation committee or a majority of independent directors."

Note that the comprehensive Sarbanes-Oxley package of legislation signed into law July 31,2003 by President George W. Bush *did not* address shareholder approval of options.

Shareholder activism

While Sarbanes-Oxley statutes, new SEC rules, pending NYSE rules, and other factors were important considerations when shareholders were developing their own proxy resolutions for 2003 contests, the full force of new rules and regulations will not be fully felt until the 2004 and 2005 proxy seasons. In 2003, shareholders pushed hard to get their proposals on the ballots and to generate support for their proxy resolutions. Many resolutions were focused on executive compensation. The Council of Institutional Investors pointed out that executive pay was the number one issue for its members (who are institutional investors such as employee pension funds).

At J.P. Morgan Chase & Company, for example, a resolution sponsored by an individual asked that the company identify in proxy filings any executive receiving more than $250,000 in base salary. The Academy of Our Lady of Lourdes asked J.P. Morgan Chase to compare pay levels of top executives in the United States with the wages paid to the lowest level workers in the United States and abroad for the years 1982,1992, and 2002.

In filing 2003 resolutions, faith-based institutional investors raised executive compensation issues at General Electric, AOL Time Warner, Bristol-Myers Squibb, Weyerhaeuser, and Coca-Cola (among hundreds of resolutions offered by religious orders, denominations, socially responsible mutual funds, and their allies).

Sarbanes-Oxley greatly strengthened the FASB (only the FASB and the SEC will now develop new accounting rules). FASB's amended Statement 123 (first adopted in 1995) requires prospective application of the fair value recognition provisions to new awards granted after the beginning of the period of adoption. Over time, as more companies adopted or announced their intentions to adopt the fair value based method of accounting for stock-based employee compensation, concerns were raised; so FASB amended SFAS No. 123. Among the changes are that SFAS No. 123 does not permit the use of the original [123] method made in fiscal years beginning after December 15,2003.

SHAREHOLDER APPROVAL IS REQUIRED FOR THE ADOPTION OR MATERIAL CHANGE IN *ANY* EQUITY COMPENSATION PLAN.

The future?

As the major equity indexes begin to rise—NASDAQ was up by two-thirds between autumn 2002 and summer 2003, and the Dow Jones was up one-third since January 2003—some skeptics have said that the CEO compensation issue could become less contentious. (Investors satisfied with their returns will not look too closely into the CEO's pockets.)

The news media will likely continue the pattern of raising the issue of CEO pay at certain times, such as when *Business Week* focuses each spring on the executive and board compensation packages disclosed in proxy statements and other documents, and may reduce coverage at other times. Or perhaps not; corporate governance issues are now a staple of virtually all of the major business and financial media.

With NYSE and NASDAQ setting new rules for listed public companies, independent directors and especially those serving on compensation committees will be front and center in the debate over executive compensation. If no material changes are made to existing plans, shareholder approval could be skirted. Corporations will need to convince the majority of shareholders that new or revised plans are important—to the shareholder and not just executives. Members of the board compensation committee will be the focal point of the debate and the targets of concerted efforts by shareholder activists to change or affect executive compensation plans.

Also, mutual funds must begin to report (1) their corporate governance voting policies, which should include philosophies and policies on executive compensation for the companies in which they invest; and (2) their record of voting for every company in which they cast a proxy ballot. Since investment companies are a huge influence in the equities market, conceivably the issue of executive compensation is important. (It may not be if mutual fund investors do not pay attention to their funds' policies or votes.)

Institutional shareholders may hold the key to the development of future executive compensation practices; recently, union pension funds, public employee pension funds, socially responsible mutual funds, and even mainstream, large cap funds have been focusing on the issue of executive compensation. Greater transparency created by recent rulemaking, regulatory mandates, and corporate disclosure practices will shed more light on executive compensation. Perhaps a glimpse of future conflicts could be seen in the recent developments at AMR, parent of American Airlines, as Chairman Donald Carty was forced to step down. As the airline asked rank and file for financial sacrifices to help the airline cope with the economic downturn, the corporation disclosed—in footnotes—a generous compensation package for Mr. Carty and some other senior level executives. The idea of "not sharing the pain" created a public firestorm for AMR and the chairman.

Other corporations no doubt were paying careful attention to the relationship of executive compensation to compensation for the lower ranks of employees, especially in times of economic downturn.

For financial executives, there are no easy answers, formulas, or, as yet, clearly winning strategies for boards and those who set CEO compensation levels. The issue will be an especially important part of board governance in the months just ahead. •