CHAPTER 1

Introduction

SHOULD THE CEO BE REWARDED OR PUNISHED FOR EVENTS BEYOND THE CEO'S CONTROL?

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BEST PRACTICE

Companies should be prepared to articulate a consistent and defensible executive compensation policy when called upon by shareholders or the media.

Many investors are shocked by the size of CEO compensation, particularly in situations in which the CEO was seemingly the beneficiary of good luck. In the case of Exxon, the good luck was the increase in worldwide oil prices, which the media presumed was not the result of CEO efforts.

It was reported that Lee Raymond, the retired Chairman of Exxon, was paid $51.1 million in 2005, the equivalent of $141,000 a day, nearly $6,000 an hour. It was also reported that Exxon gave Lee Raymond one of the most generous retirement packages in history, nearly $400 million, including pension, stock options, and other perks, such as a $1 million consulting contract, two years of home security, personal security, a car and driver, and use of an Exxon corporate jet for professional purposes. Exxon defended Raymond's compensation, noting that during the twelve years that he ran the company, Exxon became the world's largest oil company and its stock price went up 500% (as of April 2006).

Given the time pressures and other constraints media reporters placed on Exxon's public relations personnel, this may have been as good a response as possible under the circumstances. However, the Exxon defense was unconvincing to skeptics because it failed to articulate an acceptable CEO compensation theory. For example, Exxon could have stated, if true, that Lee Raymond developed a strategy to expand the company's oil production and reserves, thereby positioning Exxon to benefit from the rise in oil prices, or that Mr. Raymond's compensation was developed after an extensive competitive analysis. Merely stating that the Exxon shareholders also benefited from the rise in oil prices was not a completely satisfactory explanation for the large amounts paid to Mr. Raymond. Moreover, given what happened to former CEO of Home Depot Mr. Robert Nardelli, it is possible that Mr. Raymond would have been fired had the stock price fallen during his tenure, even though due to events also beyond his control.

Those who believe that good luck should not be the basis for increasing CEO compensation should ask themselves whether bad luck should also be ignored. If a CEO is to be rewarded for events beyond the CEO's control that increase the profits and stock price of the company, then, arguably, the CEO should likewise be punished for events beyond the CEO's control that adversely affect the profits and stock price of the company. If it is not feasible to punish the CEO for events beyond his or her control, then, arguably, the CEO should not be paid more than what is competitively required to retain the CEO even if very favorable events occur over which the CEO had no control, which increase the company's profits and stock price.

The counter-argument is that CEOs are being held responsible for increasing the price of the stock and are being punished for failing to do so even if their operational performance was beyond reproach. According to a Booz Allen Hamilton study[1], almost 1 in 3 CEOs were forced out of office in 2006, compared to 1 in 8 in 1995. One example would be Robert Nardelli of Home Depot who was terminated based upon the failure of the Home Depot stock to appreciate, even though he was successful

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[1]Lucier, Weeler and Habbel, "The Era of the Inclusive Leader," (May 22, 2007) contained on the Booz Allen Hamilton website: www.boozeallen.com

in significantly increasing the profits of Home Depot. See "CEO Forced Exit Packages" later in this chapter.

Professors Bebchuk and Fried[2] make a similar argument with regard to stock option and other equity-based compensation. They argue that executives should not be rewarded for increases in stock prices that are no greater than indexes for the market in general and, therefore, stock options and other equity grants should only reward the executive for increases in value over and above increases in these stock market indexes.[3] By rewarding executives only for stock price increases that are arguably due to their effort, the executive does not profit from events beyond his or her control.

Warren E. Buffett on Executive Compensation

The concept of rewarding or punishing CEOs for events beyond their control has caught the attention of Warren E. Buffett. The following are excerpts of Mr. Buffett's engaging views on executive compensation (including compensation of directors)[4]:

> "In selecting a new director, we were guided by our long-standing criteria, which are that board members be owner-oriented, business-savvy, interested, and truly independent. I say 'truly' because many directors who are now deemed independent by various authorities and observers are far from that, relying heavily as they do on directors' fees to maintain their standard of living. These payments, which come in many forms, often range between $150,000 and $250,000 annually, compensation that may approach or even exceed all other income of the 'independent' director. And – surprise, surprise – director compensation has soared in recent years, pushed up by recommendations from corporate America's favorite consultant, Ratchet, Ratchet and Bingo. (The name may be phony, but the action it conveys is not.) . . .

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[2]"Pay Without Performance," Harvard University Press, 2004.

[3]A similar argument for indexing stock option exercise prices was made by Alfred Rappaport in an article entitled "New Thinking on How to Link Executive Pay with Performance," which appears in the Harvard Business Review on Compensation (2001).

[4]2006 Annual Report of Berkshire Hathaway, Inc.

"When we use [CEO] incentives – and these can be large – they are always tied to the operating results for which a given CEO has authority. We issue no lottery tickets that carry payoffs unrelated to business performance. *If a CEO bats .300, he gets paid for being a .300 hitter, even if circumstances outside of his control cause Berkshire to perform poorly. And if he bats .150, he doesn't get a payoff just because the successes of others have enabled Berkshire to prosper mightily.* An example: We now own $61 billion of equities at Berkshire, whose value can easily rise or fall by 10% in a given year. Why in the world should the pay of our operating executives be affected by such $6 billion swings, however important the gain or loss may be for shareholders? . . . [Emphasis Supplied]

"CEO perks at one company are quickly copied elsewhere. 'All the other kids have one' may seem a thought too juvenile to use as a rationale in the boardroom. But consultants employ precisely this argument, phrased more elegantly of course, when they make recommendations to comp committees.

"Irrational and excessive comp practices will not be materially changed by disclosure or by 'independent' comp committee members. Indeed, I think it's likely that the reason I was rejected for service on so many comp committees was that I was regarded as *too* independent. Compensation reform will only occur if the largest institutional shareholders – it would only take a few – demand a *fresh* look at the whole system. The consultants' present drill of deftly selecting 'peer' companies to compare with their clients will only perpetuate present excesses."

CEO Compensation Theories

There are two rival theories for the rise in CEO compensation. The first theory blames lax corporate governance by directors of public companies, many of whom are selected by and beholden to the CEO. This is the Warren Buffett theory.

The second theory ascribes the increase to economic factors, including globalization and technology and other macroeconomic factors that have increased the productivity of a select few superstars. For example, a paper by Professors Xavier Gabaix, (Massachusetts Institute of Technology) and Agustin Landier, (New York University) dated May 8, 2006 entitled "Why Has CEO Pay Increased So Much?" states that a "large part of the rise in CEO compensation in the U.S. economy is explained

without assuming managerial entrenchment, mishandling of options, or theft."[5]

> "Historically, in the U.S. at least, the rise of CEO compensation coincided with an increase in market capitalization of the largest firms. Between 1980 and 2000, the average asset value of the largest 500 firms increased by a factor of 6 (i.e. a 500% increase). The model predicts that CEO pay should increase by a factor of 6. The result is driven by the scarcity of CEOs, competitive forces, and the six-fold increase in stock market valuations. Incentive concerns or managerial entrenchment play strictly no role in this model of CEO compensation. In our view, the rise in CEO compensation is a simple mirror of the rise in the value of large US companies since the 1980s."

In 1981, Professor Sherwin Rosen of the University of Chicago wrote a paper entitled "The Economics of Superstars" which he characterized as follows: "The phenomenon of Superstars, wherein relatively small numbers of people earn enormous amounts of money and dominate the activities in which they engage, seems to be increasingly important in the modern world."[6]

Professor Rosen cites examples of a small number of popular comedians who can earn extraordinary sums as a result of the capacity of television to reach popular masses. He found two common elements in all of the so-called Superstars: "First, a close connection between personal reward and a size of one's own market; and second, a strong tendency for both market size and reward to be skewed toward the most talented people in the activity."

Professor David H. Author (Massachusetts Institute of Technology) cites advances in communications technology, including the Internet, for the proposition that there are "winner take all markets," (i.e., allowing individuals with extraordinary talent to serve substantial markets almost single-handedly) and that communications technologies may displace

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[5]Gabaix, Xavier and Landier, Augustin, "Why Has CEO Pay Increased so Much?" (May 8, 2006). MIT Department of Economics Working Paper No. 06-13

[6]Prof Sherwin Rosen, "Economics of Superstars," The American Scholar, Volume 52, Number 4, Autumn 1983.

lesser talents, redistributing a larger share of the rewards to a smaller number of superstars.[7]

A January 9, 2007 blog by Stephen Kaplan of the University of Chicago[8] entitled "Are CEOs of U.S. Public Companies Really Overpaid?" makes some of the following points in defense of CEO compensation:

- The CEO job at large public companies is less secure today than it has been over the last 35 years, with CEO turnover at Fortune 500 companies running at over 16% per year since 1998 versus 10% per year in the 1970s, with CEO job retention of an average of six years today versus ten years in the 1970s.
- CEO turnover and pay at Fortune 500 companies is strongly linked to stock performance relative to the industry, citing the public dismissals of Hank McKinnell of Pfizer and Robert Nardelli of Home Depot, each of whom served over six years and presided over poor stock performance relative to their industries, and the fact that CEOs in the top compensation decile were with firms that outperformed their industries over the previous three years by more than 50%, while CEOs in the bottom compensation decile were with firms that underperformed their industries by more than 25%.

This book proceeds on the assumption that there are elements of truth in each of the rival theories. The dramatic increases in CEO compensation are both the result of economic factors, such as globalization which creates potential "superstar markets," and a failure of compensation committees of boards of directors to consistently use "best practices" in formulating and approving CEO compensation.

CEO Forced Exit Packages

The following is a chart of the forced exit packages of some prominent executives that have stirred tremendous public controversy over the last ten years.[9]

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[7]"Wiring the Labor Market," Journal of Economics Perspectives, Vol. 15, No. 1 (Winter 2001).

[8]The Harvard Law School Corporate Governance Blog.

[9]The Wall Street Journal, January 4, 2007.

Executive/Title	Company	Exit Package in Millions
Robert Nardelli Chairman, CEO	Home Depot	$210
Henry McKinnell Chairman, CEO	Pfizer	$200
Tom Freston CEO	Viacom	$59
Philip J. Purcell Chairman, CEO	Morgan Stanley	$62
Carly Florina Chairman, CEO	Hewlett Packard	$21
Jill Barad CEO	Mattel	$50
Michael Ovitz President	Walt Disney	$140

Many of these exit packages include items earned over many years, such as supplemental pension payments and stock option profits. Accordingly, some of these numbers may well be misleading.

According to the January 4, 2007 issue of *The Wall Street Journal,* Robert Nardelli, the former CEO of Home Depot, walked away with an exit package of $210 million, as noted in the CEO forced exit packages chart, a figure that was calculated before the announcement of his resignation boosted the potential value of his stock options.

Mr. Nardelli's exit package stirred up a hornet's nest of criticism of excessive CEO compensation. The Home Depot's share price had fallen 9% since Mr. Nardelli joined the company in December 2000. In contrast, the share price of Lowe's, its competitor, had risen 188% in the past six years. Mr. Nardelli defended his record by pointing out that Home Depot had posted earnings per share growth in excess of 20% per year for four consecutive years, only one of two companies in the Dow Jones Industrial Average to do so.

It has been suggested that the ousting of Robert Nardelli sent exactly the wrong message to CEOs, namely "manage the stock, not the company."[10] It used to be conventional wisdom that the CEO should run the company and the stock market would determine the share price.

Those shareholder activists who believe that the CEO should be responsible for the stock price have a short memory. Overemphasizing

[10]"Blame Home Depot's Board, Not Nardelli," V. Katsenelson, January 4, 2007, Contrarian Edge blog, http://contrarianedge.com/2007/01/04/blame-home-depots-board-not-nardelli/

the importance of the stock price is exactly how Enron got into trouble. Enron created a "numbers driven" culture in order to maintain the market price of its stock and this culture ultimately resulted in a major financial fraud and Enron's subsequent bankruptcy.

Moreover, the increasing pressure on CEOs to be responsible for share prices is an important factor in causing public companies to be purchased by private equity groups (see Chapter 4).[11]

Private Equity Compensation

The compensation received by CEOs from private equity investors is instructive as to whether CEO compensation is driven primarily by passive directors or by macroeconomic factors. In Chapter 4, there is a discussion on David Calhoun, a 50 year-old former Vice Chairman of General Electric, who was offered a compensation package worth more than $100 million by VNU, a $4.3 million media company, controlled by a consortium of private equity firms. This provides at least anecdotal evidence that there is some merit to the macro theory of executive compensation.

Other "star" CEOs have also found a home with private equity funds, presumably with large compensation packages. According to *The Wall Street Journal* of May 16, 2007, "Kenneth W. Freeman, former CEO of Quest Diagnostics Inc., is now CEO at KKR-backed door-maker Masonite and Executive Chairman of medical-device firm Accellent. Firms have lured even bigger names as special partners or advisers, including former GE CEO Jack Welch as Partner at Clayton, Dubilier & Rice, and former International Business Machines Corp. CEO Louis V. Gerstner Jr., now Chairman of Carlyle Group."

Entertainment and Sports Celebrities

Economists have noted that there is a substantial difference between the market for CEOs and the market for entertainment and sports celebrities. However, it is instructive to review the "reported" compensation of these celebrities since their compensation is clearly not determined by passive boards of directors beholden to the celebrity. Thus, the compensation

[11]See, "Is Shareholder Democracy Encouraging Private Buyouts of Public Firms?" L. Stout, The Harvard Law School Corporate Governance Blog, May 15, 2007.

levels described below are of some relevance in determining what an arms-length market value is of celebrities who achieved superstar status.

Entertainment and sports celebrities are reported to have received the following yearly compensation according to Forbes.com, although these figures are suspect and may reflect equity ownership returns as well as multiyear returns:

- Steven Spielberg $332 million
- Oprah Winfrey $223 million
- Jerry Seinfeld $98 million
- Tiger Woods $88 million
- Michael Jordan $32 million
- Shaquille O'Neal $30 million
- Barry Bonds $20 million
- Katie Couric $15 million

The reported compensation of these celebrities gives some credence to the superstar theory of the academic studies previously described.

Benefits of Good Corporate Governance

Are there any benefits of using best corporate governance practices?

Corporate governance rating groups maintain that companies with a reputation for good corporate behavior have stocks that sell at a premium, and investors agree.[12] Some argue that these corporate governance rating groups receive payments from the companies which they rate and, consequently, may not always be considered independent. However, it is clear that these corporate governance rating groups do have significant influence with many institutional investors and their ratings cannot be ignored.

Good corporate governance enhances the image of a company and there is at least anecdotal evidence that image and reputation can increase the company's stock price. In the case of United Technologies Corp., one study found a 27% increase in market value as a result of the company's excellent image and reputation.[13]

[12]P. Dvorak, "Finding the Best Measure of Corporate Citizenship," *The Wall Street Journal,* July 2, 2007.

[13]"What Price Reputation?" *BusinessWeek,* July 9, 2007.

A survey was conducted by a management consulting firm between April and May 2002 in cooperation with the Global Corporate Governance Forum. The survey covered the opinions of over 200 institutional investors collectively responsible for $2 trillion of assets under management. The survey found that institutional investors placed corporate governance on par with financial indicators when they evaluated investment decisions.

An overwhelming majority of investors stated that they were prepared to pay a premium for companies exhibiting high governance standards. Premiums averaged:

- 30% in Eastern Europe and Africa
- 22% in Asia and Latin America
- 14% in North America and Western Europe
- 13% in North America

The following table lists all the countries that were surveyed by the research and shows the premiums that investors are willing to pay for shares in a well-governed company in the respective countries.

Country	Premium (%)
Morocco	41
Egypt	39
Russia	38
Turkey	27
Indonesia	25
China	25
Argentina	24
Venezuela	24
Brazil	24
Poland	23
India	23
Malaysia	22
Philippines	22
S. Africa	22
Japan	21
Singapore	21
Colombia	21
S. Korea	20

Thailand	20
Mexico	19
Taiwan	19
Chile	18
Italy	16
Switzerland	15
U.S.	14
Spain	14
Germany	13
France	13
Sweden	13
UK	12
Canada	11

The survey emphasized that companies not only needed to be well governed but also needed to be *perceived* in the market as being well governed. However, care should be taken when determining what the results actually prove, since the research did not provide any evidence that the institutional investors actually acted on their opinions.[14]

There is some evidence that good corporate governance produces direct economic benefit to the organization. One study, conducted at Georgia State University and published in December 2004, found that public companies with independent boards of directors have higher returns on equity, higher profit margins, larger dividend yields, and larger stock repurchases.[15] This study was consistent with another study of 250 companies by the MIT Sloan School of Management which concluded that, on average, businesses with superior IT governance practices generate 25% greater profits than firms with poor governance given the same strategic objectives.[16]

The next chapter deals with methods of motivating executive performance.

[14]See also Deutsche Bank Study (2001–2002) and The Black, Jang and Kim Research in Korea (2003).

[15]Brown, et al, *Corporate Governance and Firm Performance* Georgia State University (December 7, 2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=586423

[16]Weill, *IT Governance: How Top Performers Manage IT Decision Rights for Superior Results*. (Harvard Business School Press, 2004).