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## Executive and Director Compensation

### 1984 REDUX

*But the special function of certain Newspeak words, of which [election of directors] was one, was not so much to express meanings as to destroy them. These words, necessarily few in number, had had their meanings extended until they contained within themselves whole batteries of words which, as they were sufficiently covered by a single comprehensive term could now be scrapped and forgotten. [p. 250]*

*As we have already seen in the case of the word [independent], words which had once borne a heretical meaning were sometimes retained for the sake of convenience, but only with the undesirable meanings purged out of them. [p. 251]*

George Orwell, 1984, (Signet, 1984)

We are mute witnesses to the dismemberment of inveterate and heretofore unchanging precepts of our Corporation Laws. There have been no insightful periodicals, no learned law review articles, no hearings before Congress, no administrative proceedings, to say nothing of any explicit acts of State Legislature or the Congress to inform us of this revolution, but we are aware that is happening. Berle and Means noted 65 years ago that managers had taken the place of owners in control of publicly held corporation. Today we see a further step in that progression – top management is taking the place of the purchasers of stock as the actual owners of these corporations. Legally and economically, ultimate risks and rewards of corporate performance have accrued to those who invest and risk the capital essential to the enterprise. Whether it was Andrew Carnegie, John Paul Getty or William Gates, the entitlement of the founding owner to vast wealth when the business prospered has been an accepted part of our culture.

Times have changed – now top managers (hereinafter referred to collectively as CEOs) have become substantial corporate owners – largely as the beneficiaries of option grants. Option holdings represent more than ten percent of the total publicly held outstanding stock. Institutional Shareholder Services reported as early as 1992 that the top 15 individuals in each company received 97% of the stock options issued to all employees. *Business Week* reported: “[T]he 200 largest corporations set aside nearly 10% of their stock for top executives... In almost all cases, moreover, it’s the superstar CEO who takes the lion’s share of these stock rewards.” The very best like the late Roberto C. Goizueta of Coca Cola acquire more than a billion dollars, even the mediocre like Occidental Petroleum’s Ray Irani are “bought out” with the best part of \$100 million. The compensation of top corporate officials in the United States today exceeds by orders of magnitude every comparative measure of pay irrespective of time and place. Today the average CEO makes about 209 times what the full-time factory employee does.[1]

How this has happened is an important story. Law has been followed “to the letter”, but in doing so the entire community has accepted the use of words directly contrary to their accepted meaning. Process has prevailed over common sense and the result is an emerging hegemony of the CEO which portends significant change in the role of corporations in this society.

Appearance and reality are utterly different in several critical respects:

Appearance	Reality
1. Shareholders’ interests are secured through the <i>election</i> of directors who protect their interests.	Shareholder action with respect to the election of directors can best be described as “coerced ratification”. No matter how shareholders vote, those individuals listed on the management proxy are elected.
2. The preponderance of directors are “independent” according to the rules of the SEC, the New York Stock Exchange, the Council of Institutional Investors, GM, Campbell Soup, CalPERS and the Internal Revenue Service, among others.	Boards of directors are <i>self-perpetuating</i> . The CEO has at the least the power to veto nominees, but usually actively participates in the selection process. Membership is highly valued and those selected are conscious of benefit conferred on them.
3. Most boards have Compensation Committees, comprised entirely of “independent” directors.	How can anyone be considered “independent” of someone to whom they are personally beholden?
4. Best practice requires the use of “professional” Compensation Consultants.	The realities of a successful professional practice include not being perceived as insensitive to the needs of those in whose gift lies your selection. Consider Graef Crystal.
Appearance	Reality
5. The “free market” ensures that competitive factors control the levels of CEO pay.	There is no “free market” in top executive compensation. CEOs control the critical stages of the process, including government and professional accounting treatment.

The corporate system has been significantly perverted. The received structure of management accountability to boards and shareholders has been stood on its ear. CEOs have used their power and the accommodating skill of their professional advisors to confer wealth on themselves. “Why doesn’t anybody protest?” “Why doesn’t anybody do anything?” It must be said that many of those who could testify effectively as to the inappropriateness of the redistribution of corporate wealth earn fine livings which are in the gift of those to whom it is being diverted.

When intelligent, honest professionals repeatedly use legal terms in a manner contrary to commonly accepted usage, we are entitled to ask why. When the corporation laws of 50 states recite that the stockholders *elect* directors; that shareholders *vote* for their choice of nominees; that proxies are *solicited* for the election of directors, we are given an impression contrary to the actual practice.

We used to laugh at the 99% votes secured by incumbents in the Communist elections over the last half century.

Excellent arguments can be made why boards of directors should be self-perpetuating. The benefits, indeed the need for collegiality in a managing board, is one compelling reason. Why is there, therefore, reluctance to “call a spade a spade”. Defend self selection on its own merits. In

addition to their responsibilities to assure that corporations are competitive, directors are responsible that they function "legitimately". [2] The board of directors is supposed and assumed to hold power granted to it by the owner shareholders. It is in its fiduciary responsibility to the faceless public owners that a board is deemed to assure the "public responsibility" of corporations. That its power in fact derives not from thousands of shareholders but from the CEO tends to dilute its "legitimacy" generally, but most specifically in determining the pay of that CEO. The fact that the power is self-perpetuating and not derived in any meaningful way from the shareholders may explain why the cosmetic vocabulary of "election", "nomination", "independent" and "vote" is considered useful, even though it is misleading on its face.

Consider the exquisite lengths to which lawmakers have gone to style directors as being "independent". Virtually every regulatory and professional body along with many institutional shareholders have promulgated their own exquisite definitions of independence. All of this is in aid of creating an impression that simply is not true. Some individuals, I have even served with a few, are independent by nature and will act independently whether their brother or their appointer is the object of consideration. Most people, however, are reluctant to affront someone who has done them a favor. Directorships in major companies are coveted. It is very difficult for someone on whom membership in a prestigious group is conferred to act in a way that confronts that group's exercise of power.

This is not just a theoretical concern. A critical question of corporate legitimacy is whether CEOs set their own pay. "Best practice" has decreed an elaborate "ritual" through which the board of directors creates a Compensation Committee consisting entirely of "independent" directors. The independence of the directors on the Compensation Committee is adduced in explanation of the reasonability of executive pay. Likewise, when the independent members of the Compensation Committee appoint an independent executive compensation consultant to assist them, one need suspend disbelief as to the appetite of personal service organizations to bring unwelcome advice to their clients. The reality is that very intelligent people have deliberately misused language and structure in describing the process by which the pay for principal executives of American corporations is decided.

I don't pause here to characterize the appropriateness of current levels of pay. I certainly do not impugn the integrity of the individual participants in the process. I do believe it is important for those who believe in the law as a civilizing instrument to consider very seriously the inevitable tendency to erode its legitimacy when critical words are deliberately misused. American corporate lawyers have no need to adopt Orwellian practices.

Let me take you back to a meeting of the Compensation Committee of a ten billion dollar multi national conglomerate. Its stock is trading at \$50, down from a year earlier level of \$65 at which price options had been granted to the senior executives. The CEO, who is present by invitation, is heatedly confronting the Committee Chairman: "I know that we are all big boys, that we freely took the risks, that we are complete hypocrites in our professed belief in free competition, but I am just telling you the facts of life. My guys are depressed; they have no practical financial incentive as their options are so far under water for the foreseeable future; they are not moral philosophers - they are simply the best team in the industry and the competition is picking them off." "Does that mean," said the Chairman, "that you are recommending that we reprice their options." "Either that or find some other way of giving these guys incentive right now." I have participated in this conversation. Maybe in today's ever rising stock market, most people have not heard it. What we hear instead is that options are the best way of aligning managements' interests with those of the shareholders. Where is the simple truth? Options are a free ride for management - no cost, no risk on the down side, only wins - and in those cases where the market goes the wrong way, repricing and a new start. And yet, everybody assures everybody else that a world in which managements have awarded themselves over ten percent of the outstanding capital of America's publicly traded companies represents a desirable solution. Desirable for whom?

Orwellian language has been supplemented by the Kafkaesque co-optation by business groups of professionals and ultimately the government in setting the rules under which business operates. This was exemplified by the 88-9 vote of the United States Senate in 1994 expressing its “sense” [sic!] that the current cost of issuing options not be reflected on companies' income statements. The Business Roundtable successfully organized a lobbying effort to pressure the Financial Accounting Standards Board (“FASB”) to reverse its proposal that account be taken of the “value” of options at the time they were granted. Thanks to the Roundtable's lobbying skills and power – henceforth, options not only are a one way street, but they are “free” – they don't cost anything.

Joann S. Lublin, recently interviewed Dennis Kozlowski, CEO of Tyco International, in the Wall Street Journal (April 10, 1997):

**WSJ:** “...You haven't gotten a single stock option since you became chief executive – a rare event in corporate America. Why? Is your model [restricted shares] applicable elsewhere?”

**Kozlowski:** “...[I]t's a hard sell. Accounting and tax rules all work against it. Options are a free ride. They're P&L-friendly, they're tax friendly and it's a way to earn the megabucks in a bull market with a hot company.”

Warren Buffett, whose ability to make money deprived the country of a great literary talent, wrote to Senator Chris Dodd, then Chairman of the Securities Subcommittee of the Senate Committee on Banking:

The most egregious example of let's-not-face-up-to-reality behavior by executives and accountants has occurred in the world of stock options. The lack of logic is not accidental: For decades, much of the business world has waged war against accounting rulemakers, trying to keep the costs of stock options from being reflected in the profits of the corporations that issue them. Typically, executives have argued that options are hard to value and therefore their costs should be ignored. At other times managers have said that assigning a cost to options would injure small start up businesses. Some of them have even solemnly declared that “out of the money” options (those with an exercise price equal to or above the current market price) have no value when they are issued. It seems to me that the realities of stock options can be summarized quite simply: If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go.... Managers thinking about accounting issues should never forget one of Abraham Lincoln's favorite riddles, “How many legs does a dog have if you call his tail a leg?” The answer: “Four, because calling a tail a leg does not make it a leg.” It behooves managers to remember that Abe's right even if an auditor is willing to certify the tail is a leg.”

Because the CEO community was so successful in overpowering FASB, the supposedly independent accounting rule setting organization, the challenge of creating a CEO compensation system with real alignment to owners' interests has been exacerbated. Can it be resolved in the absence of new legislation?

In its September 1997 *Statement on Corporate Governance*, The Business Roundtable (at p. 5,6) stated: “Boards have a responsibility to ensure that compensation plans are appropriate and competitive and properly reflect the objectives and performance of management and the corporation. Incentive plans will vary from corporation to corporation and should be designed to provide the proper balance between long- and short-term performance incentives. Stock options and other equity oriented plans should be considered as a means for linking management's interests directly to those of stockholders.” We need to put the Roundtable's “mission statement” into the perspective of current realities. New tax data released by the IRS in early September pointed to a trend of executive pay increase, after adjusting for inflation, of 182% from 1980-1995, a growth fifty percent higher than either corporate revenues or net income. However, the best is

yet to come. According to Graef Crystal, who publishes a newsletter tracking executive pay, chief executives at the largest 1,000 American companies made \$1.2 billion last year from the exercise of options, but still hold options worth about \$9.9 billion. Today's option payouts don't yet register in the tax data. Besides, even gains from options that have been exercised may not be reported to the IRS for years to come. That's because many companies also establish plans that allow executives to defer their options profits, sometimes until retirement.

This brings us to the present place in time when there has been a massive transfer of ownership to CEOs – the exact size of which we cannot know for many years, largely because of the effectiveness of the CEO community in obstructing reporting and accounting responsibilities relative to pay. We continue to operate under the traditional governance rules but we have to recognize that this system has accommodated an utter reversal of the legal rights of property -

- Those who provide capital for the enterprise are susceptible to have their interests diluted by
- Boards and CEOs who have successfully maintained their right to self-perpetuation and to self compensation – with no apparent limits in sight.
- Fiduciaries - boards and the institutions that own up to 60% of the stock of the largest U.S. companies - have contented themselves that requirements are observed, notwithstanding their actual knowledge that the contrary is in fact occurring.

Only a few years after the fall of the Berlin Wall, it would be supreme irony if Karl Marx's ultimate prophecy comes true and capitalism fails because of its inner contradictions – the inability of flesh and blood human beings to threaten their own comfort by effective confrontation of a system of power. That ultimately will be unacceptable to a free society. "The large private corporation fits oddly in the democratic theory and vision, indeed it does not fit."<sup>[3]</sup>

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<sup>[1]</sup> Depending upon what statistics you use, that ratio amounts to an 8- to 10- fold expansion in executive pay relative to the rest of the workforce in just 25 years.

<sup>[2]</sup> Reference is made to the writings of the late James Willard Hurst for illumination of this concept.

<sup>[3]</sup> Charles E. Lindbloom, *Politics and Markets*, p. 356.