# CURRENT ISSUES IN EXECUTIVE COMPENSATION

## SYMPOSIUM

On March 23, 2007, esteemed academics and practitioners[1] presented a number of facts and views with respect to executive compensation in the context of a panel discussion at New York University School of Law. As a result of the symposium's great success, the editorial board of the *NYU Journal of Law & Business* has decided to publish this article summarizing some of the more provocative issues discussed at the symposium. The editorial board of the *Journal* would like to express its utmost gratitude to each of the panelists for participating.

## I. INTRODUCTION

Stories relating to executive compensation are in the newspapers daily. In these stories, the compensation systems in place at American corporations are often portrayed as broken, and high-paid executives are often accused of being motivated only by greed. We see stories of executives making several hundreds of millions of dollars. As Chancellor William Allen noted, however, what we rarely see in the press are systematic studies and data on executive compensation. Almost completely lacking in the media are thoughtful articles regarding what we want executive compensation to do or how effective it is in doing that which we would like it to do. As a result, these kinds of stories can create perceptions in the public grounded either in no reasoning at all or in reasoning almost completely unrelated to the underlying facts or social functioning of executive compensation. As Chancellor Allen stated at the outset of

1. The panelists were as follows: Panel 1 – Moderator: Chancellor William Allen, NYU School of Law; Stephen Lindo, Willkie Farr & Gallagher LLP; Michael Nissan, Weil, Gotshal & Manges LLP; Darius Palia, Rutgers Business School; A. Richard Susko, Cleary, Gottlieb, Steen & Hamilton LLP; Panel 2 – Moderator: Jeremy L. Goldstein, Wachtell, Lipton, Rosen & Katz; Justice Jack B. Jacobs, Supreme Court of Delaware; Martin Lipton, Wachtell, Lipton, Rosen & Katz; Melvyn I. Weiss, Milberg Weiss & Bershad LLP; Panel 3 – Moderator: Professor Helen Scott, NYU School of Law; G. Chris Andersen, G.C. Andersen Partners, LLC; Adam Chinn, Centerview Partners LLC; Frederic W. Cook, Frederic W. Cook & Co., Inc.



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the symposium, several questions need to be asked in order to make any meaningful assessment of executive compensation, including the following:

- Is there a problem with the function and level of executive pay in this country?
- What is the function that we want executive pay to serve?
- How do we decide whether or not there is a problem?
- To what extent can levels of pay create social or political problems?
- Even if there is a seemingly optimal level or structure of pay, could this nonetheless create resentment in the workforce such that significant economic consequences might result?
- How does the law interact with all of this?
- What tools does the law have to try and shape executive compensation?
- How effectively have they been deployed in the past?

As previously implied, it is essential that any conversation regarding executive compensation be undertaken with at least some general understanding of the empirical facts.

The symposium discussed, and therefore this article discusses, some of today's most challenging issues in executive compensation. Section II will discuss a relatively recent Working Paper by Carola Frydman and Raven E. Saks,[2] whose empirical research with respect to executive compensation will provide some context for our discussion. Section III will analyze the role of regulators in executive compensation, including recent changes in the disclosure of executive compensation promulgated by the Securities and Exchange Commission, the scope and significance of backdating, and issues with respect to measuring whether compensation is functioning effectively. Section IV addresses the role of courts in executive compensation, including a discussion of the legal duties of directors with respect to executive compensation decisions, circumstances under which the courts will not defer to the deci-

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2. Carola Frydman and Raven E. Saks, Working Paper, *Historical Trends In Executive Compensation*, 1936-2003 (November 15, 2005) (constructing the first comprehensive panel data set on executive compensation that spans most of the twentieth century and citing a number of past influential articles regarding executive compensation).

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sions of directors, and how the duties of directors with respect to executive compensation differ from those in other areas of the law. Finally, Section V will analyze the role of market participants with respect to executive compensation, including the market for executive talent, the role of compensation consultants, and recent shareholder initiatives regarding executive compensation.

## II.
## EMPIRICAL EVIDENCE

Chancellor Allen set the tone for the symposium by discussing some noteworthy research conducted by Carola Frydman and Raven E. Saks.[3] In their study, which tracked the compensation of the top three executives at a total of 102 large[4] U.S. firms from 1936 to 2003,[5] Frydman and Saks found that average real total compensation went through three distinct phases:

- a sharp decline during World War II;
- a modest and gradual increase from the mid-1940s to the 1970s; and
- a high and accelerating growth rate in the 1980s and 1990s.[6]

By examining compensation patterns over an extended period of time, the study provides a much richer understanding of the possible determinants of managerial pay. Frydman and Saks chose to focus on the effects of market performance and tax policy as possible determinants of executive pay. They

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3. *Id.*

4. The sample set was composed on individual officers in the 50 largest publicly traded corporations in the U.S., which were ranked according to the value of sales in 1940, 1960 and 1990. This amounted to a total of 102 firms. Because this sample focuses only on large public firms, the results may not be representative of executive compensation in the economy as a whole. Nevertheless, the sample does comprise about 38 percent of the market value of the S&P 500 during the relevant time period. *Id.* at 6.

5. The sample set focuses on executive compensation at publicly traded firms beginning in 1936, because before 1934—the year in which the Securities and Exchange Commission was established—such firms were not required to disclose the compensation of top officers. *Id.* at 2. The authors also note that, although corporations were required to disclose compensation of top officers in 10-K reports beginning in 1934, many firms were reluctant to do so. By 1936, however, most firms included such data. *Id.* at 5.

6. *Id.* at 2.

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found that compensation appears to be significantly correlated with firm size, whether measured by market value or by the total value of sales. However, the extent to which compensation is positively correlated with firm size appears to be significantly moderated during times in which the tax code is extremely progressive, as it was during the 1950s and 1960s. In fact, they attribute much of the stagnation in executive compensation from the mid-1940s to the 1970s to very high marginal tax rates. When marginal tax rates are in the vicinity of 90 percent, for instance, executives have less of an incentive to earn another dollar than when marginal tax rates are at, say, 50 percent. Thus, Frydman and Saks conclude that "high marginal income tax rates have limited the value of total compensation by altering the correlation between the market value of firms and executive compensation."[7]

Moreover, the authors found that stock options and other long-term incentive compensation have become a larger share of compensation over time. Stock options were virtually nonexistent prior to 1950.[8] This appears to have changed substantially after the enactment of the 1950 Revenue Act, which introduced "restricted" stock options, which later became known as "qualified" or "incentive" options.[9] In contrast to unrestricted options, to which a marginal tax rate of 80 to 90 percent would have applied, restricted options were to be taxed at the more favorable capital gains rate, which was at the time 25 percent.[10] As a result, the market took notice, resulting in 97 percent of the options granted throughout the 1950s and 1960s meeting the requirements of restricted stock.[11] Since then, the use of stock options has continued to skyrocket, accounting for roughly 50 percent of managerial pay by the year 2000.[12] Interestingly, however, stock option grants appear to have increased dramatically not only for CEOs but also for the other top officers of large firms.[13]

Two other points made by Frydman and Saks are worth mentioning. The first is that, while executive compensation of

7. *Id.* at 32.
8. *Id.* at 20-21.
9. *Id.* at 21.
10. *Id.*
11. *Id.* at 21.
12. *Id.* at 20.
13. *Id.* at 14.

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top officers may appear to be growing with great rapidity, their pay is still not as large relative to the size of firms as it was before World War II.[14] The second point is that the notion of executive pay, relative to the earnings of the average worker, being at a height never historically seen is simply incorrect. As the authors note, "the ratio of executive compensation to average income was substantial throughout."[15] Compared to the distribution of wages and salaries derived from income tax returns, over 95 percent of the executives in their sample fell above the 99.9 percentile of the economy every year.[16]

Broadly speaking, the Frydman and Saks study is relevant to our discussion in at least three ways. The first is that when we talk about compensation, it is important that we as lawyers bear in mind the empirical world. There is a tendency for lawyers to discuss the SEC disclosure rules and how the Delaware courts look at executive compensation. But if we are going to look at the subject as a matter of social policy, we need to step back from the legal aspects of executive compensation and take a look at the empirical facts. Second, it is important that we look at more than simply the *level* of pay received by top executives. The *structure* of pay may in fact be more important. And finally, we, as lawyers, need to be skeptical when confronted with stories of abuse and excessively lavish pay packages. While certain cases may in fact be unjustifiable, we need to ask whether these are typical cases. Moreover, we need to ask whether they are substantively important cases, or outliers.

## III. PANEL 1: THE ROLE OF REGULATORS IN EXECUTIVE COMPENSATION[17]

### A. *Objectives of Executive Compensation*

From an economic standpoint, as Professor Darius Palia of Rutgers Business School argued we can think of executive

14. *Id.* at 13.

15. *Id.* at 14.

16. *Id.* at 14 (citing Thomas Piketty and Emmanuel Saez, *Income Inequality in the United States: 1913-1998*, QUARTERLY J. ECON. 118: 1-39 (2003)).

17. Moderator: Chancellor, William Allen, NYU School of Law. Panelists: Stephen Lindo, Willkie Farr & Gallagher, LLP; Michael Nissan, Weil, Gotshal & Manges LLP; Darius Palia, Rutgers Business School; A. Richard Susko, Cleary, Gottlieb, Steen & Hamilton LLP.

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compensation as having three main objectives. The first is that shareholders need managers to run the firm. The interests of managers, however, will often diverge from those of shareholders to some extent. This is the classic agency cost problem. The question that needs to be asked is what is the right incentive structure? Second, we want top executive officers to disclose information to shareholders and the financial markets. According to Mr. Palia, "sunshine is the best disinfectant." The executive compensation structure should be revealing, but not to the extent that it hurts compensation. Nevertheless, it is important to consider factors such as retirement benefits, loans to related parties, etc. All of this can, and should, be valued and adequately disclosed. Third, the compensation structure adopted by any given company should be designed to attract the best talent. Over the years, different compensation structures have evolved to account for these three considerations.

### B. *Insights From Private Equity*

Chancellor William Allen and the other panel members discussed some of the lessons to be gleaned from private equity. According to the panel members, the private equity approach to executive compensation can, perhaps, enlighten our discussion of the way in which executive compensation ought to function at publicly traded companies. First, one notices that private equity firms have much greater sensitivity toward the pay that they award managers and the performance of their respective companies. Private equity firms take the view that it is acceptable to pay someone $50 million if shareholders make a billion dollars, for example. By tying significant parts of management equity awards and other pay to performance measures, private equity firms have been able to align the interests of management more closely with their own. This alignment is enhanced by the timing of managerial compensation. When the private equity firms cash out, so do the managers. Moreover, if an executive is not employed at the time that the private equity group cashes out, the executive will generally not be paid. There is an important lesson to be learned here: private equity firms generally do not reward nonperformance. This is not to say that the pay levels for managers that team up with private equity firms will necessarily be less

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than the compensation paid to top executives at public firms. If the private companies are successful, these executives stand to make substantial sums of money.

### C. *Sources of Negative Public Perception*

Stephen Lindo of Willkie Farr & Gallagher LLP, with whom the other panelists appeared to be in general agreement, identified at least five different causes of problems associated with executive compensation. First, the accounting rules for the expensing of stock options have had a profound impact on their proliferation. Before 1972, there was no charge whatsoever associated with the granting of stock options, whether or not the exercise price was equal to or less than fair market value. In 1972, however, *Accounting Principles Board Opinion 25* was issued. This approach required expensing options according to their "intrinsic value." That is, an expense would be recorded in the amount that the market price exceeded the exercise price on the grant date. Yet, even under this approach, if a company granted options with an exercise price equal to or above the fair market value on the date of the grant, there was no charge at grant and no compensation expense at exercise, regardless of how much net appreciation may have resulted from the option. This message was not lost on the designers of executive compensation. Cash compensation hit the bottom line, whereas equity compensation did not. Of course, the widespread use of options created the potential for a massive dilution problem. This problem was addressed, however, through the use of annual company buybacks, which also did not result in an expense. Not surprisingly, options became a favorite compensation tool.

The second cause is associated with the new approach to executive compensation disclosure rules adopted by the SEC in 1992, when Item 402 of Regulation S-K was codified. A panel member read aloud the following quote from the *Atlanta Constitution* on October 15, 1992:

> Uncle Sam is about to make it easier for shareholders to find out how much corporate executives are paid and put more pressure on companies to justify their compensation. Something is expected to happen today with the SEC vote requiring public corporations

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> to spell out clearly in a series of charts how much they pay executives in cash, stock, and other benefits.

This was the expectation of the changes made to the disclosure rules. Summary compensation tables, in tabular form, were to lay out in a clear and concise way the pay of the top five officers of public companies in the form of salaries, bonuses, long-term incentives, and annual stock grants. But by requiring this disclosure, companies not only were telling their stockholders but also their competitors what their officers were being paid at present as well as over the previous three years. This provides a significant insight into who are the rising and falling stars are in any given industry. Also required for the first time was a compensation committee report, in effect forcing compensation committees to explain, retrospectively, why they paid the amounts they did. The 1992 changes also gave birth to the now widespread dependence on executive compensation consultants who historically had played more of a niche role in designing packages.

Third, Congress enacted Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), in 1993. This provision generally eliminated deductions for compensation of a public company's Chief Executive Officer and the other four most highly compensated executive officers in excess of $1 million, except for performance-based compensation. To qualify for the exception for performance-based compensation, most compensation arrangements are subject to a variety of procedural requirements, including the establishment of objective performance goals, the elimination of any discretion on the part of the compensation committee in determining whether the goals were met and the certification of the achievement of the goals. Stock options, however, will fit into this exception, so long as (1) the plans under which the options were to be granted are approved by stockholders, (2) the plans include a maximum per share limit on the number of options that can be granted to any one executive, (3) the options are granted by an independent compensation committee and (4) the per share exercise price of the stock option is no less than the fair market value of a share of the company's common stock on the date of grant. Because stock options did not require the establishment and certification of performance goals to satisfy the performance-based compensation exception of Section 162(m), stock options were easier to admin-

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ister in a manner that complied with Section 162(m) and, consequently, were granted frequently and in large numbers. Thus, instead of constraining executive pay, as was generally expected, total executive compensation mushroomed after Section 162(m)'s enactment.

Fourth, we experienced a spectacular rise in the stock market from 1992-2000. The combined effect of the bull market and the high level of stock option grants created tremendous wealth for executives.

Finally, the practicalities of trying to hire talented managers should not be overlooked. Boards that try to hire a top-performing manager from another company will often have to pay top dollar. This high-performing manager has tremendous leverage. The availability of compensation numbers, discussed earlier, increase this leverage, which, in turn, leads directly to companies having to hire laterally in order to "make executives whole." Such was the case with Bob Nardelli, who received $227 million from Home Depot when he was hired away from General Electric; a substantial portion of this $227 million was intended to make Mr. Nardelli whole for lost compensation from General Electric.

The Nardelli example prompted an interesting question from Chancellor Allen: to what extent is the phenomenon of increasing executive pay a function of a failure to develop correct succession planning? This very difficult question requires a case-by-case approach. The panelists noted the dramatic effects that CEOs and other top executives can have on companies. Thus, the amount of compensation paid reflects that potential effect. Boards must identify the best person for the job, whether that person can be found within or outside the firm. If a board has carried out its duty correctly—identifying as many potentially qualified candidates, questioning each thoroughly, and negotiating with them in an arm's-length manner—it is more difficult to criticize the price that the market places on human capital.

### D. *Suggestions for Addressing Executive Compensation*

Mr. Lindo suggested several potential ways in which to address future executive compensation. First, there are no quick fixes to perceived compensation problems. The compensation elements discussed thus far are deeply embedded in long-term

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contracts and practices and will not change overnight. Still, one encouraging example of the regulatory process at work is the SEC executive compensation disclosure rules. The SEC received about 20 thousand comment letters, which it processed and turned around in less than a year. Contrast this with the 20 years it took the IRS to finalize the golden parachute regulations. Second, proven abuses must be punished; there has to be some accountability. Sarbanes-Oxley contains the tools to go after compensation in certain circumstances, and these should be used when necessary. Third, board committees should use independent advisors to help them develop compensation programs and negotiate executive pay contracts. The costs of ensuring real independence are a tiny fraction of the aggregate compensation being paid out. This seemingly obvious approach can help guard against situations in which too much money is paid for nonperformance. Finally, companies, regulators and shareholders should take a cue from private equity firms, which understand how to negotiate contracts and align incentives.

### E. *A More Detailed Glimpse Into the Role of Tax*

#### 1. *Tax Code in 1918*

Richard Susko of Cleary, Gottlieb, Steen & Hamilton LLP provided an overview of some of the more relevant tax issues. According to Mr. Susko, whether or not taxation is the optimal way in which to regulate executive compensation, Congress has long used it as a regulatory tool. The Code has played a role with respect to executive compensation since at least 1918. As of that year, a provision of the Code permitted deductions for reasonable compensation. It would appear, however, that the IRS agent is the last person who should be determining whether pay is reasonable in connection with evaluating the compensation of top executive officers. The shareholders of public companies are really the ones that are hurt by the disallowance of deductions. Yet, there are people out there calling for such a provision to be aggressively applied to public companies.

#### 2. *Golden Parachute Rules*

The Tax Reform Act of 1984, among other things, set out to limit the number of golden parachute payments being

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made to executives. Section 280G of the Code was enacted as part of the Tax Reform Act and imposes a dual penalty on parachute payments: (1) imposing a 20 percent excise tax under Section 4999 on the recipients of such payments and (2) limiting the deductibility of such payments to the paying company. Thus, if compensation to be received on a change in control exceeds three times the executive's five-year average annual taxable compensation, then all such compensation in excess of one times the executive's five-year average annual taxable compensation is subject to the penalties. What has been the effect of penalizing both shareholders and the executive because of this alleged abuse? CEOs generally get "grossed up" for the excise taxes. Thus, the tax on the executive, in reality, turns out rather to be a nondeductible cost to shareholders. Moreover, these tax reforms tended to legitimize the payment of golden parachutes of up to three times the executive's five-year average annual compensation. Although these tax gross-ups may seem somewhat benign, the numbers can be large when one factors in not only the rather large gross-ups and excise tax but also the fact of nondeductibility. Bud Crystal summed up the problem in a 1984 article in the *Wall Street Journal* in which he lamented, "[u]sing the tax code in this way is dangerous. Far from simplifying the tax code, it adds incredible complexity." This complexity, of course, continues to this day. Crystal further observed, "[W]hat next? Will some Senator take an instinctive dislike to annual salaries in excess of, say, $500,000?" His prescience, as that number turned out to be $1 million, with the passage of Section 162(m) of the Code.

3. *Section 162(m)*

When Congress enacted Section 162(m) of the Code, it stated that the new tax law would reduce executive compensation. In fact, Congress believed that it would give shareholders the ultimate power in deciding whether companies would be allowed tax deductions on executive compensation of more than $1 million. As noted earlier, Section 162(m) did not achieve these goals. Nevertheless, Section 162(m) is perhaps not as misguided as many claim: It can be viewed as a politically palatable response to executive compensation while still letting the free market work. Section 162(m) introduced the first corporate governance notion that the award had to be made by an independent committee and approved by share-

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holders—two themes echoed widely today. So the performance-based exception is not necessarily a huge loophole, but rather expresses shareholders' desire to approve the kind of performance pay that they want their executives to have. There is a bias toward voting in favor, since a negative vote may be costly to the corporation by reason of loss of a deduction. Moreover, what the shareholders actually approve can be a menu of performance objectives. The actual performance metrics used by the company (*e.g.*, earnings per share of $1.25) in any given case are not necessarily put before the shareholders. However, this can be understood as trust in the notion that the independent compensation committee is the group best suited to decide what an executive should be paid. After all, the last thing that many want is shareholders, who come in all stripes and with different motives, determining each and every individual element of executive pay.

4. *Section 409A*

Section 409A of the Code was enacted in the wake of Enron as a way of curbing perceived abuses with respect to deferred compensation. At Enron, nearly 100 senior executives withdrew $50 million from the deferred-compensation plan prior to the bankruptcy, while shareholders and rank-and-file employees lost their money in the company stock. In response to this, Congress rushed to develop new legislation regulating deferred compensation, but it failed to realize that $30 million or so of that $50 million was recaptured in the Enron bankruptcy pursuant to existing law. Despite this fact, Congress decided to subject anything deemed to be deferred compensation to extremely rigid rules regarding the timing of deferral and payment. If the rules are violated, the executive is subject to immediate taxation (or, if the amount is subject to a substantial risk of forfeiture, immediate taxation upon the lapse of such restrictions) on the compensation and an additional 20 percent tax. Bud Crystal put it well: once Congress decides that it does not like some form of compensation, it starts imposing additional taxes on it. Congress's targeted approach to this particular abuse is nothing more than a solution in search of a problem. The definition of deferred compensation takes on even greater significance when one considers that legislation is now pending that would impose a tax on *any* deferred compensation in excess of the lesser of $1 million per year or

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the executive's average annual taxable compensation during the prior five years.

### F. *New SEC Disclosure Rules*

The SEC has been in the forefront of regulating executive compensation with its recent overhaul of its executive compensation disclosure rules. Michael Nissan discussed exactly what these rules seek to address, as well as the manner in which they do so. Last year, Nissan said, the SEC finalized a comprehensive set of disclosure requirements to replace its existing rules—which were last overhauled in 1992. Even before the SEC proposed its new rules, however, it had made clear that *all* compensation had to be disclosed. The quote from the SEC staff that provided guidance as to how the old rules were to be interpreted was that "all means all." The new rules take a principles-based approach to disclosure. Principles-based disclosure requires that even if something that is compensatory is not required to be disclosed under the specific rules, i.e., even if it does not fit in one of the boxes, you have to look at the principles behind the specific rules to determine the disclosure to be made. All still means all. With that background in mind, some of the elements of the new form of disclosure are worth discussing.

The rules provide for extensive tabular disclosure as well as narrative disclosure. The rules require that a new report, the compensation discussion and analysis—often referred to as the CD&A—be included. This is supposed to be a principles-based overview that puts in one place the policies and decisions relating to the named executive officers' compensation. It is supposed to establish an overall context for the specific disclosures made in the tables and narrative disclosures that follow. Moreover, it is supposed to be a thoughtful, plain-English analysis of the company's compensation decisions. The questions that the SEC requires to be addressed in the CD&A are the objectives of the compensation program—that is, what it is designed to reward, what is each element of compensation and why the company chooses to pay it, how the company determines the amount and, importantly, how each element of compensation relates to the company's overall objectives as well as how each element and the company's decisions regarding each element fit into the overall program and

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affect decisions regarding the other elements. Examples of the discussion items that the SEC wants to see are the allocations between long-term and current compensation, cash and non-cash compensation, the basis for making such allocations, how specific forms of compensation are structured and implemented to reflect items of corporate performance, and the extent to which performance is taken into account in setting the company's policies. The focus in this report is on analysis, not description.

As noted, the new rules require extensive tabular disclosure. One new element of the Summary Compensation Table is a bottom-line number of total compensation. One interesting point is that the rules for this table were changed in December regarding option compensation to conform more closely to the current financial accounting rules, but the changes can have some strange results. For example, because of the way that forfeitures are treated it is sometimes possible to see negative numbers in the options award column. Other tables include Grants of Plan-Based Awards and Outstanding Equity Awards at Fiscal Year-End which includes extensive disclosure of vesting schedules and option prices of specific awards. There is a new Pension Benefits Table and a new Non-Qualified Deferred Compensation Table. One area of compensation that is required to be disclosed in narrative form that is likely to get substantial attention, in part because of the potential shock value of the amounts that companies may be disclosing, is potential payments upon termination or upon a change in control. In this section, companies will have to disclose potential payments, under the various scenarios of terminations of employment—i.e., fired without cause, death, disability. Potential payments in the event of a change in control based on certain assumptions, i.e., change in control at stock price at fiscal year-end, including tax gross-ups, also must be disclosed. A desired consequence of the new disclosure may be to satisfy what might be referred to as a new "no surprises in the Wall Street Journal" rule.

The SEC has articulated its role as simply one of making executive compensation as transparent as possible. The SEC's role is not to limit compensation, not to be a compensation review board, but merely to encourage full disclosures to shareholders. SEC Commissioner Campos recently made some particularly interesting remarks. In January 2007, he said:

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> "It seems that many boards truly do not understand the ramifications of their executive compensation decisions, particularly as they relate to severance pay, pensions, and golden parachutes upon termination without cause or a change in control. For example, there have been numerous public reports that the NYSE's compensation committee was unaware of significant aspects of Dick Grasso's pay. The Commission is trying to help in this regard. Generally speaking, I think the breath and specificity of our new compensation rules will have the effect of focusing compensation committees on the details of executive compensation packages."

In speaking of the required disclosure of potential payments that may be made on a change in control, the Commissioner said:

> "this is entirely new disclosure, and I'm hopeful that this will lead to compensation committees actually running the numbers—and understanding them—before agreeing to specific termination payments."

In Commissioner Campos' view, the SEC is trying not only to require disclosure to shareholders, but, by essentially requiring compensation committees to make those disclosures, force them to make informed decisions in actually awarding the compensation.

One lingering question, then, is: what will be the effect of the new disclosure rules? Mercer Human Resources Consulting, a compensation consulting firm, performed a survey in November 2006. The survey, which included 110 companies across a number of different industries, was designed to help provide an understanding of what companies expected the effect of the new disclosure rules would be on the design of their compensation arrangements. A majority of firms indicated minimal or minor expected changes to compensation programs as a result of the new disclosure rules. However, over 50% of the firms have made or are considering making changes to one or more compensation programs. The most frequently cited program changes, not surprisingly amid all of the attention being paid to option backdating, are to equity grant practices. The new disclosure rules require that, if the option exercise price is lower than the closing market price of

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the stock on the date of grant, a separate column be included disclosing the market price of the stock on the date of grant. A company is unlikely to want an additional column in its disclosure, so it is not surprising that the closing market price is being adopted as the option exercise price by many companies as a result of the new rules. The next most prevalent area was severance and change in control benefits—the area where you might see the most shock value—followed by perks. In addition, the new rules require disclosure in the CD&A of practices relating to timing of granting equity compensation awards. For example, a company must state if it uses the practice of granting options at a time when it has favorable information that has not yet been disclosed—so-called spring-loading of options. Similarly, companies must disclose if options are being granted after negative information has been disclosed—so-called bullet-dodging.

All things considered, it appears that although under the new rules companies are likely to change specific elements of their compensation packages and plans, *overall* compensation levels may not decline.

## IV.
## Panel 2: The Role of Courts in Executive Compensation[18]

### A. *How Courts Apply Fiduciary Principles to Directors*

As described by Justice Jacobs, there are two basic fiduciary principles: (1) the duty of loyalty and (2) the duty of care. A subset of the duty of loyalty is the duty to act in good faith. There are three broad scenarios in which the role of a court will vary in evaluating compensation decisions. The most typical garden-variety case is where there are independent directors, an independent compensation committee, and a decision being made without any self interest or improper influence by the top management. In such a situation, the business judgment rule or standard of review will apply. The directors will not be subject to fiduciary duty liability unless the compensa-

18. Moderator: Jeremy L. Goldstein, Wachtell, Lipton, Rosen & Katz; Panelists: Justice Jack B. Jacobs, Supreme Court of Delaware; Martin Lipton, Wachtell, Lipton, Rosen & Katz; Melvyn I. Weiss, Milberg Weiss & Bershad LLP.

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tion package was completely incomprehensible that it cannot be explained in any rational terms.

The second scenario is exemplified in the *Valeant Pharmaceuticals*[19] case, where the persons deciding or approving the compensation package have an interest in that package. In that case, the board of directors that approved the compensation arrangement for the executives of the company stood to receive significant compensation themselves in connection with an initial public offering of one of the company's businesses. The Court of Chancery ultimately held that the compensation arrangement should be reviewed under the entire fairness standard under which the burden is on the defendants in the lawsuit to prove to the court, under exacting scrutiny, that the compensation package that they approved was entirely fair, both as to process and price.

Finally, there is the intermediate set of cases where the compensation package is adopted as part of a change in control. In such cases, the Unocal reasonableness test applies, requiring that the board show that the compensation package was a reasonable response to a perceived threat.

### B. *The* Disney *Case*

Melvyn Weiss, whose firm, Milberg Weiss & Bershad LLP filed a derivative suit against Disney, and Martin Lipton, whose firm, Wachtell, Lipton, Rosen & Katz, represents Disney from time to time, had an exchange regarding that case.[20] Mr. Weiss questioned whether or not courts should become familiar with the types of issues and questions raised in Section III above. For example, Mr. Weiss pointed out, it is important that companies consider appropriate comparables when deciding upon a pay level and structure. Although courts should be well-versed in these types of substantive details, Mr. Weiss does not believe that they are. Instead, courts ignore these concerns and focus mainly on the process and whether the people who made the compensation decisions were independent. As evidence, Mr. Weiss pointed to the *Disney* case, in which the Delaware Chancery court held that none of the director defendants breached any of their fiduciary duties in connection with

19. Valeant Pharm. Int'l v. Jerney, No. Civ.A. 19947, 2007 WL 704935 (Del. Ch. March 1, 2007).

20. In re Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998).

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the approval of a $140 million severance package for Michael Ovitz.[21] In Mr. Weiss's opinion, "the process that was followed in the *Disney* case, in terms of the interaction with the board, was as bad as it gets. There were bad things that happened in the front end, the middle, and the end of the process." Although certain business managers of Disney could have challenged Mr. Ovitz's conduct as a matter to be fired for cause, Mr. Weiss propounded, no one chose to do that or even negotiate with him. Mr. Weiss continued that if, on the other hand, the business managers of Disney were sitting at the table with representatives of labor, negotiating regarding whether or not to give a pay package to the employees of the company, "they would have fought over every nickel and dime." From Mr. Weiss's perspective, it is discouraging that courts have not taken a more active role in issues of executive compensation to date when one considers the ways in which they could be used to rectify problems relating to executive compensation decisions.

Mr. Lipton challenged Mr. Weiss's understanding of the *Disney* facts. First of all, according to Mr. Lipton, Disney was a well-run company which lost its chief operating officer in a tragic helicopter crash. The company was in a serious management crisis in that the talent aspects of the business were well run but the operating aspects of the business needed additional support. Mr. Ovitz, though a close friend to Michael Eisner, the then-current Chief Executive Officer of Disney, was at that time considered the single-most successful person in the movie business. Mr. Ovitz had a very successful talent agency that made a great deal of money. He gave up his interest in the talent agency in order to accept the position of President at Disney. Given his position, he was able to negotiate a very rich salary and a very rich stock option position. Unfortunately, Mr. Ovitz was ill-suited to manage the very areas for which the company was hiring him. Mr. Ovitz had been used to running his own company as a talent agent and he was not trained as a corporate functionary. Because it was not working out the company made a decision, with the advice of counsel, to terminate his employment. This was not just an idle decision. The lawyer for the company advised that there was no basis to ter-

21. This decision was later upheld on appeal. Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

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minate him for cause. These were the facts that the board of directors had at the time it made the determination to fire him without cause. And it was on that basis that the court held that the board did not violate their fiduciary duties. They were not without good faith, they were not disloyal, and they acted in accordance with an appropriate business judgment under the circumstances. While the situation was not a very attractive one from the standpoint of a legal decision, it was clearly the correct decision, according to Mr. Lipton.

Mr. Lipton then argued that courts are ill-equipped to make policy judgments with respect to executive compensation. Courts are, according to Mr. Lipton, equipped to examine the process that was used in making executive compensation decisions. If the process was a rational process by decision-makers who did not have a significant self interest and who came to a decision that was not totally irrational, the courts will not interfere. Indeed, they should not interfere, Mr. Lipton said. If the courts were to interfere in business judgments, by independent boards that followed acceptable processes, boards of directors would not be willing to exercise their business judgment. Management teams of American corporations propose transactions, business strategies and operational activities, which are overseen by a board of directors. The board of directors is not a group of experts whose job it is to tear apart management's recommendations, policies, and strategies. The board's job is to monitor, and where appropriate, ratify those decisions. The law of Delaware is the most developed law with respect to this. The law generally defers to the business judgment of the board of directors, provided that there are no impediments to their exercising their business judgment. This enables corporations to take risks and be entrepreneurial. To the extent that courts interfere with the independent judgments of directors, , the natural reaction of directors will be to resist service on boards. According to Mr. Lipton, second guessing by courts will result in a reduction in entrepreneurship, and more aversion to risk, likely resulting in suboptimal business decisions.

Mr. Lipton pointed to the growth in private equity today, arguing that too many public company management teams and boards of directors have lost their entrepreneurial spirit and readily are prepared to do a private equity kind of transaction to free themselves from the worries of overstepping the ill-

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defined bounds of entrepreneurialism. Rather than worrying whether their indemnification rights are going to be enforced, or whether an insurance company is going to reject a claim under and D&O policy, for example, many would prefer to simply operate in the private realm. For reasons such as these, it is important for courts not to criticize the level of pay that certain executives might receive despite doing a relatively poor job if the decision to pay the executives was made pursuant to a proper process by independent directors. Sometimes things simply do not turn out the way that boards and shareholders expect. If boards are criticized for their decisions with respect to executive pay, the fundamental business judgment of a board of directors is removed and the basic theory of corporate law today is undermined.

Justice Jacobs, who wrote the *Disney* opinion on appeal, agreed with Mr. Lipton's position. Justice Jacobs did add, however, that even though the Disney directors were not found liable in that case, they were fully exposed to the risk of a large judgment and were subjected to several years of litigation, including a two and a half month trial. "People may differ with respect to whether they believe the directors should have been found liable based on the compensation process carried out at Disney. But there is a difference between a process that is so good that it avoids litigation altogether and one that falls into the netherworld of litigation but fortunately is above the line separating legal from illegal conduct."

Mr. Weiss's view that courts should be involved in more than just process review is reflective of the general dissatisfaction of some with both the process and result of executive compensation in today's public corporations. Congress and the IRS have tried to address these concerns, but as panel one described, they have largely failed. Thus, the pressure remains on the courts to go beyond the scrutiny of process in regulating executive compensation. Despite that pressure, Justice Jacobs agreed with Mr. Lipton that courts are ill-suited to examine more than the process of executive compensation. Judges are trained as lawyers, not compensation experts. Most have little if any experience in compensation matters, and Justice Jacobs added that policy matters involved in compensation decisions are "totally outside the expertise of the courts."

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### C. *Best Practices and Fiduciary Duties*

The panelists next turned their attention to the best practices and fiduciary duties under Delaware law. Moderator Jeremy L. Goldstein of Wachtell, Lipton, Rosen & Katz posed this question: "Something that was in the Chancery Court's decision in *Disney* was this notion that there was a difference between aspirational ideals of best practices and fiduciary duties under Delaware law. . .Is there a point at which governance ideals become so embedded in our culture of corporate governance that the standard of due care and these aspirational ideals begin to grow together so that the procedural requirements are actually embedded in these notions of due care?"

Mr. Weiss agreed that there are certain best practices that should be embedded in the business judgment rule. As an example, he cited cases in which the argument was made that one board member out of eight with a different view was sufficient to require a board dialogue. Mr. Weiss argued that if one person on a board can change the thinking of the others, that's part of the process embedded as to how boards of directors do business. If that interaction is avoided, there are problems that are foreseeable from the outset and directors should be held accountable. In *Disney*, senior members of management told Mr. Eisner that they would not report to Mr. Ovitz. Their views were never addressed at a board meeting, and therefore, Mr. Weiss argues the process was fatally flawed. That's the kind of process that is a best practice that is easily enforceable and should be built into the business judgment rule requirement.

Mr. Lipton added an anecdote to illustrate the importance of best practices. Vice Chancellor Leo Strine [of the Delaware Chancery Court] recently noted in a non-executive compensation case that the minutes of a board meeting that authorized a transaction were not produced and actually approved by the directors for several months after the board meeting in which the transaction was approved. Mr. Lipton wrote a memo noting the importance of having minutes carefully written up and approved in "real time" so that the court does not have the impression that the actual facts were re-written in order to deal with a litigation issue. Mr. Lipton also added that he thought it was very important—bearing in mind the *Disney* case—that the minutes not only reflect what hap-

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pened in the board meeting, but also the discussions the directors had prior to the board meeting. In the *Disney* case there had been fairly extensive discussions among some of the directors that took place outside of the board meeting and were not in fact reflected in the minutes, although they were testified to during the trial.

Mr. Lipton saw this as a very cogent reminder of the important role of lawyers with respect to these issues. In most of the cases that question the process of the board, the process that a board has followed, or the substantive decisions that the board has made, are the products of lawyer neglect. They occur because either general counsel of the company or outside counsel have not ensured that proper procedures were in fact followed and memorialized so that when the decisions must be defended, there is not a credible, written memorial of the process. When people testify one, two, three or four years after the event (or even three or four weeks after the event), the testimony does not reflect exactly what happened. But if the matter is properly handled by the lawyers, there should be a written record detailing what took place. This record can be readily accepted by the court as reflecting the facts and will enable the court to decide the case on real facts and not on allegations. Mr. Lipton believes that most of the compensation cases that have been factually argued in court are caused by the presence of a bad record. The board did not necessarily do something wrong, but they did not memorialize the facts that actually existed. As a result the decision often comes down to nothing more than who the judge ultimately believes.

Justice Jacobs agreed that these cases, and the *Disney* case in particular, are essentially about the failure of lawyers to put the process together so that it would be litigation "bulletproof." This failure is particularly egregious if one compares the costs of litigating the *Disney* case compared to what would be at most a few thousand dollars to hire an outside lawyer to manage the process from the outset. He also responded to Mr. Goldstein's question as to whether best practices could become so embedded that they become part of the standard of care, such that a violation could result in liability by stating that there are areas of law where custom becomes integrated into practice. He cited the common law area of contracts, where the contract concerns a subject where there is a custom in the trade and there's an ambiguity in the contract. The cus-

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tom can be used to construe what the parties meant. The common law torts and the standard of care used in a particular industry is similar. There have been situations where the duty of care for common law tort purposes has been redefined in light of what is common practice in that industry. Despite its presence in other parts of the law, Justice Jacobs has not seen this happen yet in the corporate governance area and it certainly was not something that occurred in the *Disney* case.

Although Justice Jacobs did not view the *Disney* case as defining proper compensation decision-making practices, Mr. Lipton then noted that there have been past decisions which have ingrained certain practices into the law. He used the *Van Gorkom*[22] case to illustrate his point. In 1985, the Delaware Supreme Court faulted the board of directors with respect to the process employed by the board of directors in connection with the approval of the sale of a business. After that decision every corporate law firm in the country wrote memos with respect to the number of steps that the board should take in connection with the approval of an agreement for the sale of a company. For example, it was suggested that the directors should have two meetings, not one, and the directors should have ample time to read the entire contract from beginning to end before the final meeting so that they could ask question with respect to a long agreement with multiple warranties and representations. To this day, lawyers continue to advise boards to abide by these practices. They still believe that it is necessary to have two meetings, that the directors ought to ask questions about each page of the agreement, and that it's a good idea for a lawyer to start and say, "This is page one of the agreement- Do you have any questions on page one, page two, etc." They feel that this is the process and that it should be memorialized.

Mr. Lipton also said that the exact same thing happened when the first Chancery opinion came out 20 years later. Everyone wrote memos saying that certain procedures should be followed and memorialized. But pretty soon they become a memorialization of proper practice, whether they are or not, since they have been around for a long time. The failure to follow them results in a determination that the proper procedure was not followed and the board did not fulfill its procedu-

22. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

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ral responsibilities despite the fact that these aspirational notions are not what the law is. It can be a good idea to follow them, but if all of them are not followed but there is a proper procedure directors should not be faulted for having not satisfied the duty of due care. This is the danger with ingraining these practices into legal duties.

On the other hand, Justice Jacobs observed that *Van Gorkom* might not be the best example because it cuts both ways. There was much criticism of that case because at the time there was no obvious "best practice" that the board should have adopted when it decided to sell the company. The criticism of the opinion is that the Supreme Court declared by fiat, and often a fact what the best practice should be and then proceeded to hold the board liable for not violating that best practice. But, by the time of *Disney*, hardly anyone would quarrel that it was certainly good practice to have all the directors in one room, to have full documentation of what the compensation package would be, and to cover in writing each scenario that could foreseeably arise so that the board would be knowledgeable of what they were actually approving and what the amounts involved might be depending on what scenario developed in the future.

D. *Independence*

The panelists then began a discussion of the notion of independence and whether or not the definition is changing. Mr. Lipton stated that the purpose of the inquiry is key to the analysis. Independence with respect to the normal, everyday business of the company is different from independence in conflict situations. A good example of this is a special litigation committee that is established to decide if shareholder litigation should be continued against the directors. There is a question of the relationship between the members of the special litigation committee and the other members of the board, and the highest degree of independence in such a situation is critical because from the standpoint of a judge, it would be a lot easier to accept the decision of a special litigation committee to drop the litigation if the members of the special litigation committee were totally independent, had no ties to the other directors, and had exercised their best judgment untainted by any relationship. The same is true in a situation

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where all of the directors are dividing up a pot among themselves and each is taking $330,000 for doing nothing.

However, collegiality is unrelated to independence. Collegiality is a board working together in the day-to-day business of the company and not spending all of their time as forensic accountants trying to uncover compliance violations or regulatory violations. Boards today are spending an inordinate amount of time focusing on these procedural niceties to establish that they have carefully investigated what the company is doing in compliance, and financial reporting, and so on, all of which is nonsense. There is no way that a board of directors can guarantee such compliance. The board is not equipped to review regulatory compliance and financial reporting compliance. The board *is* equipped to take action when they see a red flag and it is clear that something is wrong. In that situation, the board has the duty to examine the situation in more depth.

The idea that a board ought to devote inordinate amounts of time on compliance and investigating management's actions is dead wrong. A board should collegially work with management to talk about business strategy, to talk about management performance. The key role of the board is to review the performance of the corporation on a regular basis as against its competitors, as against budgets, and as against the performance of peer companies. If the performance is not acceptable, then the board should take action either to change strategy or change management to enhance the performance of the company, but boards should not be wasting their time on compliance and financial reporting issues. Also, boards must delegate those functions to experts, such as inside or outside counsel.

Mr. Lipton then discussed how much boards benefit from the provision of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") requiring certification of financial statements by the CEO and the CFO so that the statements reasonably present the results of operations and the financial position of the company. If a board has no reason to believe that the officers are engaged in wrong-doing, then CEO and CFO certifications required by Sarbanes-Oxley are great protection. Mr. Lipton cited the portion of the *Valeant Pharmaceuticals* case in which the actions of Towers Perrin, a compensation consulting firm were criticized. In that situation, the consulting firm was hired

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by management to give an opinion with respect to $330,000 bonuses that were being paid to the directors in connection with an initial public offering. The compensation consultants initially criticized the bonuses as being inconsistent with market practice, but after further meetings with management during which they were pressured to change their view, they developed a new opinion which found the payments to be acceptable.

Vice Chancellor Lamb said an argument was made that under Delaware law, section 141(e) of Delaware's General Corporation Law, directors are protected in relying on the report of an expert, such as an investment banker, an accountant, a lawyer, or a compensation consultant. If their expert opinion is that the transaction is reasonable, then the directors who follow that opinion are protected. However, the Vice Chancellor in this case denied protection under section 141(e), saying, "to hold otherwise would replace this court's role in determining entire fairness under section 144 with that of various experts hired to give advice." He then said that Towers Perrin's work did not meet the standard for section 141(e) reliance. Most of this case is relatively unimportant because of the facts, but it raises the issue as to whether the decisions of directors will be reexamined in an entire fairness case when they rely on the opinion of experts, or whether the courts will follow the principle that the views of outside experts can be substituted for the views of the directors in determining whether the entire fairness standard was met. There may also be a difference in a case involving duty of care versus a case where the issue is entire fairness.

### E. *Shareholder Activism*

The panel's final discussion centered on the rising tide of shareholder activism and the role of courts either in encouraging or stemming shareholder activism in these matters. Mr. Weiss did not see how the courts could become involved in this issue. Shareholders always have the right to speak out, and the courts are probably relieved that someone else is going to take over the function of oversight. This also makes sense because the people who have their money invested in the company should have the most to say about the way in which things are run. For example, hedge funds and the pri-

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vate investment community get involved in more than just oversight. They make sure that the people they are paying to run the business are doing a good job and they are not manipulating the company's financial reports in order to increase their own personal compensation.

Chancellor Allen asked the panelists if it is a good or bad idea, from a policy point of view, to allow shareholders to have advisory votes on executive compensation. Mr. Lipton averred that this is a horrible idea. In his view, it is part and parcel of this concept that we should change the structure of American corporate law so as to give shareholders a referendum with respect to all significant corporate decisions. Companies cannot effectively operate under those circumstances. He does not think that qualified people are going to want to sit on boards of directors if every decision that they make is going to be second-guessed by shareholder referenda. Mr. Lipton noted that there is substantial press regarding the success of the advisory vote on compensation in the United Kingdom, Australia, and Sweden. In the U.K., each year the remuneration committee meets and decides on what the compensation policy is going to be, and then the chair of the remuneration committee meets with the Association of Unit Trust Managers and the Association of Insurance Companies to present the company's compensation proposal. The Associations then submit the proposal to review under a computer model which tells the Associations whether or not the policy works. If the proposal does not work, changes are recommended and if they are not made then the shareholders vote against it. Because two associations account for 93% of a company's stock, there will then certainly be a negative vote.

Thus, for at least the 100 largest companies listed on the London Stock Exchange, compensation down to the last penny is set by these two associations of institutional investors. As a result, executive compensation in the U.K. is set not by the board of directors or the remuneration committee, but by this outside organization. Comparable in the United States is ISS. ISS will make recommendations with respect to the shareholder vote that is required by the stock exchanges with respect to equity compensation plans. They have five different models which they run through their computers, and if the model does not work, they will recommend a vote against it unless it is changed. Everybody changes it to meet their model.

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For the most part, Mr. Weiss agreed with Mr. Lipton on this issue. He has to submit certain fees to judges in class action law suits, and he gets a very uneven reception depending on which judge has the matter. As a result, there are often mixed results, largely because people generally resent other people making a lot of money. While Mr. Weiss believes in the business judgment rule, there has to be a system of checks and balances. What Mr. Weiss resents about the tort reform movement is that it wants to take away litigation, it wants to take away regulation, and Mr. Lipton wants to take away the right of the shareholders to speak out against this. Mr. Weiss believes that there must be room for a free market and on the other hand there has to be some way to reign in abuses. He does not want to leave it to the government or criminal authorities. He thinks civil litigation is the right place to find that balance, but he recognizes that when it comes to executive compensation it is a very tough area for the courts to supervise.

## V. PANEL 3: THE ROLE OF MARKET PARTICIPANTS IN EXECUTIVE COMPENSATION[23]

### A. *Introduction*

The real place where executive compensation decisions get made, and the mechanism we most often resort to when we have a problem in our business systems or our capital markets, is what we call the market. We look for market solutions, particularly in areas which are fast paced and dynamic. These market solutions are speedy and forward-looking. In contrast, regulatory responses and judicial decisions take a lot of time. And, they're always retrospective. However, there is a certain perception that the market is not the best determinant of executive compensation. This section will examine executive compensation issues and question whether there really is a problem in market determination of executive pay. Is executive compensation not being constrained in any real way by forces we might consider market forces? Or is the problem, as

23. Moderator: Professor Helen Scott, NYU School of Law. Panelists: G. Chris Andersen, G.C. Andersen Partners, LLC; Adam Chinn, Centerview Partners LLC; Fredric W. Cook, Frederic W. Cook & Co., Inc.

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Chancellor Allen said earlier, really more one of perception than one of fact?

### B. *The Current Market for Executive Talent*

The panelists exuded confidence in the strength of both the American capitalist enterprise and the market's role in determining executive compensation. While there has been a complete overhaul of the disclosure obligations of corporations and a number of CEOs who have been shown the door, the strength of market forces has proved resilient. Fundamentally, executives are not paid any differently than they were paid last year, five years ago, or ten years ago. The amounts may have changed to some degree, but the process is still the same. The result? There is an active and vibrant market for human capital in the United States. In the opinion of the panelists, this is one of the reasons that the United States continues to have the most powerful economy on the face of the earth. Notwithstanding the efforts of Congress and other regulators to impede it, we are still the freest market for human capital in the world. This is a tremendous competitive advantage.

### C. *Dynamics Operating on the Market*

There is a sense in the general public that the market for executive talent is not an extremely competitive one – that most CEOs are not likely to leave their companies and therefore do not have to be dramatically incentivized to say. During the course of the panelist's discussion, a number of dynamic forces were identified. Some of these forces illuminate the basis for the public's concern – valuable executive compensation packages – and others identify how the public perception does not always mirror reality.

### D. *Superstar Phenomenon*

The people at the top of any industry – whether it is baseball or business, really make a difference. They create value, and there is an intense market for that human capital. And the superstars are going to be paid a huge premium because they are in huge demand and history indicates based on past performance that these executives make a huge difference. The newspapers today show that there are certain industries – such

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as retail or banking – where there just are not enough people to fill the positions. When boards identify those few people who can fill the positions, they fight for the superstars. That is how they can demand these amounts.

The value of these superstars should not be underestimated. Chris Andersen, of G.C. Anderson Partners, LLC, shared the following insight. When someone asked Bob Linton at Drexel Burnham Lambert why he paid Michael Milken $650 million in a single year, Mr. Linton responded with a question. He said, "do you think that when the powers that be at Bear Stearns tried to change the compensation arrangement with three fellows by the name of Kohlberg, Kravis, and Roberts that that was a good decision for that firm?" And then he asked, "do you believe that when IBM decided they were going to cut the sales territory in half and thereby half the compensation for a fellow named H. Ross Perot that was their finest hour?"

### E. *Private Equity*

The private equity phenomenon is a major driver of executive compensation today. Mr. Andersen entertained the audience with the following example. While he was serving on the board of a company, a large private equity group had recently purchased a company in the same industry. Mr. Andersen's company was performing very well – the darlings of the industry – when he received a sudden call from the CEO. The CEO had just received a call from a private equity group offering to match his current cash compensation and give him 10% equity in the private equity's portfolio company – in stark contrast to the 1% of equity the CEO currently owns in his company. After discussion and consideration, Mr. Andersen called him back and offered a new five-year plan. The plan – which had goals so demanding some did not think he had a snowball's chance in a stove of fulfilling the plan – offered a hundred million dollars. After receiving the offer, the CEO said, well now I know what to tell that private equity group. As it turns out, the private equity firms made similar bids for the company's two other top officers. At the end of the day, this CEO and his management ended up with potential equity plays that were vastly in excess of what they would have had if the private equity firm did not come in to challenge Mr. Andersen or his

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management. Again, Mr. Andersen did not think that there was any way that they would complete that plan. At the time this took place, the total equity value of this company was about $600 million. Five years was up last year. The equity value of this company today is $8 billion. The CEO has over $100 million of equity; he thinks he's underpaid; Mr. Anderson think he's underpaid; and he do not regret a minute of it.

Adam Chinn, of Centerview Partners, LLC, had a similar experience. While representing a CEO about to negotiate an employment agreement calling for $15 million of compensation per year, the CEO received a phone call from a private equity firm offering $350 million of equity to run the private equity firm's newly acquired enterprise. It so happened that this particular person loved the company that he was working for, and decided to stay. The pressure from private equity is intense.

### F. *Executive Compensation Surveys*

Years ago there was push for data surveying the compensation of corporate executives in America. Everyone wanted the data. It is helpful and pertinent information. However, the panelists agreed that they have come to be over-relied upon. Frederic Cook of Frederic W. Cook & Co., Inc. demonstrates how they have spurred an escalation of executive pay: "There are three types of executives in the world: value creators, value maintainers, and value destroyers." The creators build business. They are entrepreneurial types, and they are worth almost anything that a company is willing to pay them. The maintainers just sort of maintain an enterprise. Then, there are the value destroyers. The surveys, however, do not differentiate between who is who. The surveys provide one number—CEO, CFO, etc. They lump them all – the creators, the maintainers, and the destroyers - together. And who uses the surveys? The people who use the surveys tend to be the people who are paid below the survey average and they use the survey to justify paying somebody more than that individual might get on their own. In the absence of these surveys, where boards just set compensation based on their own good judgment, there would probably be lower average pay and a much wider dispersion of pay – a natural dispersion of value builders at the top and value maintainers in the middle and value destroyers

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at the bottom. But surveys tend to focus everyone's attention on the average. And since most people like to think they are above-average – and should be paid accordingly – the average executive compensation rises.

Mr. Chinn joined in strongly denouncing over-reliance on survey data. First, there is competition for the "right" statistics. Everyone has to have their own survey data with their own survey data provider. The compensation committees have their own compensation consultant, and management has its compensation consultant. They end up wasting huge amounts of time and energy throwing statistics at each other and somewhat ignoring the fundamentals of the business. Second, he believes that executive compensation is an art, not a science. He is a strong supporter of the American system of corporate governance, which is if a group of intelligent and financially sophisticated people is assembled in a room and provided with pertinent information, both internal and external; they will make a business judgment which is going to be reasonable. It may not necessarily be "right." But it will be a lot better and better informed than trying to put oneself on a point in the graph.

Yet Moderator Professor Helen Scott of New York University School of Law believes that there is good news. The 75th percentile effect is pretty well known, and it's more likely to have an effect on boards as the public pressures surrounding this increase. Everybody can not be in the top quarter. It actually permeates into the ways that compensation committees do their work. Mr. Cook shares this view. He does not know of any compensation committees that now espouses a 75th percentile pay objective.

In this discussion, Mr. Cook notes it is important to differentiate between the starting point in pay and the ending point in pay. The ending point in pay measures what people actually get out of stock options and bonuses at the end of the day. Those figures are diverse. It is desirable to have the people in the top quartile to be the highest performing. Mr. Cook's theory is that if everybody starts at the median target awards for stock options and grants, then the natural forces of performance will array people in relation to their performance in the company: above average executives will have above average ending points and below average executives will have below-average ending points.

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Mr. Andersen is on the board of a company which has creatively responded to the detrimental effects of over-reliance on survey data. The company has forbidden itself to pay base salaries at the 50 percentile level. They are insisting that their management should be paid less than average. To win approval for this, the board set higher targets for compensation which can be tied to performance. Thus, if management performs according to the long-term plan (an aggressive plan) they will be paid through the 75 percentile level on the incentive compensation. And this incentive compensation is designed to be significantly more than the base levels of pay. This design stands for the proposition that just showing up for work everyday is not enough to command strong compensation. Many people can be hired to show up every day, and the company does not want to pay them through the 50th percentile. But, if someone actually performs and there is value added by the team overall, the company would love to see management in the 90 or 110 percentile. But management must work for it. The compensation must have a correlation with management.

### G. *Consultants*

There are two types of compensation consultants: survey consultants, who provide data that help companies to make decisions on how to pay their people; and design consultants, who design compensation plans. These two types of consultants mirror the two sorts of issues that arise in the compensation context: how much do you pay people, and how do you pay people.

Mr. Cook joined Mr. Chinn in agreeing that – in the context of plan design – not much has changed in the last 30 or 40 years. There is a base salary and an annual bonus, typically tied to financial metrics, not stock price—such as the operating plan, operating income, ROE, EPS, essentially some kind of financial metric for the company as a whole or a business unit of the company if the manager is running a business unit. In addition, there is long-term compensation, which started off years ago with stock options and has migrated towards a portfolio of plans now: Stock options, SARs, restricted stock, performance stock, etc. It can be fun and creative to design equity arrangements that align the interest of what essentially

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is a highly educated, highly motivated, professional with no money with the people that have the money but do not have the wherewithal or the skill to manage the business. Thus, there is a passive pool of capital marrying up with an active pool of ambitious, aggressive well-educated individuals who become executives, and consultants operate at that interface to design an exchange system. As such, these equity plans relate to long term performance measured by equity.

Design consultants have a powerful influence on the compensation committee; when they take strong positions on certain issues, the committees are apt to listen to the expert. For this reason, Mr. Cook believes consultants working with the committee must take on the role of a forensic investigator: management and its own consultants present a lot of data, and the job is to look at it with suspicious eyes, question whether it makes sense, and then inform the committee. The importance of this scrutiny cannot be understated. Often, management presents bad or mistaken data about performance goals. Without assigning blame or pointing fingers, errors of these sorts invariably have been in favor of management. Thus, committees and their consultants must have a healthy skepticism of the staff officer who walks in with a big analysis and presents it to him and says it is time to decide. So there should be a little bit of tension in the room. Executive pay is about much more than just the numbers. It is the whole public face of the corporation to the investing public, to the employees, and to the communities at large. To a degree, Mr. Chinn laments this influence of compensation consultants on compensation committees. Often, the compensation committees feel pressured – often, in part because of their cautious lawyers – to heed the advice of the compensation expert, and set aside their own ideas, an abdication of sorts.

As a result of new forms and regulations, there are more complex reporting procedures. Mr. Andersen believes his work as a board member of a compensation committee was better 5-10 years ago and required about one-third as much time – simply because of the complicated procedures. The compensation committee cannot begin to do all of this on its own; a compensation consultant becomes a de facto requirement. And the compensation committee has a certain vulnerability to the consultant.

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With this in mind, it is extremely important to ensure that the compensation consultant acts only as a compensation consultant. Management must not be able to contract the board's compensation consultant for other assignments. In this regard, there is much to be learned from the experience of the accounting profession. Further, echoing the concerns of Mr. Cook, there must be some tension in the room. There is undoubtedly gamesmanship in the process, and the compensation committee itself must figure out what some of these games are. They must determine who is leading them, and on occasion determine who in the group they must change in order to move the benchmark. Otherwise, the committee is being manipulated.

### H. *Public Criticism*

One of the downsides, Mr. Chinn said, of what has been happening in the executive compensation debate is that corporations are actually getting less competent compensation committees rather than more competent compensation committees. Because of the huge criticism and spotlight, people who have very busy jobs and deal with complex issues and actually understand what is going on in the real world today are less and less interested in serving on compensation committees. This is detrimental to the corporate governance system here in the U.S.

If the panelists feel confident about the strengths of a market-determined compensation system, what is responsible for the public's criticism? There are several reasons. First, the outlier is defining the mean. Mr. Cook believes that the press has convinced the citizens at large that all CEOs are overpaid. But the press takes examples from extreme abuse in some cases or high levels of pay in others, and extrapolates to have everyone convinced that everybody is overpaid. There are 14,000 public company CEOs in the United States and there are roughly a million private company CEOs. Thus, when one says that the average CEO is overpaid or the average CEO earns 531 times the average worker, that is not the average CEO. Instead, that refers to approximately the top 100. The average public company CEO makes 43 times more than the average worker. There is the occasional problem of extreme abuse in large companies. However, as a now deceased former

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head of Pfizer once said, "Inherent in the concept of a free enterprise system is the potential for abuse. If there were no potential for abuse, then there would be no free enterprise system." It is unfortunate that the business community keeps feeding the press occasionally with abusive situations, but these exceptions are a poor basis on which to form an opinion of the overall system. Unfortunately, the public attaches to CEO pay because it is easy to see, it is emotional, it is easy to engage and understand.

Second, "performance" is difficult to define. Most companies have pay-for-performance systems, but there are differing views on what constitutes "performance." As Mr. Chinn concludes, until there is a consensus on what performance is, there will be a great obfuscation in the debate. For instance, Mr. Cook submitted the following example: compensation is often reported as a single figure (without distinguishing salary from deferred compensation or stock options). And if the stock price has gone down in a particular year, media headlines will report "Mr. X makes tens of millions of dollars while the shareholders suffer." Of course, the logical error here is two-fold: (i) first, the amount of that compensation figure which is based on the current period's performance is unknown; and (ii) the performance metric is unknown (and likely not to be based on stock price).

On the issue of performance, spotlight in the press has an inordinate sway on public opinion of that performance. Mr. Chinn illustrated the point with the following anecdote: if you have a piece of paper and were instructed to write down which of two companies has been better performing company on fundamentals, - not necessarily stock price, but on variables such as growth, growth in earnings per share, operating margins, etc. - and if the choices given were Home Depot and GE, his guess is most people would say GE. However, if one actually looks at the two, Home Depot under Bob Nardelli had much better operating results than GE on a comparable basis. Jeff Immelt is simply undoubtedly a much better public relations guy than Bob Nardelli. Mr. Chinn questions whether we ought to be looking at company-performance based on public relations. Similarly, Citigroup or Bank of America. Chuck Prince is excoriated in the press every day. But once again, if one considers their multiple of earnings, yield, and underlying operating performance, it is superior to Bank of America.

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There is also the time issue of performance, as Mr. Andersen notes. It is only over a sweep of time that you get performance. The problem is that the proxy season occurs once every 365 days after the earth has completed its circumnavigation of the sun, and that is not necessarily the way that performance goes in any given company or in any given industry. For instance, what is performance in a company that is highly cyclical. How do you dial out the cycle? How do you convince that management that is working much harder and worrying about more things, and delivering more products at the top of a cycle when they got there only because the tide came in and all the boats were lifted and you say that's not performance, that's just being here and having tenure. In sum, trying to define pay-for-performance is difficult. It is not a one-line, one-number item, and it varies from company to company, according to Mr. Andersen.

Third, the public, Mr. Chinn submits, harbors views of the compensation committees of public companies as people would turn up straight off the golf course, and this was sort of the 19th hole, and everyone was slapping each other on the back saying what can we do for our good friend/CEO. And, of course, this group of friends was an enclave sort of middle age, older, upper class white males. However, in Mr. Chinn's career, this has never been the case. In fact, he has seen a noticeable increase in diversity of opinion on compensation committees. The idea that this was some sort of closed club with a cartel deciding on executive compensation has never been the case. If one looks at the boards of most major public companies and who has participated in them, they are composed of highly responsible individuals who themselves have huge responsibilities at their own companies and understand the issues.

## I. *Say-on-Pay Proposals*

The panel generally saw little role for shareholders in matters of executive compensation. Mr. Chinn notes, that while they do own the company, that does not necessarily mean involvement in important operating decisions is appropriate. He analogized to the political structure of the United States: as citizens of the United States, we own the "company". Every so often we get to elect our representatives. Mr. Chinn

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notes that this logic is even more appropriate in the corporate context: if between annual meetings a shareholder does not like what is happening, he can simply sell his shares. This country has a representative system of corporate governance which, in Mr. Chinn's opinion, works very well. And while the system is not perfect, Churchill's words on democracy are particularly relevant: democracy is the worst system of government except for all the others. Likewise, Mr. Chinn believes that is pretty much the case of the American system of corporate governance.

There was a sentiment expressed, however, that despite their shortfalls, say-on-pay proposals are a likely reality in the future. But, Mr. Cook shrugged it off as having benign effect: "the American free enterprise system and executive compensation and the forces of compensation at the top of public and private companies are so powerful that it has and will continue to roll over obstacles. . .it will accommodate change, it will accommodate regulation. It has done it time and time again. All sorts of regulation on this, or that, it rolls over. It continues on and it will continue on."

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