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EXECUTIVE COMPENSATION

Executive Accountability and Excessive Compensation: A New Test for Director Liability

by Mark Van Clieaf

Last year's *Disney* decision significantly changed the standard for determining director liability for determining excessive executive compensation.[1] Although many directors are aware of the decision, what has not fully sunk in is that a finding of lack of good faith results in the duties of directors falling outside the protection of the business judgment rule. Directors loose their indemnification and D&O insurance and are personally at risk for millions of dollars if challenged by shareholders.

While much attention has been focused on excessive executive compensation, most boards, compensation consultants, and institutional investors are still asking the wrong question. They are asking: "How much?" rather than the more appropriate "For what?" Thus, we continue to live in a world where there is a major disconnect between executive accountability and measures of longer-term performance, such as intrinsic enterprise value and shareholder value. In other words, a large disparity between equitable versus excessive compensation continues unabated. (See Figure 2 for a comparison of high pay/low performance.)

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Mark Van Clieaf is Managing Director of MVC Associates International. A Tampa & Toronto based consultancy integrating accountability design, succession planning / recruitment and shareholder value.

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Figure 1
Level of Work
Equitable CEO Pay Multiplier

Leadership Domain	Level of Work & Innovation	CEO to CEO comparison	Example Pay Bands $USD
Global Industry • Current/Future Societies • 10-20 yr + Balance Sheet Strategy, optimizing TSR and Cash-Value Added for Societies • Transform Industry Structure/Cultures • Create change globally • Leadership of Business Leaders • Identity & Policy Control	**Level 5 Global Business/Societal Innovator** Creates enterprise sustainability, new industries (R&D), and wealth creation for global society by managing the inter-dependencies between economic, environmental, social, and political factors worldwide *(Stratum 7)*	32X	$3.18m 2.88m
		16X	1.92m
	Level 4 Industry Innovator Model corporate citizenship/stewardship, policy, and investment strategies leveraging *business models* across multiple geopolitical, socioeconomic,& technological boundaries *(Stratum 6)*		1.44m
		8X	$960,000
Business Development • Current/Future Stakeholders • 2 to 10 yr Investment Plans • New Products, New Businesses & Return on Invested Capital • Anticipate change nationally and globally • Indirect Leadership • Strategy & Management Control	**Level 3 New Business Model Innovator** Transform the business model leveraging customer, competitor, regulatory, capital market, NGOs, and other socio-economic factors *(Stratum 5)*		720,000
		4X	480,000
	Level 2 New Product/Service Innovator Integrate and synthesize stakeholder needs resulting in development of new products, services, markets, & channels *(Stratum 4)*		360,000
		2X	240,000
Operational • Current Customers • 1 to 2 year profit plan / EPS • Operational & executional efficiency • Respond to change locally and nationally • Direct Leadership • Operational Control	**Level 1 Process Innovator** Optimize process, technology, and people to deliver a suite of products & services to meet the needs of current customers *(Stratum 3)*		180,625
		X	$120,000

One of the fundamental problems in companies today is that too many CEOs and senior executives are being held accountable solely for short-term (i.e., one- to two-year) operational work; yet they are paid as if they are accountable for longer-term (two- to 10-year) strategic work and value creation. In fact, nearly 60 percent of the top US companies have failed to provide a profit greater than their cost of capital over a period of five years. In Canada, it is closer to 65 percent.

Despite these shortcomings, many boards fail to even try to establish appropriate goals and metrics for the appropriate longer time spans necessary to measure CEO and senior executive work to ensure that they are held accountable so that they strive to create longer term enterprise and shareholder value, the very goals of all shareholders.

Equitable executive compensation, which should include pay-for-performance, forms the real acid test to gauge the effectiveness of a board of directors. Yet, over the past five years of the economic cycle (which included a boom, bust, and rebound), at least 40 percent of boards have failed this critical test, as executive compensation continues to be ratcheted up to higher and higher levels with no apparent link to sustained business performance and wealth creation for shareholders. While earnings dropped and shareholders lost significant equity value, executive compensation has continued to climb, partly due to previous compensation commitments.

The following statistics illustrate how too many executives are held accountable at too low a level of accountability and are being overpaid for the work they are doing:

- Our recently completed financial analysis of the top 700 publicly traded corporations, representing more than 80 percent of US market capitalization, has identified that, over five years ending in 2002, 464 companies, or 59 percent, failed to provide a Net Operating Profit After Tax (NOPAT) greater than their cost of capital. The resulting poor return on invested capital over this period raises the question of how viable are the business strategies/models of many of these companies as well as what are the respective boards holding their CEO's accountable for. It also it raises the question of what shareholders are holding Boards accountable for.

- A review of compensation policies disclosed in proxy statements indicates that 89 percent of the S&P 500 CEOs and their executive teams are *not* held accountable, or paid, for business (as opposed to stock market) performance beyond three years. Yet, many shareholders, including State Treasurers and pension trustees, are accountable for long-term pension liabilities. This is a serious mismatch in time scales for accountability among large stakeholders. Unless this mismatch is fixed, companies will not be run in the long-term interests of shareholders and stakeholders.

- Ninety-five percent of the S&P 500 companies have failed to disclose any criteria that would allow for measurement of the triple bottom line (financial/shareholder, environmental, societal/community). Thus, some companies may be creating environmental, product, and societal liabilities, while overstating earnings and overpaying the executive team given that long-term costs will have a negative impact on enterprise value.

- CEO compensation in the United States has skyrocketed from 42 times that of the average front line worker

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in 1982 to 531 times in 2000, a five times multiple. From 1990 to 2003, the aggregate market capitalization of the S&P 500 rose by a multiple of 2.4 and corporate profits rose by a multiple of 1.3.

- Through the exercise of stock options, the CEO of Walt Disney earned more in 1997 than the combined compensation of the top 500 British CEOs in that year; but Walt Disney has not returned a profit greater than its cost of capital since 1997.

Why the Lack of Accountability?

In addition to benchmarking bias discussed below, much of the excessive executive compensation can be blamed on two factors: the exploding use of stock options and the focus of management to increase stock price and manipulate short-term earnings per share.[2] Compensation for many executives became a windfall as the whole stock market moved, regardless of business performance. During the past decade, pumping up short-term stock price and exercising options as soon as possible became the primary focus of too many executives.

Pay-for-performance was, and continues to be, confused with pay delivery.

Pay-for-performance was, and continues to be, confused with pay delivery. Stock options created wealth for management, but most options were granted without setting any type of multiyear performance target. As a result, they were akin to a gift. A majority of boards and compensation consultants failed to understand the unintended consequences of the unbalanced incentives that they had designed and failed to link compensation to the performance of the underlying longer-term economic fundamentals of the enterprise.

In setting accountabilities, including specific goals and metrics, many boards have failed to look at the top three levels of the organization (known as the triad of management) to calibrate CEO goals and objectives relative to the rest of the company. Thus, goals and objectives across these top three levels in far too many companies are set at the same short-term (*i.e.*, one- to two-year) measure. If the goals, targets, and time span for measurement, as well as decision authority, are the same across multiple layers of management, then the company is over-layered with too many managers in the vertical organization structure doing the same work and wasting compensation dollars. Moreover, the board has potential liability if it is found to have wasted corporate assets, although courts historically have used a high standard in applying this test.

Flawed Accountability and Compensation Practices and Resulting Potential Liability

Another key factor that has perpetuated the marching rise of executive compensation is the widespread use of flawed benchmarking to set pay scales. Much of the current practice for benchmarking executive compensation is biased and flawed and perhaps not legally defensible. While there are a number of biases that contribute to the ratcheting effect of executive compensation, we will focus on two specific problems of peer group selection. One is selecting companies and CEO roles for benchmarking that are exponentially more complex than the role to be matched. The other bias arises when poor performing companies select high pay/high performance companies to benchmark against, without any type of calibration of pay for performance, or they fail to use a relevant measurement period.

Through a number of recent court decisions, the most well known of which is the ongoing *Disney* case, judges appear to be refining the well-established duties for directors that relate to executive compensation decision-making. In addition, the regulatory onslaught in the wake of Enron and other corporate scandals has added an additional layer of considerations that directors must take into account when setting pay.

In particular, the following are current hot buttons:

1. Establishing and documenting the process. There are now minimal procedural standards for compensation committees, and courts will ask whether a genuine process was used not a check-the-box exercise.

2. Ability to show that decisions were made in good faith as amplified by the *Disney* decision, directors must be able to show that they exercised good faith in order to rely on the business judgment rule for their decisions, which includes showing they made an effort to be informed.

In an environment in which the judiciary is scrutinizing boardroom activities more then ever, there might be an argument that a board has breached its fiduciary duties if the board cannot show that is has a process to:

- Set accountabilities and metrics that differentiate operational work from strategic work;

- Differentiate accountabilities and metrics across the top three levels of management; and

- Conduct an executive job analysis to define key executive roles and their accountabilities and use this analysis to job match CEO and other roles, beyond just using titles when benchmarking roles and executive compensation.

In other words, a board might have difficulty establishing that it was informed when it made executive compensation decisions if it did not even consider the basic, fundamental issues related to the accountability of the executive roles for which compensation is set. And without being informed, directors might be found to have acted without good faith and face personal liability, without indemnification and directors and officers' insurance to back them up!

Not All CEO Roles Are Created Equal

Not all senior executive roles have the same level of work complexity and accountability. For example, the work of the CEO role at Johnson & Johnson is exponentially more complex than it is at Eli Lilly. Similarly, the CEO role at Procter & Gamble is more complex than at Kimberly Clark. In both examples, one company is a significantly more complex enterprise than the other due to the variety of distinct businesses and countries in which they operate. So even though these companies are in the same industry, they are not true peers.

Most boards have no grounding in effective accountability design. In the absence of an objective framework for understanding and designing accountability, many CEOs have defined their own roles, accountabilities, and level of authority. Even those few directors with some knowledge about accountability design fail to use their knowledge. More than one director has told us that they have not established clear three- to five-year accountabilities and performance metrics for their executive teams for fear of seeming confrontational. Thus, some directors have failed in meeting their fundamental duty as directors.

Current operational goal setting and excessive compensation practices for operational work continue unabated for executive roles. Many lack a clear framework for measuring and comparing CEO and other executive roles across companies that are defensible. However, designing an effective accountability structure and integrating it with executive compensation are the most powerful levers that a board has to protect the financial interests of its shareholders.

A board cannot defend its decisions about executive selection, performance evaluation, compensation, or succession planning to shareholders without a standard of measure for defining and comparing executive work, leadership accountability, and the required level of executive capability. This is a core problem with corporate governance today, even after the heavy dose of reform that has taken place over the past few years.

A Framework for CEO/Executive Accountability

What would a framework for CEO/executive accountability design and measurement look like? What principles, processes, and tools could a board use to ensure that a minimal procedural standard has been followed to exercise judgment about CEO/executive accountability and equitable compensation? These are good questions that fortunately have answers.

What Not to Use

The size, revenue, and headcount of a company have little to do with determining the complexity of a role, it's contribution to shareholder value, and how to compensate a senior executive. These factors only blur the issues. Nevertheless, they often are used today because they are easy to measure and have been ingrained as the traditional way of approaching this issue, a tradition handed down from an operational and command-and-control view of organization design and compensation in an industrial economy.

Few companies (with the exceptions including Johnson & Johnson and 3M) have disclosed their metrics for measuring the CEO's and executive team's contribution to creating customer and shareholder value from new products, services, and businesses. Only 11 percent of the S&P 500 have disclosed a time period beyond three years for measuring business (as opposed to stock market) performance and appear to have linked this to their executive compensation practices.

While General Electric is to be commended for developing a new rolling four-year measure of compounded cash flow growth as a key performance measure for its CEO, even this measure is deficient. The longer time span for measurement must also be linked to the value created from new businesses and or new industries beyond current operations, which reflects the appropriate Organization Value Added-OVA™ -of the executive work and justifies significantly higher CEO compensation.

Level of Work as a Solution

CEOs, boards, and shareholders would benefit from a framework called ***Level of Work*** to help instill executive accountability, assess executive leadership capability and performance, and establish equitable and defensible levels of executive compensation.

Applying Level of Work organization design principles ensures that each level in a company has differentiated accountability, authority, and processes and adds unique value for customers and shareholders. The Level of Work framework uses six factors; four of which are innovation complexity; planning horizon; complexity of assets/capital managed; and the complexity of stakeholder groups to be managed (*e.g.*, if the enterprise operates a number of different businesses in various countries).

Ten years of our research and more than 400 interviews at the global CEO, Group President, President, and Vice President/General Manager levels have provided insight into five levels of work complexity and CEO leadership accountability. The five levels of CEO work cross three major domains of leadership work: the operational domain, the business development domain, and the global industry domain (Figure 1).

These leadership accountability levels and leadership domains have been further validated over the past 40 years through thousands of management interviews based on Levels of Work and stratified systems theory.[3]

When undertaking an accountability audit, we analyze a number of key factors to assess the true complexity and value-add of an executive position to ascertain the current Level of Work for a particular executive role. These include:

1. What is the level of innovation that the role should be held accountable for; including consideration of:
    - Process innovation and productivity improvement;
    - New Product / New Service innovation; and
    - New Business Model innovation.
2. What customers/stakeholders does the role need to work with to add the highest value, including consideration of:
    - Today's current customers related to today's products/services;
    - New and current customers for new products, new services and new markets; and
    - Key stakeholders that impact the external environment on a country level in which the business operates and could impact creating a new business model.
3. How far into the future is the role held accountable for planning and results, such as:
    - One to two years;
    - Two to five years; and
    - Five to 10 years.

A CEO title can apply to any of the three levels of work complexity that we have identified above, out of the five possible levels.

A CEO title can apply to any of the three levels of work complexity that we have identified above, out of the five possible levels. However, answers to these questions and others define the true level of work complexity of a particular executive role. Each of the six job design factors is used to assess current accountability, identify jam-ups where roles are overlapping in the accountability structure, and re-design accountabilities to remove significant role overlap and excessive and misplaced compensation.

All too often we found executive roles that are held accountable at too low a Level of Work. The organization is too short-term focused and not designed to create longer-term sustained value for shareholders.[4] We often found high levels of compensation that would be commensurate at a much higher work level being paid out for roles accountable for lower levels of work accountability. We also find that "title creep" is rampant in many companies because the titles fail to reflect the true level of accountability and decision authority.

Companies that have set only one- to two-year operational targets for EBITDA, earnings, and EPS from current operations have set the bar too low for their CEOs and executive teams. Three- to five-year return on invested capital is one of the better and least used measures to assess whether management is creating intrinsic value. TIAA-CREF, CalPERS and Hermes are institutional investors that have identified this as a primary business performance measure to evaluate potential investments. But even this financial metric does not measure whether the CEO/executive team is conducting, and being paid for, valuable strategic work, rather than purely operational work.

Boards also need to be careful not to allow CEO tenure to distort executive accountability. Just because a CEO may be a few years away from retirement does not mean that the role should be held accountable only for short-term operational work. Doing so risks the longer-term sustainability of the enterprise and continues to create the problem of excessive compensation for accountabilities at too low a level.

How to Select Peer Groups for Compensation Benchmarking

Today, too many compensation committees take a consultant's compensation benchmarking report at face value that may have grouped companies of different complexity and performance levels into the same peer group without any calibration in creating median and percentile rankings of compensation. These directors may have exercised poor or no judgment in applying this data during their compensation decision-making.

The major problems inherent in most peer group selection is that compensation committees are using an industry model, not an employment model, and relying too heavily on titles to match jobs. In summary, current peer selection and compensation benchmarking practices:

- Fail upfront to include an executive job analysis of the internal roles for which compensation is being established;
- Fail to take into account the complexity of the enterprises and jobs being selected at benchmarked companies, thus mixing up roles and compensation at various Levels of Work complexity; and
- Rely too much on titles to match jobs between companies when roles with same titles across companies are not comparable without calibration.

For internal equity analyses, human resource departments typically use an employment model comparing roles at each level in the company to each other based on some level of job analysis. Yet a number of compensation committees have failed to apply these same principles when setting senior executive pay.

In addition, many compensation committees have not undertaken an effective executive job analysis of key senior roles using appropriate factors that truly differentiate executive work that adds long-term value. Thus, they really don't know what the roles are, what they are held accountable for, and how each leadership level and their respective roles adds value relative to other roles in the enterprise.

Most peer selection mistakenly relies on factors such as the size of the company, budget, headcount, reporting structures, and market capitalization, all of which indicate almost nothing about the true level of complexity of the enterprise and its top executive roles. Using titles of jobs when CEO and other roles operate at significantly different levels of work complexity results in excessive compensation for less complex CEO roles and underpayment for more complex CEO roles.

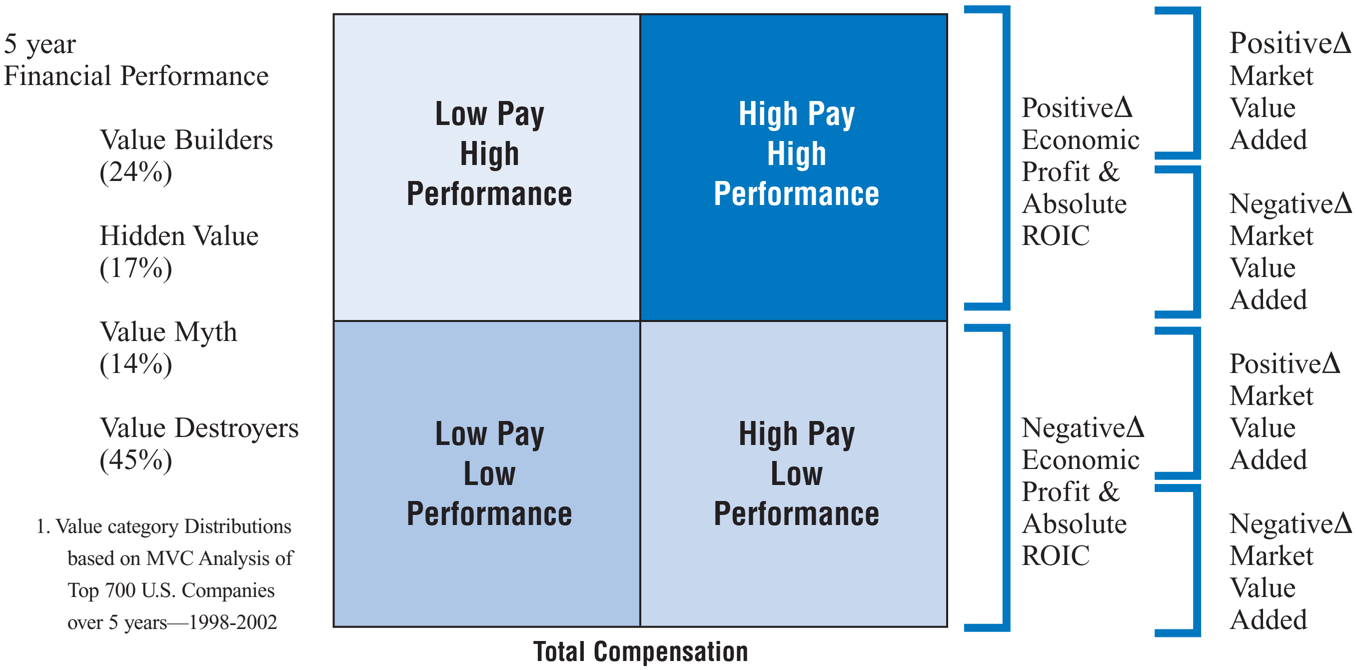
Over the past 15 years, there have been nine research studies that investigated the relationship between differential pay and position in the hierarchy. These studies, involving more than 1,000 participants from CEO to manager levels in the US, Canada, and UK, identified that the "felt fair pay" and differential compensation between the real work in organizations consistently differed by a multiple of two. In other words, the research identified that each work level is worth two times more in total compensation then the level directly below it. For example, a Level 3 business model innovator CEO role (*e.g.*, Schwab—new discount brokerage business model) is worth two times more in total compensation than a Level 2 new product/new service innovator CEO role (Ameritrade—new financial products within the discount brokerage business model) (*See* Figure 1.)

The problem of comparing CEO roles (titles) that operate at different levels of work complexity and accountability is perhaps easiest exemplified by the highly publicized NYSE Board's decision to compare the CEO role and compensation of Dick Grasso to the CEO roles at JP Morgan Chase, Merrill Lynch, and other glob-

Figure 2

Executive Pay-for-Performance

Integrating Innovation, Value Creation and Compensation



al financial institutions. The rationale disclosed for using these companies in the peer group was that Grasso could have gone to work for any of these firms.

But the NYSE Board should have at least made an informed decision that would have quickly revealed how erroneous this comparison truly was. In comparing the CEO roles at JP Morgan Chase and Merrill Lynch (CEO Level 4 Industry Innovator at a 16x multiplier) to the CEO role at the NYSE (CEO Level 1 Process Innovator at a 2x multiplier), an adjustment should have been made using a factor reduction of eight times to create comparable compensation. This adjustment apparently was not made due to a lack of adequate process.

When industry sample sizes are too small, boards need to include peripheral industry sectors for benchmarking and matching of executive roles and compensation at the same Level of Work in other industries. This shifts compensation benchmarking from an industry-based model to an employment model. This type of comparison also follows the trend in the recruiting of executives across industry sectors.

Boards also need to be careful in selecting peer groups that are in different pay and performance categories (Figure 2). No peer group is appropriate for pay-for-performance benchmarking if its neglects the metrics of performance as a basis for selection. In particular, high pay/low performance companies need to be careful if they principally select high pay/high performance companies to benchmark, as they could be accused of gaming the system. If a board does not even know which pay/performance category it falls within relative to its industry, and even within a broader index (*e.g.*, S&P 500), it could be seen as failing to be informed and breaching its duty of care and good faith.

What Boards and Compensation Committees Should Do Now

Once a board has agreed what Level of Work it is holding its CEO and other key executive roles accountable for (the use of expert advice is suggested to meet the legal test of being informed), it is now in a position to exercise judgment about the peer group that it selects for compensation benchmarking and calibration of pay to the complexity of the role. Clearly defined levels of accountability can help minimize the compensation ratcheting effect that current benchmarking practices using industry peer group comparisons, compensation averages, and 75th percentiles have created.

To properly set executive accountabilities and compensation, boards, compensation committees, CEOs, and investors must ask themselves:

- What Level of Work has the CEO role been designed at and has the right organization structure been established to differentiate operational from strategic work?

- Have strategic accountabilities and three- to five-year metrics been designed for the CEO and executive team to create sustainable long term value for all stakeholders?

- To what extent is an accountability audit required to evaluate:

  - Current organization structure, operational versus strategic roles, decision authorities, and potential need for re-design?

  - Are there too many layers of management doing the same work and wasting compensation dollars ?

- Is executive compensation paid out based on a clear line of sight to accomplish both longer-term business and stock market performance?

- Is total executive compensation equitable and a fair exchange or excessive given the level of accountability and valid comparison to internal/external roles and markets for executive talent?

Boards and CEOs must also recognize that expertise in accountability design and performance management is *not* the same as expertise in compensation. Only through informed decisions about accountability, and what they are paying for, can boards and CEOs carry out their fiduciary duty and defend their decisions of how much to pay and create the appropriate linkage between pay and performance.

Notes

1. The Walt Disney Company Derivative Litigation, 825A2d 275 (Del Ch. 2003).

2. Although these are the two primary reasons, there were many more factors. See the May-June issue of The Corporate Counsel for a fuller explanation of all these factors.

3. The original research contributors upon which our research was built included Elliott Jaques, Gillian Stamp, David Billis, Warren Kinston, Walt Mahler, Stafford Beer, Luc Hoebke, and others.

4. This problem of executive accountabilities at too low a level leading to excessive compensation is reflected in a recent NYSE Compensation Committee Chair's response to the SEC Chair about NYSE CEO compensation. In this response, accomplishments of the NYSE over 2000 and 2001 are outlined as the performance metrics linked to their Longer Term Incentive Plan and executive compensation payout. Yet, the majority of the accomplishments listed were operational and productivity improvements over one to two years, work that Vice Presidents or even middle management should be accountable for, and for much less compensation.