

Executive Compensation - February 20, 2009

Executive Pay Caps: Proceed with Caution

Hasty measures to limit executive compensation could deprive struggling corporations of talent just when they most need it

By Steven Hall and Pearl Meyer

As citizens try to hang onto their jobs and savings, we are being barraged by tales of executive waste and abuse – sometimes true and often misleading. Public indignation has spurred calls for legislative action, and indeed the economic stimulus package just signed into law by President Obama contains provisions aimed at controlling pay at firms that receive large amounts of bailout money.

But measures to cap or limit pay should be viewed with caution. Past efforts to impose executive or employee compensation controls have yielded results directly contrary to the stated purpose of such actions. Instead, the Obama Administration should recognize that a variety of more finely calibrated measures would more effectively address the current crisis of confidence in our business leadership, without depriving companies of the talent they need to pull out of this crisis.

SAY ON PAY: A PARTIAL SOLUTION

The best opportunity for improved governance of the public corporation, including executive compensation, is direct communication between directors and shareowners. “Say on pay” is required under the economic stimulus bill at firms receiving bailout money. However, activists have long sought imposition of such a measure on all public corporations. But say on pay, which gives shareholders an advisory vote on the compensation of senior officers, is not a panacea. It does foster communication between shareowners and boards. But, it may also lead to confrontation rather than consensus, enabling special interest stockholders with their own individual agendas (i.e., environmental, social or labor causes) to use compensation as a wedge issue. To achieve its purpose, say on pay should limit the vote to responsible shareowners – specifically, those with a minimum stake in the business who own shares, rather than hold borrowed stock, and who have owned their shares for a meaningful period of time, perhaps a year or more.

However, it is questionable whether a no vote, even by responsible shareowners, would be meaningful since it is neither binding nor specific. Another and perhaps complementary approach would be to require formation of a standing committee of shareowners owning a minimum stake in the company. This could serve as a bridge to boards by facilitating ongoing communication about critical issues, including executive pay and performance. A third approach is to have the Securities and Exchange Commission mandate a periodic direct survey of shareowners on corporate governance matters, including executive compensation, with the results published. Such an ongoing third party process conducted publicly by the SEC would provide boards with direct uncensored input from the owners they represent.

STIMULUS RULES DON'T FIT ALL

There is also some movement to expand the executive compensation restrictions included in the stimulus bill to all public corporations. While a government role in executive pay appears warranted where a company accepts capital infusions from the American taxpayer, our best counsel is that such interference is not in the best interests of a depressed economy which requires stimulation, including appropriate incentives that make it worthwhile to strive and succeed in this difficult business climate. We have found that responsible compensation programs, when aligned with strategic corporate objectives, serve as powerful drivers in creating jobs, decent employee wages and shareholder value. Some of the best historic examples have been IBM and GE, as well as McDonald's. This is surely the worst time to limit directors' ability to exercise their judgment in attracting, retaining and motivating those required to restore and grow our businesses which, rather than the Fed, the Treasury or Congress, are the true engines of job creation and our country's economic recovery.

ENHANCED REGULATION AND SEC OVERSIGHT

To restore investor confidence in the integrity of the public corporation, current regulatory safeguards should be reviewed and buttressed. Critical to effective protection of the individual investor is enhanced oversight and enforcement powers, funding and staffing of bodies such as the SEC. Total transparency, improved design of proxy disclosure and a watchful eye are required to provide stockholders with clear, accurate and relevant information in the face of increasing complexity and media distortion. For example, the current proxy Summary Compensation Table was designed by the SEC to disclose annual accrued accounting charges for senior officer compensation, rather than what an investor wants to know: What pay was awarded for that year's performance and how much did the officer actually take home that year?

UNINTENDED CONSEQUENCES

In our view, any attempt to impose absolute caps on executive compensation would be misguided and likely ineffective. Caps, in our experience, while possibly reining in excesses of a few, are far more likely to serve as a beacon for those whose compensation is below the cap. The last such attempt, the \$1 million limit on the deductibility of executive salaries, actually had the reverse effect of encouraging higher executive officer salaries right up to the million dollar mark and beyond by those companies to whom the lost tax deduction is not meaningful. Despite the stimulus bill passed by Congress on Friday the 13th of February which contains no absolute cap, the President is reported to prefer a cap. Such an approach may deter TARP firms from attracting the talent required or retaining such executives for more than the one or two years during which they will likely need to either draw down on their savings or cut back on family lifestyle. Both the current stimulus bill as well as the President's approach will result in high fixed salaries with little, if any, reward for results achieved, an approach more appropriate to government service rather than enlisting the best people to safeguard the taxpayers' investment.

Do we want our most troubled corporations led by undercompensated management teams who have no incentive or stake in the short- or long-term outcome of the taxpayer investment in the businesses they have been asked to manage? Some may choose to serve out of dedication to the public good. But there will always be other, more rewarding opportunities for talented executives wishing to move out from under the harsh spotlight likely to shine on companies accepting taxpayer funding.

Rather than impose artificial constraints on the market for human capital, we believe that legislative and regulatory energies could be more effectively utilized to encourage board governance that assures appropriate incentives. While the vast majority of boards endeavor to practice good corporate governance, improvements could and should be made. President Obama has a real opportunity to focus this debate on meaningful action. Whether legislative or regulatory, such solutions should ensure shareholder views are taken into consideration, while preserving the discretion and flexibility directors need to ensure that compensation programs motivate achievement of desired business objectives for the ultimate benefit of the long-term shareowner.



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