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Your Opportunity at the Board

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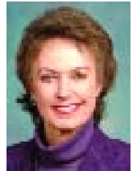

It's ironic that the one group with the power to decide the fate of an organization — the board of directors — is the one group in an organization that often is randomly selected, casually engaged, rarely evaluated and almost never held accountable. What better examples exist than Enron, WorldCom, HealthSouth, Adelphia, Tyco and now the New York Stock Exchange?

In each case, compensation abuses either triggered or magnified the scandal. Compensation is a clear target for shareholder activists and corporate naysayers. As a result, compensation is certain to be the focus of governance reform in 2004 and 2005.

But how are compensation professionals affected?

This is a time of extraordinary opportunity to influence compensation policy reform. To accomplish this, today's compensation professionals must become aware of and engaged with board-level compensation issues. The compensation professional can be a key and powerful resource to the board. But how does one read between the lines to see what truly is happening within corporate governance? There are several red flags and key indicators to watch for.

Conflicted Directors

First, there must be independence. That means independence in fact, in thought and in practice. It means no conflicts — subtle or otherwise.

Directors are the best bargain in corporate America, and the overwhelming majority has high integrity and prioritizes shareholder interests. The exceptions result in failed boards and shareholder losses. At Disney, the law firm of Sen. George Mitchell (who sits on the board) received consulting fees; director Robert Stern was an architect paid by Disney and board member Roy Disney was awarded a company salary of $624,000. Another director, Andrea Van de Kamp, CEO of the Performing Arts Center of L.A., received $45 million for the Center and the Disney Concert Hall. Because of their conflicted relationships, none of these people are truly "independent" directors.

Interlocking directorships can be especially treacherous. CEOs who sit on interlocking boards get paid 17 percent more than CEOs who sit on truly independent boards, according to a

University of Illinois study. Directors sitting on one another's boards are likely to have allegiance to one another, rather than the shareholders, because they do not want to embarrass a colleague by asking tough questions, such as challenging compensation levels.

Dick Grasso, the NYSE's CEO, sat on the Home Depot board. And at the NYSE, Kenneth G. Langone, director and founder of Home Depot, chaired the compensation committee that awarded Dick Grasso the $187.5 million retirement package that was his undoing.

Committee MakeUp

Compensation is one of the most powerful tools at the board level to ensure accountability and performance. Committee makeup is pivotal. Diversity is essential in the broadest sense (age, function, expertise, background, geography, gender and ethnicity) because it can drive discussion and help obviate the "me too-ism" that is so prevalent on today's boards. Here is an opportunity for compensation professionals to help add a critical dimension to the boardroom.

Comparative Data

As officer pay escalates, many feel there is too much reliance on comparative data. In my experience, board members are inclined to believe that their CEO is worth at least 25 percent more than his or her counterparts. Second, there can be an overreliance on the comparative data to the exclusion of other factors, fueling the trend to ratchet pay ever higher. Professional "experts" are increasingly relied upon to provide legal sanctity. Thus, the average CEO pay in the 200 largest companies soared from $6.7 million in 1996 to $11.3 million in 2002, according to a Pearl Meyer & Partners study.

Justified largely on the basis of "comparative" data, Grasso was awarded a retirement package of $187.5 million — he served as CEO from 1995 to 2003 — despite the fact that the NYSE made only a $28 million profit in 2002. The best pay packages are performance driven.

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Rewarding Failure

Using devices such as repriced options, exit packages and compensation guarantees, too many boards reward mediocrity and failure instead of achievement. And too many directors hand management a blank check. Bonuses should be awarded for outstanding performance, not automatically, as is so often the case.

At Disney, CEO Michael Eisner received a $5 million bonus in 2002, yet share prices are off 60 percent since 2000 and 19 percent since 2002. At Motorola, from March 2002 to March 2003, then-CEO Chris Galvin's pay doubled to more than $2.8 million while the stock price halved from 16 to 8. Zero-based compensation is another tool to break the cycle of incremental increases spawned by comparatives.

Exit Guarantees

Former AK Steel Corp. chairman and CEO Richard Warkrop was slated to receive $51.7 million in severance and retirement pay as of December 2003. Yet AK lost more than $500 million in 2002 and $400 million by the end of third quarter 2003, according to a report in the Nov. 17, 2003, issue of the Hamilton, Ohio, *JournalNews*. Former Schering-Plough CEO Richard Kogan may be charged with securities violations, yet he retired with a $50 million severance payout. Even the secretary to Jeff Skilling, the indicted Enron CFO, claims she is owed $875,000 in severance.

These are payouts that are unrelated to the CEO's performance, regardless of whether he or she did a bad job, was fired, etc. How do inappropriate exit payouts help the company going forward?

Combining the Chair and the CEO

According to Standard & Poor's, 75 percent of S&P companies combine the chair and CEO roles. This highlights one of the most sensitive conflicts in the governance system — the irony of the chairman essentially overseeing his own pay as the CEO. It's not easy for members of the compensation committee, no matter how independent, to challenge their chair, their fellow board member, even indirectly, on this most delicate matter.

Passive Directors

As compensation experts, you can help ensure that the compensation

committee members are well informed, thus substantially enhancing best practices. Passive, failed boards are legend. At the NYSE, compensation committee members admitted they did not know what Grasso's pay was. And that's not a surprise. The compensation terms that spawned his pay package were buried in his 1,200-page contract.

At HealthSouth, CEO and board chair Richard M. Scrushy banked a salary of nearly $4 million in 2001, along with a $6.5 million bonus based on false profits of some $1.4 billion. Where was the board?

Enron is a classic case of a passive board that failed to ask the difficult questions and take responsibility for the company's welfare. Every step along the way the board had the opportunity to say "no." The board could have refused to suspend the ethics code. It could have denied the outrageous pay packages for failing executives, including $1 million for an administrative assistant.

What if this board had fulfilled its fiduciary responsibility? What if the directors had asked the hard questions? Would the company and the jobs of tens of thousands been saved?

Failure to Conduct Independent Meetings, without Management

According to reports in *The Wall Street Journal*, Lord Conrad Black at Hollinger received some $32 million in unauthorized payments. It is estimated that he and other executives took as much as $300 million from Hollinger. Expenses included two private planes and some $300,000 for servants. The board did not hold independent discussions outside the presence of management. Incredibly, Black was only removed as chairman of the board in January, many months after the abuses were uncovered.

Evaluation of the Compensation Committee

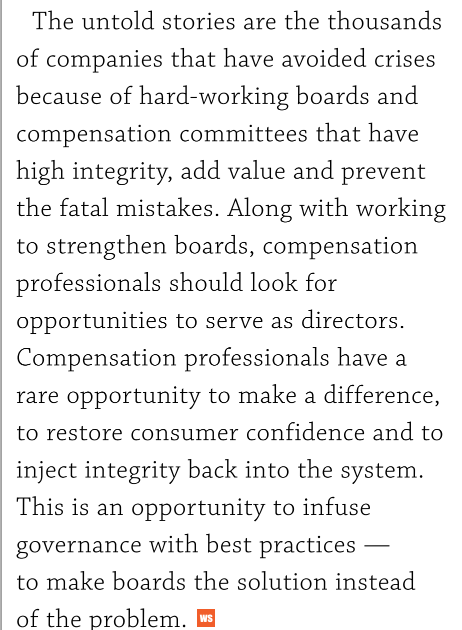
Both the NYSE and Nasdaq now require their listing companies' boards and the mandated committees (compensation, audit and governance) to evaluate their performance. Accountability can make the difference in making the board a strategic force in the company's success.

What Else Can Help?

Companies should rely on objective, confidential evaluations for their compensation committee to help businesses identify their strengths and areas for improvement. In considering the effectiveness of the compensation committee, think about the mistakes that have been outlined. Also, ask a few more questions:

- How engaged is the board?
- Is the compensation committee independent and diversified?
- Is the committee informed and proactive?
- What is the tone and substance of the discussions?
- What is the culture at the top?
- Is there an objective, confidential evaluation of the committee's effectiveness?
- How independent are the directors?
- Do directors approach the compensation staff for information, or do they wait for the information to come to them?
- Does the compensation committee add value?

Simply put, *better boards mean better companies.*



The untold stories are the thousands of companies that have avoided crises because of hard-working boards and compensation committees that have high integrity, add value and prevent the fatal mistakes. Along with working to strengthen boards, compensation professionals should look for opportunities to serve as directors. Compensation professionals have a rare opportunity to make a difference, to restore consumer confidence and to inject integrity back into the system. This is an opportunity to infuse governance with best practices — to make boards the solution instead of the problem.

ABOUT THE AUTHOR

Susan F. Shultz is CEO of The Board Institute Inc. and author of *The Board Book*. She can be reached at sshultz@theboardinstitute.com or 480/998-1744. WorldatWork is the content partner with The Board Institute on a new Compensation Committee Index, due for release soon. The index is designed as a self-assessment tool for corporate compensation committees.

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