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The Crystal Report on Executive Compensation



by Graef Crystal

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DEAR NANCY AND BARNEY: YOU'VE BEEN HAD!

Perhaps there will yet be some changes made, but based on proposed legislation that I reviewed at 5:30PM ET on Sunday, Sept. 28, the score seems to be: Henry Paulson: 10; Nancy Pelosi and Barney Frank: 0.

It was Ms. Pelosi and Mr. Frank who championed the notion of curbing executive pay at financial institutions that Henry Paulson wants to bail out.

Under Section 111(a)(2)(A) (Page 30 on the PDF I received), the pay control clauses begin with some ominous language, to wit: Controls shall include "Limits on compensation that exclude incentives for executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary [of the Treasury] holds an equity position in the financial institution."

What does that mean? My first thought is that it might mean no more stock option grants, which are thought to be the most risky part of the executive's pay package.

But are options so very risky? If they really inspired "unnecessary and excessive risks", then the entire country would be bankrupt, not just some financial institutions. Take Steve Jobs and Larry Ellison. Both have received options the size of which would require a multi-car freight train to transport them. Yet Apple Computer Inc. and Oracle Corp. have delivered excellent returns for their shareholders.

But if not options, then what? Maybe this is just fancy language that is, to use William Shakespeare's famous line from "Macbeth" "...full of sound and fury, signifying nothing".

All I can say here is "stay tuned".

Under Section 111(a)(2)(B) (Page 31 on the PDF), there is a so-called “clawback” provision, which allows for the recapture of past pay that is predicated on financial results that later prove to be fraudulent or at least full of hot air. Nothing wrong with that. Indeed, best practice in corporate governance already acknowledges that such provisions are needed in every company.

Under Section 111(a)(2)(C) (Page 31 on the PDF), we have what seems to be a denial of severance benefits for what appear to be the Top Five executives on a company’s proxy statement. This section talks about “Golden Parachutes”, but my sense is that the limitation is not being imposed only on change in control payments. Other language suggests that a discharge for vanilla incompetence will also be covered here.

Now, at first glance, this clause appears to have some teeth in it. One might indeed ask: “If I am being recruited to join a “troubled” company (the word in the regulations, not my word), and I am being told that there is no severance for me – not for termination for other than cause, change in control or any other reason – then why do I want to join the company?”

Good question. But this brings to mind the situation with Michael Ovitz, the former president of The Walt Disney Co.

Prior to joining Disney, Ovitz was the chief executive officer of Creative Artists Agency, Hollywood’s top talent agency. In at least one magazine cover, he was referred to as “The Most Powerful Man in Hollywood”. And he was earning compensation of around \$25 million a year – in cash.

When Disney started negotiating with him, Ovitz wanted a huge upfront bonus to compensate for the risk of giving up his highly-successful job. He was talking in the neighborhood of \$25 million – maybe more.

Disney’s board compensation committee nixed the idea of an upfront bonus. Among other things, its legendary (at least at that time) CEO, Michael Eisner, joined with no upfront bonus.

Ovitz was worried – as are many executives joining a company – that he might fall victim to the thought imbedded in the title of a song from World War I, “Will you love me in December as you did in May?” So, thwarted in his quest for an upfront bonus, he turned to another way for protection, namely, a cushy severance package.

Well, what do you know, one of those proverbial “Decembers” rolled around, and it turned out that Disney did not love Ovitz anymore. He was fired. And by the time the smoke cleared, he ended up receiving about \$110 million in severance for just about 16 months of work.

All this is by way of saying that if I can’t give you severance, I can give you something else to get you to cross the street – say an upfront bonus, or a really-large base salary. Compensation consultants don’t get to charge their clients upwards of \$1,000 an hour by being dumb as posts.

Finally, under Section 111(d)(1)(A) (Page 33 on the PDF), a totally-discredited idea from the Clinton administration has been trotted out, namely, denial of the corporate tax deduction, in this case for any amounts in excess of \$500,000 a year.

Under the Clinton-inspired legislation, pay in excess of \$1 million could not be deducted by a corporation. But, as mentioned in an earlier article (see “Executive Pay Controls – Bad Idea Then, Bad Idea Now”, published earlier this month on this website), an exemption was provided for anything that seemed to resemble a pay-for-performance payment, such that the one tooth left in the legislation’s mouth was a stricture on paying a base salary of more than \$1 million. But that certainly hasn’t stopped anybody who wanted to pay more. In a study of 508 CEOs running companies with \$3 billion or more of market cap, I found that 191 are paying more than \$1 million in base salary.

Face it, do you think a pay sociopath who is paying himself excessively, courtesy of a rubber-stamp board, is going to shrink back in horror at the thought of hurting his shareholders? To him, shareholders are a large piggy bank from which he can withdraw whatever he needs. And if they can’t benefit from a tax deduction, why isn’t that sad.

More than that, will any of the affected financial institutions have any positive income against which they could have taken a deduction for pay above \$500,000? Being denied a deduction you couldn’t take anyway is, to my mind, not the most stringent of pay controls.

Any pay consultant who is not now a rabid Democrat, or about to become one, should hang his head in shame. Nancy and Barney have brought home the bacon for them.

And any rabid Republicans out there can go back to sleep. Problem solved? What problem?

Certain of the compensation data for this article were obtained from Equilar, Inc., a leading provider of executive pay data (www.equilar.com).

2009 marks Graef Crystal’s 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley’s Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley’s Boalt School of Law.