Don’t cut exec pay, help it make sense

Excessive pay of corporate executives has become the poster child of the financial crisis. From the president down, condemnation of compensation levels of those deemed responsible for the demise of our financial system has provided some emotional relief for the pain inflicted on so many. The decision of the federal government, however, to impose pay limits raises serious questions for America’s twin pillars of democracy and capitalism.

There should remain little question that pay policies in American businesses have become disproportionate and bloated, and, in many cases, ill-guided. Good compensation policies motivate and reward executives who successfully execute long-term strategies set by boards, which balance returns to shareholders with acceptable risks associated with those strategies. It is hard for the financial industry to make the case that its pay policies have fit this description.

But business pay standards are too complex and too unique to each setting to lend themselves to heavy handed, uniform government standards. What is similar about selling RF Micro’s chips, Honda’s jets (or lawnmowers), Natty Greene’s beer or Lincoln National’s annuities? The answer is nothing. And good pay policy recognizes that knowledgeable, independent directors, responsible to the owners of those businesses, are the most competent persons to achieve this difficult task.

Besides, we tried this already and failed miserably. In 1992, Congress eliminated the tax deduction for compensation over $1 million for executives of public U.S. companies unless “performance based” and approved by shareholders. Corporate lawyers quickly crafted revised “performance-based” plans (reciting long lists of possible performance standards) that were blindly blessed by shareholders. The conclusion again is that pay standards are so complex and individual to businesses that attempts to apply any single standard will miss the mark for most situations and drive behavior in unintended ways. Following the 1992 Washington intervention, executive pay rose significantly.

Rather than federal intervention, corpo- rate governance practices should be restructured to strengthen director independence, and the components of executive pay should be re-aligned. In some cases, directors have been too comfortable with management. The “independence” requirements say nothing about golfing partners or old college friends.

The nominating system and proxy voting provisions in the U.S. almost insure that only insiders select new board members. Also, the last round of legislative “reforms,” dubbed Sarbanes Oxley, have so overextended director attention to accounting obscurities, that there has been less time and energy for setting complex pay policies.

Lastly, the practice of setting pay based on comparisons with peer group companies provided by “independent” consultants has unleashed an “arms race” in pay spiraling ever upward.

So, what’s the solution going forward? The four traditional executive pay components (base salary, annual bonus, long-term incentive and perquisites — or “perks”) should be reshaped as follows:

- Base pay should continue to be set high, relative to each community’s standard (New York City pay will be higher than in Kansas City) simply because executives’ decisions impact more people than any other in the private sector. Annual salaries should support a high quality of living standard (and commensurate charitable giving), but not high enough to support lavish second homes, yachts, planes or their ilk (these benefits should come only via long-term incentive award success).
- Annual bonuses for top executives should be eliminated and merged into long-term incentives for the simple reason that the impact of strategic decisions takes more than 12 months to be implemented and assessed.
- Long-term incentives should form the backbone of success rewards for executives. But setting and monitoring these incentives (and the related risks) are intensely local and personal, made on a job by job assessment. This is the role truly independent directors must, and can only, play. Such awards should be tailored to mature as the impacts of strategies become evident. Directors must retain authority to measure success and value awards accordingly. The now popular concept of “clawbacks” is unworkable, punitive and demoralizing to the entity; instead award payouts should be delayed until success is clear.
- Long-term awards should never be convertible into instant cash, but should instead be in the form of restricted stock (not tradable), and all such awards should have performance-based vesting standards and a mandatory re-tenure percentage built in, i.e., executives can never fully “cash out” while on the job.
- Perks in their myriad of forms should be carefully scrutinized and in most cases eliminated for several reasons. First, they create a visible, privileged class in the organization that detracts from a “one company” morale. They set up internal competitions. And finally, they necessitate an additional bureaucracy for monitoring “perks.” Two particularly egregious forms — tax gross ups of payments to executives and lengthy severance payment periods (and amounts) without mitigation clauses — also deserve the “delete” button.

And what about the role of shareholders? With the exception of the large institutional holders of stock, shareholders who can understand executive pay issues (or care to) are rare. So the panacea of shareholder “say on pay” votes is very likely to be an uninformd, and in reality, merely a vote of (no) confidence in management and the board. However, for this very reason, I support non-binding proxy votes on pay, simply to give management a litmus test of how their efforts are perceived by their owners.

America’s businesses need to reform pay practices. Hopefully the specter of Washington’s hand on the payroll will arouse the independent directors in boardrooms to consider the kinds of changes that will motivate and reward successful strategy implementation in an increasingly competitive world.

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