TURMOIL IN EXECUTIVE AND DIRECTOR COMPENSATION – IS THERE A SILVER LINING?

By Dirk Schlimm

This is the fourth article in our series on the value-added contribution of the Corporate Secretary. It explores the Secretary’s role in the tumultuous world of executive and director compensation.

The financial crisis of 2008 continues to send its shockwaves through the global economy, financial markets and Board rooms. As governments grapple with ever larger bailout and stimulus packages, hundreds of thousands (millions in China) are losing their jobs, and stock prices keep taking brutal hits, executive pay packages, especially those of once high flying investment bankers, have become the object of universal wrath.

President Barack Obama is leading this charge as he advances his “change through sacrifice agenda” lending eloquent expression to the vox populi. His words are worth repeating:

"We all need to take responsibility. And this includes executives at major financial firms who turned to the American people, hat in hand, when they were in trouble, even as they paid themselves their lavish bonuses … that’s the height of irresponsibility. That’s shameful … Companies receiving federal aid are going to have to disclose publicly all the perks and luxuries bestowed upon senior executives and provide and explanation … as to why these expenses are justified. And we are putting a stop to these kinds of massive severance packages we’ve all read about with disgust; we are taking the air out of the golden parachute … We’re going to examine the ways in which the means and manner of executive compensation have contributed to a reckless culture and quarter-by-quarter mentality that in turn have wrought havoc in our financial system. We’re going to be taking a look at broader reforms so that executives are compensated for sound risk management and rewarded for growth measured over years, not just days or weeks.”

Obama’s verdict is clear: not only have (banking) executives been overpaid, but the pay practices themselves have been a major contributor to the current crisis. US commentators have pointed to Canada as an (unexpected) role model for sound banking and taxation practices and the US President himself had some kind words for Canada. However, Canadian bank executives have not remained unscathed but have joined their US counterparts in returning parts of their paychecks. Earlier this month, for example, BMO Financial Group CEO, Bill Downe, announced that he had decided to forego his mid and long-term compensation of $4.1 million for 2008 “as a result of [his] reflection upon the current economic environment.” The twist, of course, is that BMO’s compensation committee had earlier decided to “exercise upward discretion” in determining Mr. Downe’s compensation and awarding another $550,000 in addition to his calculated package of $5,982,000. In the meantime, calls for executives to return their pay have been extended to their governors, i.e. Board members, together with “crisis management advice” that Board members should work for free.

There is no question: executive and directors compensation have joined (if not momentarily eclipsed) strategy, leadership...
(succession) and financial performance as top Board concerns. As a result, they should be on top of the secretary’s list as well.

I. Hot topics in executive and director compensation

Even prior to the financial meltdown executive and director compensation had developed into a hot topic culminating in the adoption of new disclosure rules in the US and Canada. Many of those themes found their way into the Obama charge confirming suspicions that the full costs and risks of compensation schemes were often not understood. Key issues include:

1. “Pay for performance”. (Over)paying executives for substandard performance has been a long-standing concern for shareholders. In that regard, the new disclosure rules require a clearly articulated pay philosophy, compensation benchmarks, and performance goals and charts. In addition, however, pay plans may create “perverse incentives” to incur huge risks (so called “tail risks) in pursuit of the big pay-out. If, for example, Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers and Bear Stearns had retained some of their record $39 billion in 2007 bonuses (up from $3 billion in 2006) the magnitude of the financial crisis could have been significantly less. Paying these bonuses even after companies have been brought to the brink has triggered an intense debate and court action over compensation claw-backs. Therefore, claw-back provisions should be considered as part of a “pay-for-performance compensation strategy.

2. Supplementary executive retirement plans (SERPs). The true cost of (defined benefit) SERPs can be surprisingly high. Key issues include the inclusion on bonuses in calculating pension entitlements, survivor benefits, and extra years of service. SERPs can easily add a lot of extra value (cost) to pay and bonus increases. All of this is in contrast to a time where most rank and file employees have been converted to defined contribution plans (which have greatly suffered) or where remaining employee defined benefit plans are in trouble. Disclosure of executive pension plans is required under the new rules.

3. Golden parachutes and perks. As with SERPs and incentive plans there can be an awful amount of surprising detail in termination arrangements. This includes questions regarding the triggering event of a golden parachute (resignation, termination, change of control, change in responsibilities) and their definition (what exactly is “change of control”). Details need to be understood and disclosed giving rise to the question whether the parachute has been unduly “inflated”.

4. Director compensation. There has been a strong trend towards increased director compensation given the increase in time demands and risks. These risks have just taken even larger dimensions while Boards have received their share of blame for the current crisis.

5. Share ownership. Share ownership by executives and directors has been recognized as a means to create alignment while option plans have been criticized for their lack of downside risk and excessive dilution of shareholders’ equity. Share ownership for executives and directors is de rigueur.

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II. Compensation plans in a time of global meltdown – where do we go from here?

The above list of hot compensation topics and the new disclosure rules had in and of themselves created a daunting challenge to compensation strategy and administration. Now the seismic changes brought about by the financial crisis and resulting global recession/depression have opened up additional dilemmas that are far from easy to solve. Yes, we do want to claw back outrageous bonuses that were paid despite utter failure; but what about companies whose performance is suffering badly and need good people to work hard in order to survive, recover and position themselves for the post-crisis future? Their Boards and compensation committees face a whole raft of tough questions:

1. Do we ask our CEO and Board members to forego any of their compensation, including working for the symbolic $1 salary? Is such a step required to maintain employee morale at a time of lay-offs and other sacrifices borne by the rank and file (including lay-offs, benefit and wage cuts, serious devaluations of the retirement portfolios)? Is this just a public relations move or a real cut in pay?

2. How do we benchmark compensation given that last year’s proxy data reflect a totally different reality and that competitors or other comparators may have been affected quite differently by the financial crisis?

3. How do we deal with bonus plans that pay out a lot less than in the past or even nothing? How do we motivate people to make tough decisions, give their all, and march for many extra miles to stage a turn-around?

4. How do we create meaningful performance targets in an uncertain economy with little or no visibility as to levels of demand and customer behavior?

5. How do we deal with option plans that are hopelessly under water and will likely remain there for some time to come?

6. How do we value option grants at a time were traditional valuation methods will likely create a skewed picture? How do we deal with share ownership guidelines if executives and directors have fallen below required thresholds due to share price implosion?

There are no easy answers for any of these questions. Instead, they require thorough debate, and the answers will be rooted in the organization’s unique circumstances, leadership culture, values, shareholder expectations and many other factors. First and foremost, the answers will require return to first principles: Pay for performance (corporate and individual); need to motivate and retain the right people; plain reasonableness (how much is enough!) and, yes, risk management. And they will require some truly independent thinking.

III. The role of the Corporate Secretary

As compensation committees and boards wrestle with these serious questions and dilemmas the corporate secretary is well positioned to play and important role that goes well beyond administrative support. The secretary is positioned at the intersection of management, Board, external
advisors and shareholders. This unique position combined with the knowledge of the issues and strong relationship skills puts him or her in a unique position to coordinate participants, provide decision support, facilitate Board and committee process and be a trusted resource. Doing so effectively will require the following:

1. **Develop a solid understanding of executive compensation and director compensation issues from a Board perspective.** There is some great literature but an overview seminar with a compensation consultant or employment lawyer is an excellent investment at this time. They will not have all the answers but they can explain key principles, pitfalls, and possible alternatives in the context of the organization. Insist on plain language and principles (rather than degenerating into a detail discussion of complex option arrangements).

2. **Become fluent with compensation disclosure requirements.** There are excellent summaries prepared by law firms and compensation consultants but nothing beats reading the actual rules and some examples of clear disclosure.

3. **Get a detailed understanding of the current compensation framework in the organization.** Do not rely on summaries but read and understand the source documents (compensation and bonus plans, option and share incentive plans, retirement savings plans, pension documents, employment contracts).

4. **Lead the disclosure effort under the new rules.** Compensation disclosure will require cooperation among finance, human resources and legal departments; compensation consultants and legal advisors; as well as the compensation committee and the full Board. The secretary is well positioned to coordinate, facilitate and make sure that things get done right.

5. **Take on the thankless/thorny jobs.** A key example is perk administration. Is a combined personal/business trip on the corporate jet eligible for reimbursement, is there gross-up for certain expenses, do Board members always travel business class? Someone has to decide and be the messenger. Any Board or compensation committee chair will be glad to look to the secretary as a first line of defense!

6. **Become a trusted resource and sounding board.** As a member of (senior) management the secretary will likely be impacted by pay policy decisions. Therefore it will be crucial that he or she adopts an attitude of complete independence that is guided by what is in the best interest of the company. The secretary’s knowledge of key people, organization culture, and his or her own perspective can make them a valuable sounding board at a time where communication between the compensation committee and management has become more important. The secretary can quietly explore possible reaction to major compensation decisions (“how would you truly feel about a major cut in pay?”) and be a friendly face to all involved in the process. Putting people on the spot without prior diplomacy could do a lot of damage.
IV. Towards a new compensation culture

Mutually reinforcing benchmark data, real or perceived competition for top talent, and plain greed have led to a loss of perspective in executive compensation. If there is a silver lining in the current crisis and the resulting compensation mess it is the fact that a down-to-earth approach to compensation is no longer a sacrilege.

Peter Drucker once proposed that senior management should not be compensated more than twenty times the lowest paid employees. The reverence for the “father of management” quickly turned to outrage from those affected. Now, the Obama cap of $500,000 for bailout companies looks awfully close to Drucker’s thinking. In the same manner, management thinker Jim Collins has questioned the dogma of performance driving compensation plans. Incentive plans are helpful but they are certainly no substitute for leadership and a moral compass:” The right people will do the right things and deliver the best results they’re capable of, regardless of the incentive system.” Therefore companies should not focus on how they are compensating their executives but which executives they have to compensate in the first place.20 Clearly, one would expect that the CEOs of BMO and TD Bank are still fully engaged and contributing to their full ability despite the fact that they have returned some of their earned compensation.

The unrepentant view, however, has not disappeared. Deutsche Bank CEO Klaus Ackermann sees the Obama cap of $500,000 as a competitive opportunity as he plans to pay well above it and to attract people who will be eager to get out from under it.21 After all he says, “We are in the people business.”22

It will be fascinating to see where the current crisis and the ensuing debate will lead us. One thing is certain: The world of executive compensation will be anything but boring; but it will be fraught with risk, dilemmas and uncertainty. The right person with the right attitude may just enjoy the excitement!

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1 Full transcript available at The Huffington Post, 3 February 2009.
3 CBC interview, 17 February 2009.
4 BMO news release, 2 February 2009.
5 BMO Proxy Circular, p. 30
6 “Geithner’s redemption, Fortune, 16 February 2009, p. 16.
8 The Canadian rules came into effect December 31, 2008, see e.g. Form 51-102F6 (2008) 31 OSCB 12047.
9 Sharfman/Toll/Zydowski, “Wall Street’s Corporate Governance Crisis”, The Corporate Governance Advisor, Volume 17, Number 1, p. 5.
10 Some European courts have decided in favour of the bonus recipients, see “The Shameless”, Der Spiegel, 16 February 2009, p. 60.
14 See e.g. Elizabeth Greville/David Crawford, “20 Questions Directors Should Ask about Executive Compensation”, published by The Canadian Institute of Chartered Accountants.
16 See e.g. Hugessen Consulting, “An overview of the CSA’s new rules for compensation disclosure (issued 18 Sept ’08)”, September 08.
17 See e.g. Form 51-102F6 (2008) 31 OSCB 12047.
18 See e.g. BMO proxy circular, p. 25-33.
19 Pay Plans for the Downturn, p. 55.
21 See Der Spiegel article above, p. 72.
22 See above.