As We See It . . . .

Why Boards Need a "Holy Cow!" Calculation

Recent statements by some leading corporate Directors that they never realized the true size of their chief executives' pay packages are falling on highly skeptical ears. How could the Directors qualified to sit on the Boards of major corporations not be aware of the value of programs they oversaw and, in many cases, they themselves approved?

As we see it, such claims of ignorance are neither disingenuous nor particularly surprising. The fact is, the newest storm of controversy over executive compensation highlights a fundamental governance flaw in how many Boards oversee complex, multi-million dollar pay packages, particularly those involving supplementary benefits and perquisites. We'd like to explore what the problem is - and suggest a simple solution.

At most large companies, major decisions on executive pay, especially benefits, are very often made on a piecemeal basis. In addition to their almost routine, regularly scheduled determination of annual salary increases, incentive awards and stock grants, Directors only periodically consider the redesign or formulation of a particular element of compensation, such as a long-term incentive plan or supplementary pension or savings program. Before making a decision, Board members usually receive for their review a detailed analysis showing how the proposed program compares with that of other companies.

What they are missing is an assessment of how the proposed plan would fit with, and build on, the pay programs already in place- and what it might all end up costing. Similarly absent is an analysis of how the proposed payment might grow over time if deferred or invested. Essentially, members rarely get a full view of the broader compensation landscape. And ironically enough, the rotating membership of many Compensation Committees, while considered good governance, actually contributes to a lack of continuity or perspective.

This would not be such an issue if, as a matter of practice, Boards periodically sat back and took a good hard look at what an executive's pay package costs and yields in total - both today and tomorrow and under varying scenarios. Such a detailed review would entail calculating and adding the built-up value of every component approved over the years, including deferred compensation, accumulated pension benefits, equity awards, option holdings and exercises, as well as modeling out potential future values. If Board members have never or only rarely seen such an analysis, they might well have a "Holy Cow!" moment.

However, if members don't seek out the numbers on their own, it's likely such a total pay calculation eventually may be forced upon them by circumstance. In a change in control situation or upon a CEO's sudden departure, the entire value of a package is often paid out in a lump sum, rather than in installments or through an annuity. Only when the reconciling is done does the total cost become clear to the Board - along with shareholders and the media.

The circumstance in which former NYSE Chairman and CEO Richard Grasso's withdrawal of almost $140 million became public was unusual, in that he planned to continue in the position. The outsized payout was no sudden windfall, but reflected accumulations from multiple plans approved by the NYSE Board at different times over Grasso's long tenure. Those plans ranged from long-term incentives and supplemental executive retirement and savings plans to capital accumulation and deferred compensation plans.

Evaluated in a vacuum, each benefit plan and compensation element could easily have been deemed reasonable when it was approved by the NYSE Board, especially given Grasso's generally well-regarded performance in the position. Taken as a whole, however, the huge package was untenable, understandably offending a public and press already highly sensitized to executive pay and dubious of the rigor of Board oversight.

Corporate governance will improve as Boards learn - sometimes the hard way - what questions should regularly be posed to management. Following the highly negative publicity over disclosure of Jack Welch's full retire-

ment package from GE, for instance, attentive Boards at other companies added "total balance of retirement benefits and perquisites" to the list of information sought annually from management for review with their consultants.

Going forward, we are cautiously optimistic that the puzzle pieces of executives' total compensation package will be more regularly put together by Boards and taken into account when new plans are being considered. If so, Boards of Directors will be far less likely to miss seeing the forest for the trees.

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