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A Board-Based Solution to Overpaid CEOs

In many U.S. corporations, executives are paid much more than their performance seems to justify. The problem of overcompensation will not be solved, however, by the Clinton administration's approach to the question.

Arguing on Feb. 11 that "the tax code should no longer subsidize excessive pay of chief executives," President Clinton requested in his budget, and Congress then mandated, that executive compensation over $1 million a year "unrelated to the productivity of the enterprise" no longer be deductible by the offending corporation as a legitimate business expense. The president apparently concluded that all executive salaries above $1 million were somehow inherently suspect. He has missed the point completely.

There is nothing inherently wrong with a large salary. The problem is overcompensation, not high compensation. Many executives who earn well over a million dollars are worth every penny, considering their contributions to corporate profitability. Corporations will gladly pay high-performing executives handsomely, not only to reward their performance but to retain their services in the competitive labor marketplace. High compensation can also be a valuable incentive for future performance. To limit arbitrarily the compensation that all corporations may offer limits the effectiveness of this important incentive.

Furthermore, the Clinton approach to corporate overcompensation fails to address its root cause. Overcompensation is usually the result of a failure in the bargaining process between a corporate board and management over salary.

In many of America's leading corporations, management is supervised by a board largely appointed by management. Excessive compensation results when passive boards beholden to management agree to salary packages on demand, in the absence of spirited negotiation.

Manager's Journal

By Charles M. Elson

An empirical study I recently conducted suggested that bargaining between board and management will be more effective when outside directors have substantial stockholdings in the corporation. Business Week, in conjunction with Standard & Poor's Compustat Services Inc., conducts an annual survey of executive compensation in 500 of the nation's largest publicly traded corporations. Compensation is then compared with executive performance as measured by corporate profitability and total return to the stockholders in stock appreciation and dividends. My own study reviewed the 158 businesses in the Business Week survey that received either the poorest possible rating for compensation in relation to performance or the best.

An intriguing fact emerged from my examination. Those companies with apparently excessive levels of executive compensation tended to have corporate boards controlled by outside directors with insignificant equity holdings in the business. On the other hand, those businesses with levels of executive pay considered in line with services delivered tended to be controlled by boards whose outside directors held substantial equity positions in the companies. There appeared to be a link between substantial stock ownership and more effective compensation oversight by the outside directors. An alignment of directors' interests with those of the shareholders, rather than management, through the possession of large shareholding positions, would explain this phenomenon.

Based on the findings of my study, I believe that some reform in board structure is warranted to create more effective board-level review of executive compensation and to promote more reasonable compensation schemes. The outside directors must be made to consider management compensation proposals not from the perspective of one engaged by and beholden to management, but from the viewpoint of the stockholders to whom they are legally responsible. The best way to create this perspective is to appeal directly to these directors' pecuniary interests. To ensure that they will examine a management initiative in the best interests of the stockholders, we must make them shareholders as well.

Corporations should pay their directors their annual fees in company stock that is restricted as to resale during the director's term in office. In a few years, each outside director will have accumulated a reasonably substantial portfolio and will therefore possess a powerful financial incentive to act more independently of management.

Although some might argue that a stock-option grant to directors may serve the same purpose, such an approach would prove less effective than direct equity ownership, simply because of the highly tentative nature of an option prior to exercise. Stock ownership provides the director with a present tangible stake in an enterprise, not merely some speculative expectancy of a discounted future position.

Additionally, directors' term lengths must be significantly expanded. This would ensure that their equity positions will reach the level necessary to influence their decision making; by stretching out the time between elections, it would also make it harder for management to bully directors with a threat not to renominate them.

Director stock ownership may not prove the comprehensive cure to the overcompensation controversy—but it will have a strong salutary effect and is a much more positive approach than the Clinton administration's taxation-based plan.

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