Oversight of executive pay: Business as usual may lead to personal liability for directors

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Greed, arrogance, or perhaps just poor judgment with regard to executive compensation nearly resulted in American Airlines having to file for bankruptcy recently. American Airlines' CEO Donald Carty infuriated the airline's unions and was pummeled in the press when it was disclosed in governmental filings that the company had agreed to pay substantial retention bonuses to its top seven executives if they stayed with the company until 2005 and had paid $41 million into a trust fund to protect the pensions of the company's top executives in the event of a bankruptcy filing. Mr. Carty has been vilified for not disclosing these executive compensation arrangements when, to avoid having to file for bankruptcy, the company sought and obtained wage cuts and other concessions from its unions. Ultimately it cost him his job and resulted in the company having to renegotiate the concessions that had previously been agreed to by the unions. The company also has since eliminated the retention bonuses and stopped funding the trust fund.

Was the failure to disclose those compensation arrangements to the unions an error in judgment? Absolutely. Was it a breach of trust that would prevent the type of cooperation with its unions that American will need to turn its business around? No doubt it was. Was Mr. Carty's resignation as CEO of American Airlines necessary? Probably. Would, however, everything have worked out well, if only the company had been more forthright in its dealings with the unions? Absolutely not.

Hiding those executive compensation arrangements from its unions until after they agreed to concessions cannot be justified. Because it was so clearly wrong it has obscured the fact that what angered the unions was not only that these executive compensation packages were not disclosed but that they were granted in the first place at a time when the company was faring poorly. Can anyone really believe that the way to turn around a business is to ask your rank-and-file employees to take wage and benefits cuts and at the same time reward the management that got the company into trouble by granting them bonuses and protecting their benefits? Is it reasonable to think that the unions would have agreed to the concessions being requested had American disclosed the retention bonuses and the pension trust?

Link pay to performance

Therein lies the story that everyone seems to be missing. The company's CEO did not grant these benefits to himself and the other top executives. The board of directors approved the retention bonuses and the pension trust at a time when there would seem to have been little justification for either. There are times when retention bonuses are appropriate and when a pension trust might serve an important purpose. Nor is the American Airlines board alone in granting compensation and benefits to top executives seemingly without regard to performance. As a result, however, a serious problem exists in terms of the perception, and the reality, of how top executives are compensated in corporate America today. CEOs and other top executives seem to reap huge financial rewards, even when the companies they run, and their shareholders, fare poorly.

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Worse yet, at many companies the "pay for performance philosophy" that results in large bonuses for key executives in good times becomes "pay notwithstanding performance" when things are not going so well. Bonus plans seem to be designed to ensure that executives get their bonuses year in and year out, regardless of how the company does. When that does not work, the bonus plans are changed to make it easier for executives to get their bonuses. For example, AT&T Wireless recently lowered the performance targets in its bonus plan mid-year, thereby enabling its top executives to get bonuses in amounts they would not have earned under the original plan. Until recently GE included pension plan earnings, which are totally unrelated to how well the business is run, in determining earnings for purposes of calculating executive bonuses. Some companies have issued new stock options or repriced existing options for their executives when stock value has fallen dramatically. While these types of actions may sometimes be the right thing to do, to the public, they are akin to a local referee moving the goal line forward and signaling a touchdown, when the home team fails to get the football into the end zone.

The recent scandal at the New York Stock Exchange over the pay package of its chairman, Dick Grasso, is another example of boards of directors not treating executive pay decisions with key executives as negotiations in which the position of management (and often the consultants management hires) differs from the interests of the organization.

Director liability for pay decisions

It is easy to second-guess these various compensation decisions because, at least in hindsight, they are hard to justify. More problematic to directors is the fact that courts have indicated a willingness to hold directors personally accountable for compensation decisions if they do not adequately exercise their responsibility to oversee those decisions. A recent decision by the Delaware Court of Chancery in *In re The Walt Disney Company Shareholder Litig.* should be a wake-up call to directors to take a more active role in reviewing compensation decisions. The court held that, based on the facts alleged, if proven, the directors could be held personally liable for damages that could exceed $100 million with regard to the employment and subsequent termination of Michael Ovitz. The court faulted the board for allegedly having relied on its CEO, Michael Eisner, to negotiate the terms for hiring Ovitz as his second in command, as well as his subsequent severance when the relationship did not work out. The court seemed to be willing to find the board members personally liable because, according to the facts alleged in the complaint, the board was aware that its CEO was negotiating with Ovitz and allowed him to do so, thereby approving the compensation arrangement "without adequate information and without adequate deliberation" (*Directorship*, December 1998 and January 1999).

Similarly, SEC Chairman William Donaldson has sent a message to board members everywhere by demanding that the NYSE board show that it was paying adequate attention when it granted Dick Grasso a pay package that is impossible to justify in terms of what was needed to keep him and provide adequate performance incentives.

Even without the threat of lawsuits, though, directors need to take a more active role in making compensation decisions because those decisions can have a very significant impact on the success or failure of a company. Why then do boards so frequently approve compensation packages for top executives that appear to be excessive in terms of the company's actual results? Most directors take their responsibilities to the company and its shareholders very seriously. They are conscientious and seek to use compensation as a way to attract and retain the best talent to drive company performance. Maybe, as some critics claim, directors are too close to the CEO. Or it may be that because most directors are CEOs or former CEOs, they tend to see things from the CEO's point of view. While both of those factors may play a role, I would suggest that much of the problem stems from the fact that most boards simply do not have sufficient expertise in negotiating compensation to be able to negotiate effectively with a self-interested management more knowledgeable about compensation and the specific business situation facing the company. Moreover, they often fail to view management recommendations about compensation as a negotiation. As a result, directors often fail to distinguish between what is necessary to attract and retain top talent and what is necessary to motivate executives who are already in the company's employ and not likely to leave any time soon. Each requires a very different compensation philosophy.

Divided interests

The appropriate compensation package will likely be different for someone you are trying to recruit into a troubled company than it would be for the current management, for whom you want to provide incentives to improve company performance. Too often boards, at the urging of management, develop compensation programs for senior executives as if they were designing a package needed to recruit someone from another company. While the ultimate target salary might be the same, a new employee might require certain things to get him to leave his current job. Moreover, it might take some time for a new executive to be able to make the changes necessary to impact the bottom line. Therefore it might be appropriate to tie a smaller amount of a new executive's initial compensation to measurable performance than it would be to do so for an executive who had been with the company for a period of time. Similarly, boards too often treat a long-serving CEO who already is a major shareholder in his or her company the same way they would a CEO who has just been recruited to join and has no equity stake in the company. That almost always results in the veteran CEO being given a package that is too generous and ties too little of his or her compensation strictly to results.

That appears to be what the American Airlines board did. How does guaranteeing already earned pensions of top executives serve to retain those executives or encourage better performance? If anything, it serves to reduce their monetary incentive to avoid bankruptcy. Why was it necessary at that time to grant retention bonuses not tied to performance? Retention bonuses are sometimes appropriate, and I will admit to having used them myself when working with companies in bankruptcy that were actually experiencing the loss of key employees. But there is no indication that the top executives at American Airlines were about to leave if they weren't given retention bonuses. Moreover, if the managers running the company have so little faith in their ability to turn the company around that they need guarantees not related to performance to keep them in place, are they really the executives you want to spearhead your turnaround efforts? The board at American Airlines seems to have acquiesced to management's desire to be protected as if they were new employees being recruited into a troubled company, rather than the leadership team at the helm when the company got into trouble. They should be rewarded, and rewarded well, but only if they are successful in turning the company around.

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Ultimately, there is no substitute for boards of directors recognizing that the process of setting compensation is a negotiation between the company and its key executives, each side having very different interests. Boards need to be prepared to negotiate compensation packages. That requires selecting board members, especially those sitting on the compensation committee, with appropriate expertise in compensation and negotiating. It requires educating board members on the compensation issues facing the company and the alternatives available to them. Most important, it requires recognizing that there is no one simple answer to how best to compensate key executives. The board has to take into account the specific needs of the company and the circumstances of the executive and then ensure that the compensation package that is actually negotiated provides rewards to the executive consistent with the company's performance. D

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