Geneen on executive pay

Boards must show more gumption in evaluating the CEO's performance. Here's how we could make the current system work better. **BY HAROLD S. GENEEN**

YOU HAVE TO ask, What are corporations paying those megamillions for? The solemn answer comes back from the board of directors: "Demonstrated capability." But if the company is doing well, surely the CEO's predecessors deserve some credit. I propose breaking up Fortune 500 chief executives' pay, giving one half to the incumbents and splitting the other half among his demonstrably capable predecessors and their heirs.

Absurd? Of course. That's the point. At the moment, there is no logic in these things. The size of the pay package is dictated by habit. To be sure, most companies will hire consultants to advise them on an "appropriate level" of compensation, but all they do is tote up what everybody else in the industry is making and recommend that their clients pay roughly the same. They are, after all, eager to please their clients' bosses. As I said, it's a matter of habit.

This also leads to a steady escalation in the size of compensation packages. Are CEOs worth their paychecks? If so, by what standards? Who sets the standards? Who enforces them? To what extent does dumb luck decide the total?

All good questions — and ones that can't be answered by outbursts of moral indignation. To say that "no man is worth $203 million" (what Michael Eisner reaped in 1994 at Walt Disney Co., mostly from exercising options) isn't a reasoned argument. It is a value judgment. It fails to account for accidents of circumstance. And once we let our gut reaction to supposed excesses guide our social policy, we will be well on the way to socialism.

I have a suggestion. Why not just use logic? To start off, why not ask: What is excessive? There should be some measure of reasonableness. You have to set some objective standards for measuring worth. Otherwise, all you get is hot air. One critic says, "This is unfair. Who can be worth that much?" And the CEO's defenders retort, "That's the price of genius."

If I had to choose, I would err on the side of paying too much for proven performance. It's a risk, but it's a smart risk. However, I would ask a lot of questions: Was the performance really as extraordinary as everybody seems to think? Against what odds did he achieve it? How did the company's profits and stock price stack up against others in the same industry?

Unfortunately, most boards don't delve too deeply into the methodology of calculating the true worth of performance. Doing so might ruffle feathers. Much easier to follow the practice of posing two simple questions to the CEO: What did you make last year? And what should your increase be this year? (I'm oversimplifying, of course. Boards deliberate the question of the CEO's pay with great solemnity. Then, nine times out of 10, they approve a double-digit raise.)

'What are you worth?'

Only when a company is desperately seeking a *new* chief to put its house in order does the question become: What are you worth? Unfortunately, in such a crisis, the rigorous analysis that would make sense in ordinary times becomes irrelevant. All the probing of the candidate's strengths and weaknesses boils down to a single question: Can he save the company? If the answer is "no," he is worth nothing. If the answer is "probably not," he is worth nothing. If the answer is "maybe," he is worth nothing. If the answer is "probably," he is worth nothing. Only if the answer is "yes" is he worth even a penny. But in that case, he is worth pretty much whatever he asks.

It all goes back to "true performance." The board of directors' problem is to identify the who, the how, and the why.

While it would be a mistake to assume that the number of prodigies capable of running a big corporation is so small that boards have no choice but to pay them $5 million or more, it would also be a mistake to shrink from paying *whatever it costs* to get the best. After all, it is the most important investment a company ever makes. So important, in fact, that the question shouldn't be: How much does he, or she, cost? The main ques-

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tion is: How do we know he really is the best?

Of course, financial reality always places an upper limit on what any company can pay. Lou Gerstner couldn't have demanded a salary of $100 million. A $10 million maker of organic baby food can't pay some Harvard-educated whiz kid $2 million to turn it around. But as a general rule, I'd argue that boards should focus on how, not how much.

That's what we did at ITT, and it paid rich dividends. In addition to going through the obvious motions — looking at the candidate's record, talking to his previous employers and their directors, seeking out the opinions of his old high-school and college teachers, and of course, interviewing him — we put him through a rigorous psychological review, using standardized tests.

Maybe all those options don't spur people on to better performance, as is widely believed.

When I say rigorous, that is what I mean. We had a small department of trained industrial psychologists who conducted the tests and drew up profiles on the job seeker based on the results. Then we brought him in for yet more interviews, using our knowledge of his psychological makeup to probe even deeper into his character and motivation.

Tough? Sure. But it worked. It was our secret weapon. It enabled us to identify the cream of the crop. At a conglomerate that was growing as fast as ITT was, we needed the best of the best. And we got them by offering salaries that were 10% above the industry average. That motivated them to join us instead of somebody else, and to work harder than they otherwise might. Money well spent. It gave us a real competitive advantage.

Curbs on CEO remuneration have been suggested. For example, boards could decide that in no given year should the chief executive be able to collect more than three times his combined salary and bonus in stock–option gains. But the board still must decide what he is worth — and pay him that and a little bit more.

In other words, it may make sense to set guidelines, but not to dictate ceilings. There has always been a rule of thumb that a company shouldn't have more than 10% of its shares outstanding represented by options, for example. And 10% is high. Yet, more and more companies are breaking the 10% threshold.

In fact, 10% is now the national average, three times the level of the 1970s, and almost all of the options often go to a dozen or so people at the very top. As of 1995, Time Warner had set aside 20% of its stock outstanding for option plans. Upon acquiring Turner Broadcasting System, Time Warner said it would award Ted Turner 2.2 million options over four years. Ultimately, that could reap Mr. Turner tens of millions of dollars. His risk? Zero. Also in 1995, H.J. Heinz's Anthony O'Reilly received 4 million stock options, in addition to the 750,000 he got in 1994, all priced *below* the market. (His contract did state his eventual take couldn't exceed $125 million.)

There is nothing wrong per se with breaking the 10% rule of thumb. There is nothing wrong with paying an executive whatever it takes to hire him and keep him. I'm not even sure I'd approve of the limit on Mr. O'Reilly's compensation. The goal should always be reward for performance, and mathematical formulas would obstruct that.

To the moon

Compensation consultants tell corporate boards: "You're not out of line with other companies in your industry." But this thing just keeps drifting higher and higher. You can collectively get to the moon and still not be "out of line." Being in line or out of line is relative. So it isn't so much how much the CEO is earning as whether or not his compensation is out of kilter with the company's performance.

And yes, it's legitimate to consider the impact on company morale if the top guy is getting $20 million and blue-collar workers are struggling by at $7.30 an hour and worried about the next round of layoffs. The workforce feels disconnected from the 0.2% who run the show. They don't think the higher-ups are in the same world.

They can do some math of their own –– like figuring out if only 10 of them, out of 10,000, earned the same kind of money, the company would go bust. In reality, they are thinking mostly in their own terms — what do I think I am entitled to? Am I getting it? Is my pay better than last year? Is my job secure? Can I expect a promotion? Pretty simple. It's when the answers to these questions come out "no!" that employees start looking for somebody else to blame. Again, it's a matter of the company's performance.

In bad years, CEOs might find it hard to justify enormous pay packages for themselves at the same time they are laying off thousands of people. Even if the guys before them caused the problems, they ought to be aware of the discrepancy and consider ways to share the pain. Perhaps by taking a pay cut.

Otherwise, loyalty becomes a lost cause. Workers begin to lose faith in the system. In their minds, the company becomes "the damn fool company."

Rewarding mediocrity

Options were designed to avoid such situations, because they aren't supposed to be worth much unless the company really is doing well. While I support the idea of rewarding performance, I think the current system should be reformed so options don't reward the fluctuations of the business cycles, or chance economic disturbances, or the momentum created by the CEO's predecessors.

Right now, they often reward mediocrity or worse. And I feel compelled to note a minority viewpoint that is anathema to many: Maybe all those options don't spur people on to better performance, as is widely believed.

I myself have conducted numerous studies on the subject, and found that linking pay to performance increases long-term

shareholder return. But it is not the only factor; it is not even necessarily the main factor.

Moreover, the linkage must be designed effectively. Performance must be measured in *profit per share over an extended period.* Options must be linked to that performance. If you do that, there is no way that they won't affect performance.

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To the uninitiated, options might seem complicated. Here is how they work. The compensation committee informs the CEO: "You've done such a wonderful job that we've decided to award you 200,000 options." A dozen or so other senior officers get lesser grants. An exercise price is set, usually at the stock's market price on the day of issue. And an exercise period is set, typically 10 years.

Here is the advantage for the company: Options don't cost it anything! The profit that the executives make is essentially skimmed off the top of grateful shareholders' stock gains because the newly created shares dilute their holdings. (Few understand this, of course.) And there is no downside. If the stock price languishes, or sinks, the paper in the bank is worthless. But even a CEO who bumbles the job loses nothing. In some cases, the board will feel sorry for the guy and actually reset the exercise price downward for him and all. Will they reset the price if the stock goes way up? Never.

There's a discrepancy there, even though the purpose is to get the job done. If a company's stock tanks along with the broader indexes, you can bet the CEO will point out that "it's the market." But when the broader indexes go up, you won't hear him say, "It has nothing to do with me. It's the market."

The corporate CEO likes things the way they are. If the market goes down, he often gets more stock options, plus an alibi for his stock's poor performance. If the market goes up, he gets credit for his stock's surge, and maybe a great cash payout. That is, if he has done everything else right.

Reforming the system

How could we make the current system work better? Here are some ideas:

Relate the option's exercise price to the broader swings of the market, which the company cannot control.

A chief executive should be rewarded for outperforming the market, not coasting on it. If the Dow Jones Industrial Average doubles and his stock goes up by only 50%, he is clearly lagging. There is no reason why he should get a large unearned windfall. Similarly, if the Dow tumbles by 50% and his stock only slips 25%, he has excelled. He should get a compensatory adjustment in the price.

Perhaps the exercise price should be readjusted every three months in tandem with the broader market. Thus, if the Standard & Poor's 500 index, say, gains 10%, the exercise price of $20 should go up to $22. If the index falls 10%, the exercise price should go down to $18. The real progress of the company would easily be measured by its cumulative gain from the adjusted award-cost amount.

This is a commonsense proposal. The board's attitude would be: We're here to pay you bonuses on performance, not bonuses based on the Fed's interest-rate policy or the twists and turns of the business cycle.

In the five years ended in 1994, H.J. Heinz's stock fell behind

18 years, $2 million

I myself made some money on options. It was nothing like some of the modern-day bonanzas. I actually exercised the ones I received on joining ITT at an early date and financed the purchase myself. Even though I had 10 years to cash them in, I felt that as CEO I had the responsibility to shareholders to take the same risk they were taking. I also believed in ITT, and believed in the way I was running it. So I borrowed $2 million from several banks to pay up front for those shares because I wanted to be a stockholder, not an option holder.

Unfortunately, when I left ITT in 1977, sky-high interest rates of over 20% and rising oil prices weighed down all stocks. By the time I paid off my debt to the bank, I was ahead only $2 million. That was my payback for 18 years of building ITT into one of the great companies in the world. It was just bad luck — and one reason why I think option prices should be related to stock market trends.

But on the bright side: If I had gotten $12 million instead of $2 million, maybe I wouldn't have worked so hard after leaving. With $12 million in the bank — $36 million in today's dollars — even a workaholic might get a little lazy. But I would do the same thing again, and exercise my options early, and for the same reason. A leader has to share risks. A leader has to lead. Besides, I didn't need a huge retirement nest egg because I had no intention of retiring.

Harold Geneen: No bonanza upon retiring from ITT.

the S&P 500. Yet Mr. O'Reilly, the chairman, made $37 million from exercising his options in the same period.

A few companies take a tougher approach. Colgate-Palmolive, for example, gave its CEO, Reuben Mark, 1 million shares of stock in 1993, exercisable at 10% above the market price at the time but then at higher and higher levels in future years. In 1996, Monsanto created four sets of options, with varying exercise prices. Devised when the stock was trading at $116, the plan allowed executives to purchase shares at $150, $175, $200, and $225, with the cheapest options expiring earliest and the most expensive ones expiring after only six years, instead of the usual 10. In addition, the top executives had to buy stock at market value with money borrowed from the company at full interest.

Spread the options' payoffs over a longer period.

One of the flaws of the current system seems to be that options are leveraged off short-term results. That encourages the CEO to do all sorts of things to pump the stock price up, even if the long-term impact will be negative. This is especially a risk if he has to retire before his 10-year exercise period is cut short.

For example, he might act to raise dividends excessively. It'll hurt the company's long-term health by funneling profits to shareholders that might otherwise go into research, equipment, or just a cash cushion against emergencies or downturns in the business cycle. But the stock will go up near term. Or he might spin off divisions or split the company up, both dramatic moves, and both irreversible. Will that increase the company's worth? Or will it merely jack up the stock price — for a short period?

The average CEO's stint is about five years. And the company has a whole bunch of guys lined up to replace him. I would say that he should get some grace period of, say, four years beyond his retirement date to cash in his options. That would motivate him to strive to improve long-term results. It would also encourage him to seek out a talented successor — even one who might outshine him.

Otherwise, you couldn't blame him for thinking, "I'm going to run this show damn careful, boy. We're not going to take any unneeded risks. I have a million dollars coming to me. I can lose it by doing something magnificent for the company that might also be detrimental to my short-term option gain." The board might even want to stipulate that only two-thirds of the CEO's options can be exercised during his tenure, and the final third after his retirement.

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Introduce penalties for poor performance as well as rewards for sterling performance.

Currently, stock options are a one-way street. There's no downside, only an upside. But even if the current system pays out one dollar per option for every dollar gain in the market price of the stock, one could require the recipient of such largess to pay a more modest sum, say fifty cents on the dollar, for stock-price declines. We could call this the "exercising price" of the option to reflect the fact that a lot of corporate honchos would get pretty exercised if it were implemented.

While options represent the most obvious target of reform because they can create the instant pots of gold that some pundits have found so "obscene," other parts of the compensation package are also ripe for critical scrutiny.

Bonuses, for example. Many boards pay hefty bonuses, and if they are tied to performance, they are earned. But perhaps they should be scrutinized more closely to make sure they don't reward mediocrity. Take a look at the prospectuses of any 10 companies whose performance was average last year for their industry. You'll find that most or all of them paid their top people very respectable bonuses. It sort of resembles the tipping habits of some restaurant goers: They automatically give their waiters 15%, and only withhold the extra money for extraordinarily bad service, though they add a few percentage points if they are treated like royalty.

Boards must show more gumption in scrutinizing their CEOs' compensation packages. Yet, this might create tensions, even upset stockholders. So be it. The risk is worth it for the very reason that a tougher stance introduces a healthy element of risk into the CEO's calculations. He'll know that he must work harder and show more imagination or else run the danger of forfeiting a pay increase, forgoing a bonus, even losing his job.

Getting it right

In sum: Tinker with the system, but don't fault it. Above all, the government shouldn't shoulder in with the social engineering solutions. David Ricardo, the nineteenth century economist, got it right 1817: "Wages should be left to the fair and free competition of the market, and should never be controlled by the interference of the legislatures."

The system works well so long as the board of directors does its job and management does its job. Options can be a powerful incentive to performance and reward shareholders at the same time. But they must be an incentive for performance, not a substitute for it.