

WEIGHING IN

Views from Governance and Boardroom Experts

EXECUTIVE COMPENSATION

Heads We Win, Tails You Lose

“A one-time grant of full-value shares provides perfect alignment with long-term ownership.”



Paul McConnell



Jeff McCutcheon

Paul McConnell and Jeff McCutcheon are managing directors of Board Advisory, LLC – (www.board-advisory.com) an independent executive compensation consulting firm providing companies with trusted advice on executive compensation performance and succession planning.

You may contact Paul at (407) 876-7249 or pmccConnell@board-advisory.com and Jeff at (904) 306-0907 or jmccutcheon@board-advisory.com.

It is not surprising the public perceives that executive compensation is a “heads we win, tails you lose” proposition. For the past three decades, executive pay plans have grown like kudzu in a muddy Georgia field. In an attempt to balance performance, competitiveness, risk and rewards we have also increased the complexity of pay. Given our lack of success to date, it may be time we fundamentally rethought this process.

Each year, compensation committees spend a great deal of time determining appropriate levels and establishing incentives to provide executives wealth consistent with expected future investor gains. But the reality is that much of the eventual executive gain is determined by business cycles and the timing of option exercises and stock sales – items essentially independent of the long-term investors' gains.

Recently, there has been a movement to reduce the impact of the timing of sales on executive pay by requiring that executives hold stock received until retirement. This is a powerful tool for aligning executive and shareholder interests, but it only solves part of the problem. In too many cases, the size of annual awards is largely driven by competitive considerations where a specific dollar amount of expected value is used to determine the number of shares or options granted annually. This produces the nonsensical result of increasing the number of shares granted when stock prices decline or decreasing them in response to superior performance.

A better and simpler approach would follow the lead of private equity and venture capital firms,

where executive compensation is largely dictated by individuals with substantial personal capital at risk. In this approach executives would receive a one-time competitively sized grant of full-value shares when hired or promoted. This grant would vest over a long-period of time like a typical career (10 years) or until retirement—based on time vesting and/or by achieving performance goals. No further grants would be contemplated unless a promotion or significant business combination occurred. Thus, we introduce two concepts not frequently used by most companies: 1) one-time grant of full-value shares based on a percent of the outstanding shares of the company (rather than projected value), and 2) long term vesting and holding requirements that ensure management has an ongoing stake in the company.

This one-time grant approach to equity compensation, by definition, has a perfect correlation with shareholder wealth over the same period. In contrast, the competitive annual award process mutes the relationship by annually adjusting poor performers up and strong performers down. For example, looking back at the 10-year performance of companies that are currently still in the S&P 500, we find that about one-third of the value earned from competitive awards is unrelated to changes in shareholder value.

This one-time grant of full value shares approach has a number of other advantages:

- Executive would have an appropriate level of “skin in the game” from day one instead of waiting 5-10 years until cumulative equity awards provided adequate net shares.

- Illiquid full value shares balance risk and reward consistent with long-term investor, TARP and emerging Obama administration pay objectives. Options and other leveraged grants don't have the same element of “loss” to balance risk-taking.
- It would eliminate the need to provide severance if terminated without cause or following a change in control. Contractual vesting of a portion of the shares would provide executives with adequate security in a more shareholder friendly manner.
- When tough economic conditions occur (like we are currently experiencing) reported compensation would be limited to base salary and bonus earned (if any). This would likely show a much clearer link between pay for executives and employees – particularly if companies annually reported the change in the market value of executive holdings.

By eliminating the concept of an annual “competitive” equity award, we will take an important step in changing the public perception that executive pay is a “heads we win, tails you lose” proposition. We believe that by isolating the ownership interest of management as a discrete, contractual incentive, boards of directors can better manage the cash incentives and salary of executives, providing a more coherent and transparent oversight process. If we want executive management to think and act like owners, we should pay them like owners—long-term owners.