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Reining In the Overpaid (and Underperforming) Chief Executive

by William J. Holstein

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Corporate governance expert Nell Minow explains the relationship between outlandish severance packages and the risky financial instruments linked to subprime mortgages.

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The boards of directors of Citigroup, Merrill Lynch, and other financial institutions may have contributed to their massive subprime mortgage–related write-offs by creating compensation packages for their chief executive officers that didn't punish them for failure, says Nell Minow, editor-in-chief of The Corporate Library, an independent research firm that rates governance practices. In fact, this approach to their compensation encouraged them to take undue risks, she says. These CEOs were guaranteed outsized exit and separation packages, regardless of how they or their firms performed. And now that many of them have been shown the door, there is little hope that shareholders or directors could "claw back" any of that pay, Minow says. One important solution, she argues, is for more companies to adopt rules specifying that to be elected, directors must receive a majority of shareholder votes cast, rather than a plurality as is typically the case now (indeed, currently even if a large number of shareholders abstain, a director can be elected with just a few affirming votes). This would raise the prospect that directors could more easily be ousted by dissatisfied shareholders if they grant overly generous compensation packages. William J. Holstein, a contributor to *strategy+business*, talked to Minow in late January 2008 about her attempts to refashion the relationship between boards, shareholders, and top executives.

S+B: In what ways were the boards responsible for the current debacle in the financial-services sector?

MINOW: There were a couple of precipitating factors. One is that the boards weren't paying enough attention. They weren't asking the right questions. And the other is that they were creating executive compensation plans that had the effect of pouring gas on the fire.

You can see how it worked by looking at it in hindsight. All of the CEOs who failed got paid very well. Therefore, the pay plans had very perverse incentives. Yes, the CEOs did receive incentive compensation, but incentive to do what? If the incentive was to essentially offload risks — which is what happened, because the CEOs were pushing much of the risk off to shareholders — then this is what you get.

S+B: It seems that the vast majority of U.S. companies have more independent boards and more effective governance than they used to. So what went wrong in the financial sector?

MINOW: Generally speaking, yes, there have been tremendous improvements. Boards are doing a much better job than they did a few years ago. They're provid-

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ing much more diligent oversight. But in the financial-services sector, I don't think there has been much improvement. In the very first set of corporate governance grades that we at The Corporate Library issued in 2003, Citigroup was dead last, even though Institutional Shareholder Services (another governance ranking agency) was giving them top marks. On paper, Citigroup looked like it had wonderful corporate governance policies. But on the two issues we thought were most important, the board failed abysmally. One was pay for performance — their approach was awful — and the other was how the board responded to the analyst scandal (in which Wall Street firms were found to have falsified positive research about companies in an effort to win investment banking business). Citigroup was the only company in which the CEO was personally involved in one of the most outrageous conflicts of interest and one of the most outrageous breaches of ethics of that period: the incident involving analyst Jack Grubman. [According to investigators, in 2000, Citigroup CEO Sanford Weill asked Grubman, the company's top telecommunications analyst, to raise his rating of AT&T; after Grubman complied, Citigroup won a US$45 million assignment to help underwrite a share sale in AT&T's wireless unit.] As a result of his personal involvement, Weill was restricted in his ability to meet with his analysts without an attorney present. And yet the board did not impose any sanctions on him. That is the definition of a bad board. They didn't know how to respond when the CEO failed.

S+B: What could the boards of financial-services firms have done to help avoid situations like the subprime meltdown?

MINOW: You can't do better than what Warren Buffett said to the people at Salomon Brothers many years ago: "If you lose money for us, we will be forgiving. If you lose reputation for us, we will be ruthless." You make the situation clear by stating your intentions and you back them up in the design of your compensation program. If there's any suggestion of bad behavior, the money goes back to the company. That's the only fair and credible way. Any CEO who won't come in on that basis is somebody you don't want to bet on because he is not willing to bet on himself. The moral of the story is that you get what you pay for. If you tell the CEO he's going to get paid tremendously for short-term gains even if he has an "après moi, le deluge" philosophy, then he's going to go for it.

S+B: Are you now going to push more intensively for reforms in CEO compensation?

MINOW: I don't know how much more intense I can get. I've been pushing for a long time. But I'll continue. I'm enthusiastic because now it's like a perfect storm; three different forces for positive change are coming together at the same time. One is majority voting. I think that's going to be very powerful as it gets widespread adoption. Right now, under the law, a director who is unopposed can get elected with one vote because voters have only two options: to affirm a candidate or not to vote at all. Thus, it's not very meaningful to withhold a vote. But as companies adopt the rule that a director must receive a majority of the votes cast in order to win, directors will know they can be voted out if there are a lot of abstentions. Second, the broker vote change will eventually go through so that actual shareholders, or beneficial holders, will vote for directors. (Currently, in many cases, large brokerages hold shares for individual investors and vote on their behalf without consulting with their clients; frequently, they join management in supporting their board slate and opposing shareholder resolutions.) Third, mutual funds and money managers now must disclose which way they voted on board appointments and resolutions under a ruling by the Securities and Exchange Commission.

We do a "naughty and nice" list every year of who votes for shareholder value and who does not. So that will put pressure on mutual funds to vote more thoughtfully. One way or another, votes are going to become much more meaningful. If compensation committees start getting voted out for signing off on outrageous pay packages, then I think boards will start to do a better job. +

Resources

Nell Minow, Testimony before the United States House of Representatives, Committee on Financial Services, March 8, 2007: This is an excellent summary of her views on CEO pay. ww.house.gov/apps/list/hearing/financialsvcs_dem/htminow030807.pdf

Citigroup Web site: Provides a list of the company's board of directors, which includes many top CEOs and former CEOs. www.citigroup.com/citigroup/corporategovernance/bddir.htm

The Corporate Library Web site: Provides an overview of how this independent firm, founded in 1999, evaluates corporate governance. www.thecorporatelibrary.com/

Institutional Shareholder Services Web site: How the largest proxy advisory firm evaluates companies. www.issproxy.com/issgovernance.html

Merrill Lynch Web site: Provides a list of the company's board of directors. Its board does not include as many high-profile corporate leaders as Citi, but appears to be highly independent.www.ml.com/index.asp?id=7695_8134_8305_6078

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