What's Wrong with Executive Compensation?

A roundtable moderated by Charles Elson

When it comes to rewarding managers, does top dollar really buy top performance? Experts weigh in on one of the most important issues in business today.

At the height of his success, Al Dunlap described in his book *Mean Business* a philosophy of executive compensation that came to hold sway in the late 1990s: "The best bargain is an expensive CEO.... You cannot overpay a good CEO and you can't underpay a bad one. The bargain CEO is one who is unbelievably well compensated because he's creating wealth for the shareholders. If his compensation is not tied to the shareholders' returns, everyone's playing a fool's game."

Today, the dot-bomb, the telecom bust, and the corporate accounting scandals seem to have done for that logic what "Chainsaw Al" did for Sunbeam. The value that many superpaid CEO superstars supposedly created has largely disappeared, and the likelihood of it being recovered anytime soon seems remote. Indeed, the very profits that many of the companies reported appear to have been the product more of auditors' imaginations than of any CEO's strategy for seizing or creating value. On top of all that, a good number of senior executives treated their companies like ATMs, awarding themselves millions of dollars in company loans and corporate perks. It's hard to dispute the idea that executives were somehow corrupted by the dazzling sums of money dangled in front of them.

So what's wrong with executive compensation, and what can we do about it? To explore these questions, HBR and the University of Delaware's Center for Corporate Governance convened a roundtable of compensation experts last October on the university's campus in Newark, Delaware. The 12 panelists represented an extraordinary diversity of viewpoints, from CEOs to investors, from the professionals who advise them to a chief justice who rules on their disputes. The discussion was moderated by Charles M. Elson, the Edgar S. Woolard, Jr., Professor of Corporate Governance at the university. Elson also serves as an independent director at a number of major corporations and heads the Center for Corporate Governance.

–The Editors

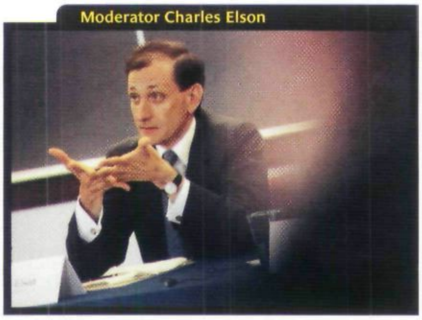
Charles Elson: Let's begin by asking, Is there a problem today with executive compensation, and, if so, how has it come about? Eric Roiter, perhaps you could start by speaking for the shareholders – the people doing the paying.

Eric Roiter: Anyone discussing this topic ought to approach it with humility. It's daunting and complex. I think we can all agree that we ought to pay for performance. We ought to try to align senior executives' interests with the company's longer-term interests by, for example, requiring the ownership of real stock with extended holding periods. And we ought to introduce some downside risk into compensation packages. But while we all can agree on such steps in theory, it's the execution that bedevils us.

There are three related avenues we could try. One approach is to attempt to devise a substantive test for what constitutes reasonable executive compensation. The test might be based on benchmarks for peer groups and adjusted to temper the spread between the pay of the most senior officers and that of the rank and file. Creating such a test would be a very difficult challenge, partly because it would depend on finding better standards than we have now for tying compensation to company performance. An alternative approach, which de-emphasizes a "substantive" reasonableness test, would focus on the approval process for executive compensation within a corporation. That's where we are headed with the recent New York Stock Exchange and Nasdaq proposals, which will require that compensation committees and nominating committees consist entirely of independent directors and that boards consist, at least in the majority, of independent directors. These proposals, I think, hold out a prospect for real improvement in the process by which compensation packages are structured and put in place. Third, since executive compensation is only one of a number of corporate governance issues that companies now face, we need to consider how to foster greater accountability by removing impediments to the market for the transfer of corporate control. We've made it harder for shareholders to join together and shift control of a company by supporting tender offers from outsiders – outsiders who may be able to deliver stronger performance. That, I think, has made the market less efficient than it was 20 years ago. This issue needs more study, but I believe part of the overall answer on executive compensation is to restore a greater liquidity in the market for corporate control.

Peter Clapman: I hope the new stock-exchange requirements help change things, but I'm not counting on it. We're talking about a closed-door process that happens at board meetings, and I don't think we can count on real progress until we're able to influence the private discussions that take place behind closed doors. TIAA-CREF has retained, as consultants, two retired CEOs who also sit on compensation committees of major American companies, and they've talked about the way compensation is actually discussed in the boardroom, based on their informal discussions with compensation consultants. Here's what they told us about the process. Let's say a board is discussing whether to award the CEO options on 2 million shares. During the conversation, somebody points out that the options aren't going to be an expense, so they won't cost the company anything when they're granted. Someone else picks up on that and says, "In that case, why not give the CEO options on 4 million?" I think a lot depends on getting a better, more informed, more independent person into that compensation committee room.

Jamie Heard: The system of checks and balances that we depend upon to make sure we have good corporate


Moderator Charles Elson

PETER OLSON

The panelists (in order of appearance)

Eric Roiter is a senior vice president and the general counsel of Fidelity Management & Research Company.

Peter Clapman is a senior vice president at TIAA-CREF and its chief counsel for investments. In that capacity, he has spearheaded TIAA-CREF's increased engagement in and influence on shareholder issues.

Jamie Heard is the CEO of Institutional Shareholder Services, which advises institutional investors on corporate governance issues. ISS's recommendations are often seen as material to the outcome of controversial proxy votes, such as in last year's merger of Hewlett-Packard and Compaq.

Joe Bachelder is the founder and senior partner of the Bachelder Law Firm in New York. One of the country's leading compensation lawyers, he has negotiated contracts on behalf of superstar CEOs such as Larry Bossidy and Lou Gerstner.

John England is a principal at compensation consultants Towers Perrin and the coauthor, with Charles Elson and Dennis Carey, of the 1996 article "How Should Corporate Directors Be Compensated?" in *Directors & Boards*, which pioneered the idea that pension plans for independent directors should be eliminated or converted into retainers paid in company stock.

Greg Lau is the executive director of global compensation and corporate governance at General Motors.

governance has broken down. For instance, you might think that shareholders would get to approve option plans. But many companies have subverted this requirement, and until very recently, SEC rules haven't required companies to disclose the scope or even the existence of option plans that haven't been approved by shareholders. We're in the process of trying to fix some of these problems through legislation and regulation. But the jury is still out on whether all the fixes are going to work. Ultimately, the CEOs of public corporations still have a lot of power over the process, over the selection of directors, over the decisions of compensation committees. Institutional investors need to step up and play a much more vigorous oversight role in corporate governance.

Elson: Let's get the other side's perspective. Joe Bachelder, you represent CEOs. What's your take?

Joe Bachelder: Pay itself is not the only problem. The problem also is how we look at pay. Did you pay too much for your house? If so, what does "too much" mean? Did XYZ Corporation pay too much for a CEO? The fact is, there are markets that determine the prices of such things. If this were 1972 instead of 2002, we would be coming off two decades in which production workers' pay grew faster than CEO pay. Yet in 1972 we were criticizing CEO pay. We were still doing it in 1982. In 1992, a raft of regulations and legislation were directed at reining in CEO compensation. Today we are still discussing it. Much of the current criticism comes from the fact that, as the Conference Board recently reported, nearly 80% of the gain in CEO pay in the 1990s is attributable to stock options. And stock markets did pretty well in the 1990s. Weren't we saying in the 1980s that we should tie CEOs to the market in order to identify them with shareholder value? We got what we asked for. Apart from stock options, CEOs get paid a lot because they are perceived by boards of directors as worth a lot. If you polled the directors of major U.S. corporations, I imagine that almost all of them would say that one of the most important factors in a company's future performance is the CEO.

That said, I think there are ways of improving CEO pay. We can certainly disclose more in proxy statements. We also need greater director independence, though that's not an easy issue. We are dealing with people, by and large, who know one another and have common experiences, and it's not an environment likely to foster a great deal of independence from the CEO among board members. And in trying to create independence, you do not want to create an adversarial relationship. One solution, perhaps, is to have the nominating committee chosen by some mechanism that is completely independent of the CEO. After all, it is the nominating process that really determines the degree of independence in the board and its committees, including the compensation committee.

Elson: Okay, let's say the compensation committee is independent. But if management controls the committee's compensation consultant, then we've gotten nowhere. How do you keep consultants independent from management? John England, you're a consultant. What would you do?

John England: Ten years ago or so, there was a movement to have two consultants. The compensation committee would have one consultant; management would have another. What happened, invariably, is that the consultants duked it out. It was entertaining, I'm sure, but it wasn't terribly productive. Good consulting practice is to provide counsel assuming that we're 51% working for the board and 49% working for management and that we expect to be called into an executive session with the committee, without the CEO, to defend our advice. But in almost 20 years of consulting at the board level, I've only seen a handful of committees regularly call executive sessions with the compensation consultant. I trust that the advice and counsel consultants give wouldn't change, but I do think the corporate governance process could

Edgar S. Woolard, Jr. is a former CEO of DuPont. He has served on the boards of numerous large companies, including Apple, Citigroup, and IBM.

Pearl Meyer is the founder and president of executive compensation consultants Pearl Meyer & Partners.

Brian Hall is an associate professor at Harvard Business School in Boston. He is the author of numerous articles and case studies on executive compensation and incentives. They can be found at www.people.hbs.edu/bhall/ec/.

Hank Barnette is the chairman emeritus of Bethlehem Steel. He is of counsel to the law firm Skadden, Arps, Slate, Meagher & Flom. A leader of the corporate bar, he has served on the Committee of Corporate General Counsel as president of the Association of General Counsel and chairman of the American Society of Corporate Secretaries.

Warren Batts has served as the CEO of Tupperware, Premark International, Mead, and Triangle. As a board member at Sears, Allstate, and Cooper Industries, among other companies, he has chaired or served on many compensation and CEO search committees. He is a member of the board of the National Association of Corporate Directors.

E. Norman Veasey is the chief justice of the Supreme Court of Delaware, the state where most of the leading U.S. businesses are incorporated.

be greatly improved by following the New York Stock Exchange listing rules that the compensation committee must hire, fire, and monitor the payment of the consultant who advises on executive compensation. Having this responsibility might help the committees use consultants more effectively.

Greg Lau: The answer doesn't only lie in better disclosure and processes. The values of the corporation are also very important, and we shouldn't lose sight of that. At GM, for instance, no one would even have thought of giving–let alone asking for–the kinds of loans to executives that we've seen at some of the companies in trouble. Our values would make that unthinkable. I'm not talking about the values of the senior management only, but of the whole organization. In some companies, the entire value system seems to have broken down.

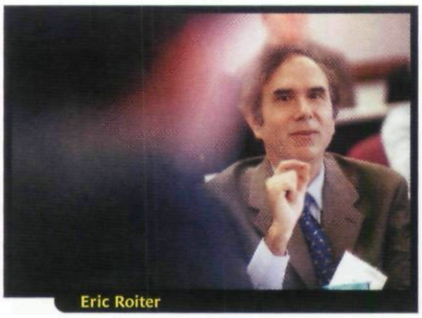
Elson: What do the CEOs themselves have to say? Ed Woolard?

Ed Woolard: Someone was saying to me the other night that trial lawyers are ruining the country, and the wife of one of my friends asked, "Are they any worse than CEOs?" I don't like being identified in that mode. It negatively affects people's respect for business institutions and the stock market. How did we get here? I think we fell for three big myths that I'd like to see exploded. Myth number one: George Melloan recently argued in a *Wall Street Journal* op-ed piece that CEO compensation is driven up by competition for CEOs' services. I do not believe that is true. The main reason compensation increases every year is that most boards want *their* CEO to be in the top half of the CEO peer group, because they think it makes the company look strong. So when Tom, Dick, and Harry receive compensation increases in 2002, I get one too, even if I had a bad year. We stopped doing that at DuPont in 1990, my second year as CEO. We no longer base the compensation of the CEO on what other CEOs are getting. Instead, we use the pay of the senior vice presidents – the people who actually run the businesses – as a benchmark and then decide how much more the CEO ought to get. The CEO isn't going to overpay the SVPs, because he has to make a return on them. So that avoids the upward spiral.

The second myth is that compensation committees are independent. They really are not. They bring in outside experts like Joe and John here who tell them that compensation for the peer group's CEOs has increased. Then the top HR guy, who's usually a stooge for the CEO, says, "By the way, the CEO really would appreciate it if he was in the top end of the range, because it's important that the outside world knows that the board supports him." That's a lot of pressure. I think it's important to get input from consultants and from HR, but it's essential not to let them stay in the meeting when the final decisions are made.

The third myth is that share prices reflect CEO performance. Jack Welch likes to say he deserves all this money because he created $400 billion worth of value. But if all the people who owned stock in GE had tried to cash in and enjoy that $400 billion, it would have crashed the stock. Now 60% of that paper value has vanished along with the stock market bubble. I'm not saying that Jack didn't create a lot of value. Heck, he's the best CEO in the last 50 years–maybe ever. But he should not be saying he created $400 billion of value.

Pearl Meyer: Unfortunately, institutional investors, corporate governance activists, and even SEC regulations have led many corporations to define performance simply as stock performance–to disregard a corporation's vision and, as Greg pointed out, its value system. As a result of all this emphasis on stock price, 60% of CEO compensation today is in stock options. If I add in other elements of pay, 70% in all is stock-based among our 200 largest corporations. That structure stimulates extreme emotions – exuberant greed when things are going well, demoralization when the market falls and everyone's options are under water. John Bogle, who founded Vanguard, said once that we've turned CEOs into casino operators, that it's much easier to hype a stock and push its price up over the short term than it is to build long-term value. Companies have clearly overdosed on options, turning a generation of executives and employees into speculators watching quarterly results and the daily ticker rather than into long-term operators and owners of stock in their businesses. Therefore, I believe that we need to rebalance the elements of executive compensation and tie them more closely to the organization's mission and an-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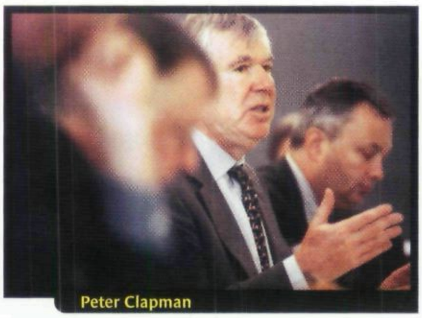
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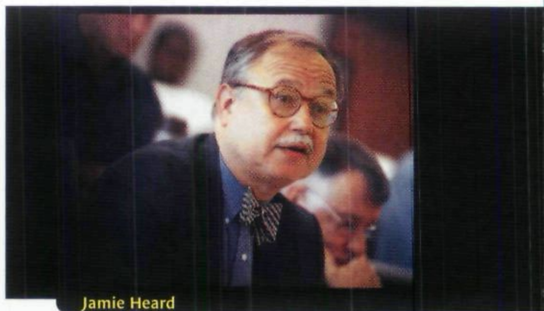
Jamie Heard

nual business performance and to long-term financial results that will create real shareholder value over time. For instance, if a company is going to issue restricted stock grants as a way of making sure executives are owners rather than optionees, the grant should be earned on a performance basis – it shouldn't be just a giveaway.

Elson: Pearl brings us to the heart of the debate. The bulk of CEO compensation today is in options. Jamie, a number of governance activists, including you, used to be fans of options as a way of aligning executive and shareholder interests. What do you say today?

Heard: We've had a very sad and expensive lesson. I don't know how many billions of dollars of wealth have been transferred from shareholders to executives via option plans. We never dreamed that we would see the megagrants of options and the levels of dilution that we've seen. We never dreamed that we'd see the wholesale repricing of underwater options that has been happening. We had a naive faith that compensation committees would and could police this practice. At Institutional Shareholder Services, we recommend voting against more than half the option plans we see, because they either cause too much dilution or end up transferring too many assets into the hands of executives. Far from being an effective motivational device, many option plans have the taste of a gigantic scam.

Clapman: For our part, TIAA-CREF advocates replacing stock options with grants of real stock. There are three reasons for this. First, we've got to link pay to performance. But most stock option plans are adopted for accounting reasons and are not geared to performance. Second, we want executives to hold on to equity positions longer. Executives paid in options can get out of their stock right away after they have exercised their options. Third, we want executives to bear some downside risk, and stock options, in the main, do not do that. I'm not saying that TIAA-CREF wants to eliminate using stock options altogether, but our preference is for real stock, because that's what gives an alignment to shareholders.

Meyer: I don't think we can say that executives don't bear any downside risk with options. The average top-200 CEO last year was paid 60% in options. When 60% of your compensation is in options that might not be worth anything, you are at risk for 60% of your total package. I don't know how *you* would feel about it, but I would be distressed if I were under water in that situation.

Brian Hall: The problem isn't that stock options don't have any downside risk. The problem is that they have so much. They have value when granted and can fall out of the money very quickly and end up worth nothing. Then boards feel pressure to either reprice them or give additional grants to make up the difference – practices we all hate, for good reasons. Stock is much less fragile – it never falls under water and creates no repricing pressures. Stock is also more transparent to shareholders and to the board, which helps them make better decisions. Stock is also more understandable to a lot of executives. There's no need to rely on a highly complex model to understand its value. Accounting rules have skewed compensation awards in favor of options for far too long. Once we start treating options as a real expense, we're going to see a lot more stock and a lot fewer options.

Lau: GM has announced it will expense options, which I agree levels the playing field between different kinds of compensation. I think, though, that there's a place for options, even plain vanilla ones. Everybody struggles with performance measures once they're set, and there are some exceptions. You don't see that with options, except for repricing.

Hank Barnette: Let's go back to basics. Options are just one tool in the compensation kit. Obviously, stock is also quite effective. But whichever you use, it has to be related to the other compensation and business-plan components – the annual plan, the bonus plan, the long-term plan – and they all have to be related to a performance objective. What is it that makes the option vest or be exercisable? What are the disclosure obligations when those events take place? Those are the questions that need to be asked, it seems to me. And the answers will vary, company by company, industry segment by industry segment, because the performance objectives will be quite different. There's no easy answer. A good compensation plan has to be tailored to the circumstances.

England: I, too, was an advocate of using stock options as a long-term incentive. What we should have realized,


Joe Bachelder

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–Joe Bachelder

perhaps, is that options are inherently speculative. When a share price is high, optionees exercise and cash in. That's generally true not just for CEOs but for all employees who receive options. Options tend to be exercised when the share price is attractive, and the action is almost always taken in the expectation of an immediate sale of the stock. Why else would optionees exercise before the term is up? They cash in to buy cars, boats, or houses or simply to diversify their investment portfolios. Options aren't a great way of creating executive share ownership, as many of us mistakenly assumed. We didn't think enough about what might happen after exercise, about requiring executives to hold the shares from exercise throughout their careers. Unfortunately, options became just another form of currency, rather than an incentive to own shares.

Meyer: Companies granting options don't realize they are awarding two rights with their options: the right to exercise and the right to retain the gain. This means you can design options in very different ways. For instance, you can grant an option that has a short vesting period before it can be exercised but then require a further period of service before the executive can retain the gain. This is the old-fashioned restricted stock option. A company could continue its two- or three-year vesting requirement to exercise the option and tack on another two- or three-year or to-retirement period before the optionee can keep the option profits that have been realized – and during that time, the executive is invested in company stock. The executive would not have to pay a tax at exercise, because the profit shares would be restricted or deferred up to time of receipt.

Roiter: I sense there's some consensus here that options have fallen short in aligning the long-term interests of management and shareholders, or at least that they have been a vehicle for abuse. Failures are instructive. Let's go back to the arguments advanced for options. Performance-based measures are very difficult to administer, and executives can always come up with very good reasons why events beyond their control ought not to detract from their pay. The fact that option plans purportedly got around that problem was a big point in their favor. Another reason advanced for using stock options is that they promote–here comes this overused word–transparency. The same argument is advanced for stock grants. What could be more transparent than the stock price of a company that's publicly traded? But I hesitate when anyone promotes transparency as a paramount reason for any particular vehicle of compensation. I would ask: "Transparency toward what end?" I am not dismissing the notion that restricted stock held for a long period can provide an appropriate incentive, but I think we should go back and test restricted stock by the lessons that we've learned from the use of options.

Elson: You get what you pay for, it's often said, and high levels of compensation certainly appear to be associated with the emergence of CEO personality cults. Warren Batts, what do you think? Should we reevaluate the merits of charismatic leaders?

Warren Batts: Well, I've been CEO of four companies. If charisma were a requirement for the job, I wouldn't have gotten a single one of those posts. Charisma is good for the media–it's hard to write articles about boring people. But most CEOs I know are not all that exciting. The short answer is that the movie-star CEO is not nearly as important as the guy who attends to the company's knitting and gets long-term results. I used to be in the paper industry. Darwin Smith, who took over Kimberly-Clark, was the most unpersonable guy you've ever seen. And yet he beat the hell out of Scott Paper as well as P&G in his product lines and left a very strong company. Now that's the kind of CEO I'd rather work with.

"Options aren't a great way of creating executive share ownership, as many of us mistakenly assumed.... Options became just another form of currency, rather than an incentive to own shares."

–John England

John England

Elson: Do you think salaries would come down if you replaced the celebrity CEO with the stay-at-home CEO?

Batts: I think it's a different issue. Back in the old days, most large companies had management development programs. They were trying to develop both functional and general management skills. With the exception of maybe General Electric, nobody's doing that anymore. We're so focused on the short term these days that we don't invest the money in people to encourage them to stay and to move from assignment to assignment. So when the time comes to have a general manager for a group or even the corporation, we don't have a broad base of people to choose from. We're forced to look outside. I'd bet that since 1980, the number of CEOs selected from the outside has increased substantially. But most don't make it – over half the CEOs hired from the outside are fired within the first three years. With that kind of batting average, why would you want to go outside? I've been personally involved with a half-dozen or so CEO searches at Sears, Sprint, Allstate, and Cooper Industries. Most times, we ended up promoting people from within who were not quite prepared for the job, who were not particularly charismatic. And they performed like crazy. The outsiders we could have brought in to fill those jobs have since been failures somewhere else.

Elson: Is boring better, Ed Woolard?

Woolard: I start with what Warren Buffet said: "If I had to bet on a great CEO and a bad business, or a mediocre CEO and a great business, I'd take the great business." A lot of the high-profile CEO hires just haven't been successful, though they've all made out very well financially. Jill Barad went to Mattel, didn't do well, got a multimillion-dollar severance package, and left. Gary Wendt was unable to turn his new company around but received a big financial package. AT&T brought in Mike Armstrong, but he hasn't been able to bring that company back either. I think the celebrity CEO thing is on the way out.

Barnette: You have to look at integrity first, then leadership skills – especially if the person is to lead a team-based organization. Then there's experience and how that relates to the problems of the company and the industry. Only after all that should you look at what some might call charisma, but which I think of as communication skills. That's a relatively new requirement, and it results from the emphasis on public presence and disclosure. With all the public speaking, TV interviews, and so on that CEOs have to do today, the communications focus has intensified, and those who communicate more effectively are more sought after by the media. If a good CEO is naturally charismatic, it will advance the interests of the company he or she leads.

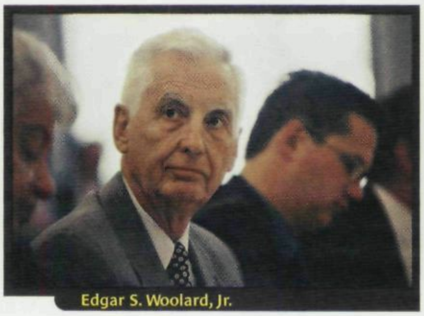
Bachelder: The CEO media villains and their excess pay do not represent the bulk of CEOs. My firm studied about 950 U.S. corporations where the CEO had stayed for at least five years. We found that the median ratio of dollars attributable to cash compensation (salary and bonus) for those years to dollars attributable to option gains (unrealized option spread plus gains realized on option exercises) for those same years was approximately one-to-one. This is not an unreasonable ratio. I would also like to defend the currently criticized Mr. Welch because I had a "feeling in my gut" not long ago that perhaps he had contributed more than we appreciate. When I looked at the numbers, it turned out that he had taken out approximately one-quarter of 1% of the value he added to GE over the 20 years he was CEO. I daresay that if 20 years ago he had made a covenant with the shareholders of General Electric that he would guarantee in the neighborhood of $250 billion to $300 billion in increased market capitalization of GE over the following 20-year period, thousands of shareholders might have been trampled to death in their effort to get him to sign up.

Elson: Where do we go from here? There's a lot of talk about Congress getting involved. Is that a good solution?

Clapman: The business world – if you believe in the private market system – has to preserve credibility with the broader public to reassure people that we can manage the system appropriately. So it behooves all of us here, whether we're on the corporate or the investor side, to make that system work. To my mind, the legislation coming out, the regulation of lawyers and accountants, demonstrates a mistrust of the system. I think the response by the New York Stock Exchange recognized that there was a crisis in confidence. But unless the system can reform itself, legislative reform will happen, whether or not we here think the measures are good public policy.

Roiter: If we turn to Congress or the courts to solve the problem of excessive executive compensation, the cure may prove worse than the disease. Substituting mandatory rules for the discipline of a free market would be, I think, an indictment of our free market system. I for one operate on the presumption that the markets and the corporate governance process can be made to work here, and so I think the emphasis should be on finding a way to bring market forces to bear on the setting of executive


Greg Lau


Edgar S. Woolard, Jr.


Pearl Meyer

compensation and allowing boards of directors, through independent compensation committees, to develop their own standards, subject to the judgment of shareholders. I do think the answers lie in process changes. We mentioned a number of them earlier, such as having compensation committees hold regular executive sessions and allowing them to engage their own independent consultants and lawyers. Strengthening the role of the compensation committee should bring greater balance in the negotiating positions of management and the independent directors. As a matter of fact, much of what we're talking about has been addressed in the context of mutual funds, where each fund has a board of independent trustees or directors who decide on management fees and who can retain independent advisers. That model is not perfect, but it can be made to work. Allowing shareholder approval not only of equity-based compensation but also of the basic structure of pay packages for the officers of the company could also be part of the solution.

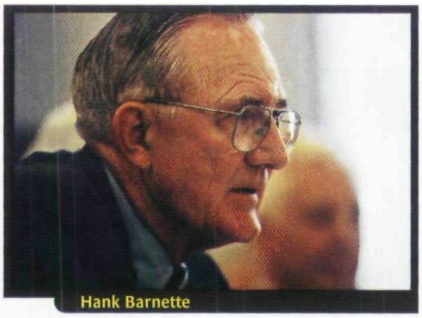
Elson: One regulatory body that has existed forever is the courts. Should we be looking to the courts for guidance on these issues? Chief Justice Veasey?

E. Norman Veasey: I do think the changes in corporate governance that we're seeing through the voluntary best practices codes, for example, or through the New York Stock Exchange listing requirements have created a new set of expectations for directors. And that is changing how courts look at these issues. In particular, I urge you to read our opinion in the Disney case, which ties in with some of the things that have been said here. The case before us was an appeal from a group of shareholders to set aside a ruling of the Court of Chancery that found that Disney's board had acted properly in its termination settlement with Michael Ovitz. Well, as we said in our opinion, the complaint was presented in an awful manner. It was a pastiche of prolix hyperbole – it even had a cartoon. But we felt there could have been something in it. In particular, did Disney's board act in good faith in agreeing to Mr. Ovitz's compensation? Although the company had retained an outside expert, that expert later admitted that the board had never looked at what it would cost to buy Mr. Ovitz out. In the end, we said that the shareholder group's arguments were not good enough to justify setting entirely aside the ruling of the Court of Chancery in favor of the Disney board. We did say, though, that we would be willing to allow the stockholders to file a new pleading.

Elson: That sounds like a fairly dramatic expansion of the good-faith concept, which has been traditionally restricted to some kind of self-dealing. On this seeming change of tack, how would you determine whether or not a board was acting independently?

Veasey: We can't set down rules for independence. In Delaware, we're a judicial body, not a legislative one. Our statute is an enabling one, not a regulatory one. But we didn't just fall off the turnip truck, you know. We can tell whether somebody is acting independently or not. I don't think, for instance, that lawyers who get substantial fees from a corporation can be considered independent directors for most purposes, although they might be for some. And if directors claim to be independent by saying, for example, that they base decisions on some performance measure and don't do so, or if they are disingenuous or dishonest about it, it seems to me that the courts in some circumstances could treat their behavior as a breach of the fiduciary duty of good faith. I would urge boards of directors to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively, not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to them in court from a properly presented complaint. Compensation committees should have their own advisers and lawyers. Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently.


Brian Hall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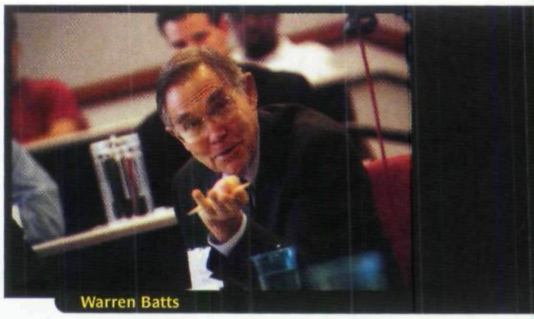
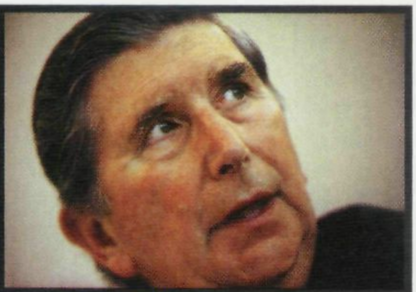

Warren Batts

Elson: Let's shift gears. Until now, we've been focusing on fixing institutions and processes. But maybe the problem is with us. Are we somehow greedier than we used to be?

Batts: I think that by and large, executives try to play by the rules. When Congress passed the Foreign Corrupt Practices Act in 1977, 400 public companies came forward during the amnesty period and admitted that they had been bribing foreign officials to get business. But they cleaned up their act, and today you don't hear about foreign corrupt practices. In 1890, the British economist Alfred Marshall said, "It is a strong proof of the marvelous growth in recent times of a spirit of honesty and uprightness in commercial matters that the leading officers of great public companies yield as little as they do to the vast temptations of fraud which lie in their way."

Woolard: I agree with Warren. Let me quote from last year's DuPont proxy statement. The board says in here that they went through all the appropriate analysis, and they concluded that my successor, Chad Holliday, should receive a 60% bonus for 2001, given the difficulty of the environment. It further states that because of the recession, Mr. Holliday requested that no variable compensation be granted to him or any of his senior leaders. Chad did not think that the organization should see him getting a bonus in this atmosphere. I believe that like Chad, the vast majority of CEOs are honest and want to do the right thing. That said, we still need strong independent directors to hold some CEOs' feet to the fire. Unfortunately, those kinds of directors are hard to find, and some of the few that we have are starting to step down because they don't want the hassle. So I strongly encourage the institutional investors to play a bigger role in this effort.


E. Norman Veasey

"Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently."

–*E. Norman Veasey*

Roiter: I think the unstated assumption of your question, Charles, is that executives should exercise self-restraint. Self-restraint is a good trait, and I'm all for it. But we have to assume that at least a fair segment of the CEO population will not exercise self-restraint. I feel that the moral debate is interesting, but it shouldn't be driving the issue here. Any appropriate structural response has to be based upon an assumption that at least some executives are greedy. I'm reminded of a quote attributed to Babe Ruth at the onset of the Depression. When reporters pointed out that he was making more money than President Hoover, he quipped, "But I had a far better year than President Hoover."

Hall: I agree that relying on self-restraint is not likely to work. Top executives are highly competitive, and one of the things they compete over is who gets paid the most. Back in 1993, when we changed the corporate tax laws, you'll recall that we also required greater disclosure in proxy statements about how much people are paid. The idea was that if we shed some light on the problem, CEOs and boards would get embarrassed and maybe the problem would disappear. Well, if you look at the data, it almost looks as though we passed the CEO Pay Acceleration Act, because pay accelerated almost at once. I think what happened was that executives saw how much other people were making, and they got competitive about it. Self-restraint is a good thing, but I don't think we have any evidence that it can be a solution.

Elson: This discussion brings to mind a Georgia governor's response to a question about conditions in his state prisons. What we need, he is supposed to have said, "is a better class of prisoner."

Bachelder: If I owned a professional football team, I would not want the fullback to go out on the field and exercise self-restraint. Nor would I want a general commanding an army to be self-critical going into battle. I think Milton Friedman put it well when he said one of the biggest risks we face today is that management will cease to want to take risks. And I think not only in compensation but more broadly in examining corporate governance, we must be careful not to diminish the motivation for risk taking and entrepreneurship that drives so many of our corporate leaders.

Veasey: I'll just say that, from the court's point of view, if a company genuinely and in good faith has good corporate practices in place, if independent directors have the guts to make sure those practices are followed, without being adversarial, then we don't dampen risk taking. I trust that at the end of the day, the system will correct itself. If we don't fix it, Congress will, but I hope they've gone as far as they're going to have to go.

Elson: I think it only appropriate that the judge be given the last word. Thank you all for a lively and informative discussion of one of the most pressing issues in business today.

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