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Executives Took, but the Directors Gave

By HEATHER LANDY

LITTLE of the ire against outside C.E.O. paychecks has been aimed at the people who signed off on them: corporate directors.

Instead, the anger has been concentrated on the executives themselves, particularly those running companies at the heart of the [financial crisis](#). And boards — thrust into the limelight only rarely, as when the directors of the [New York Stock Exchange](#) were in a legal battle over the pay collected by [Richard A. Grasso](#) — have managed to stay in the background.

The exchange's board "really took a lot of heat for that controversy," says Sarah Anderson, an analyst on [executive pay](#) at the Institute for Policy Studies in Washington. "But so far, with this crisis, I don't feel like boards have been getting as much attention as they should be."

Last spring, the House Committee on Oversight and Government Reform examined pay practices at [Countrywide Financial](#), [Merrill Lynch](#) and [Citigroup](#), but those issues eventually took a back seat to broader concerns about the viability of the country's financial system. As investors frustrated by the continuing crisis start seeking ways to avoid the next one, advocates of change in corporate governance expect boards to come under renewed scrutiny that could yield big changes.

Emboldened shareholder activists are pressing more companies to hold annual nonbinding votes on executive pay packages. They're also pursuing, and appear increasingly likely to win, rules to make it easier for investors to nominate or replace board members.

And as more people start connecting the dots between pay incentives that boards laid out for executives and the risk-taking at the heart of the financial crisis, some lawmakers have been eager to step in, and many directors themselves are re-examining their approach to compensation.

"When you look at cases where compensation of senior management was out of line, or where people arguably were overpaid, it's definitely the fault of the compensation committee of the board," says Thomas Cooley, dean of the Stern School of Business at [New York University](#) and a director of Thornburg Mortgage. "Congress has gotten into the business of dictating executive pay now, and they shouldn't be in that business. What they should be doing is turning the light on the committees."

Activist shareholders have been criticizing executive pay practices for well over a decade, accusing directors of being too cozy with C.E.O.'s, too eager to lavish pay on them and too ambiguous about the formulas they use for setting compensation.

Improved standards for determining director independence and disclosing the procedures of board compensation committees were supposed to help solve those problems. And activist shareholders played a major role in spreading the notion of pay-for-performance, by which executives would be compensated based on their ability to meet board-devised financial targets.

But amid all the changes, a crucial piece of the equation — the unintended risks that could arise from these pay-for-performance incentives — went unnoticed, said James P. Hawley, co-director of the Elfenworks Center for the Study of Fiduciary Capitalism at St. Mary's College of California.

“The problem isn't just when people in a particular firm are getting rewarded in ways that take away from the shareholder. That's been well recognized,” Mr. Hawley says. “What's not been recognized is that the misalignment of incentives has resulted in firm, sector and systemic risks. None of the corporate governance activists ever made the connection.”

It took the disastrous results of 2008 to expose such links, and to make compensation a central issue for politicians and corporate America.

TWO factors contributed to the pay scales that now have C.E.O.'s earning more than 300 times the pay of the average American worker.

First was the advent of giant stock option grants, a form of compensation made all the more attractive by a 1993 change to the tax law that maintained corporate tax deductions for executive pay over \$1 million, but only if the pay was tied to performance.

Second was the widespread practice of linking pay to the levels at companies of similar size or scope. Every time a board tries to keep an executive happy by offering above-average pay, the net effect is to raise the average that everyone else will use as a baseline.

In the absence of fraud or self-dealing, it's hard for shareholders to make a legal argument that boards have failed at their job. State law in Delaware, where most big public entities are incorporated, simply requires companies to have boards that direct or manage their affairs, and it affords broad legal protection to board members so long as they act in good faith and in a manner “believed to be in or not opposed to the best interests of the corporation.”

That was the basis for the recent ruling of a Delaware judge who threw out most of the claims in a shareholder lawsuit seeking to hold Citigroup directors and officers liable for big losses tied to subprime mortgages. But the judge did allow the plaintiffs to pursue one of their claims, which alleged corporate waste stemming from a multimillion-dollar parting pay package that Citigroup's board awarded [Charles O. Prince III](#), the former C.E.O., in 2007.

While legal protections for directors have changed little over the years, boards have operated under a new level of scrutiny since enactment of the Sarbanes-Oxley law, Congress's answer to the scandals at [Enron](#) and WorldCom. Among other things, this 2002 law strengthened the litmus test for director independence and laid out new responsibilities and requirements for boards' audit committee members.

Now, the furor over executive pay has heightened the profile of compensation committees, says R. William

Ide, chairman of the Governance Center at [the Conference Board](#), a private research group.

“Board members now, even if they’re not on the compensation committee, want to know everything the compensation committee knows,” says Mr. Ide, a lawyer in Atlanta who serves on the compensation committee of the [Albemarle Corporation](#), the chemicals maker. “We’re all revisiting our practices and saying, ‘It’s a new day, there are new practices, are we vulnerable, and is there anything we need to change?’ ”

In March 2008, the staff of the House oversight committee examined pay practices and circulated a memo to members criticizing Citigroup for giving Mr. Prince a cash bonus, millions in unvested stock and options, and other retirement perks like an assistant and a driver. The memo took Merrill Lynch’s board to task for allowing [E. Stanley O’Neal](#) to retire in 2007 instead of terminating him, a decision that kept Mr. O’Neal eligible for \$131 million in stock and options he would have forfeited had he been fired. The memo also raised questions about standards that Countrywide used to set the pay of [Angelo R. Mozilo](#), the former chief executive, alleging that the mortgage lender had switched pay consultants when the board’s approach to compensation was questioned.

The Countrywide board was disbanded when the company was bought by [Bank of America](#), which declined to comment.

The committee plans to question [A.I.G.](#) directors in the next few months about the retention bonuses that caused a recent uproar.

While the financial crisis has again shaken investors’ faith in boards, Kenneth Daly, president of the National Association of Corporate Directors, doubts that Congress will be quick to become involved again in mandating specific duties for boards.

“Did Sarbanes-Oxley avoid the problems we’re in? Absolutely not, and I think the Hill recognizes that,” Mr. Daly says. “But I think you will see legislation that makes it easier for shareholders to remove directors who aren’t doing their jobs.”

Corporate governance activists continue to press for regulations that would make it easier for shareholders to put their own board nominees on proxy ballots. Opponents worry that giving shareholders greater proxy access would be too disruptive to boards, but supporters say the current system makes it too difficult, and too expensive, for shareholders to elect anyone who isn’t on a company’s slate of nominees.

Another development that could shake up director elections is a proposal by the New York Stock Exchange that would bar brokers from casting votes for shareholders who have not provided specific voting instructions. Because brokers typically vote with management, victories for the company’s slate of nominees would be less certain.

“All of this means that directors need to be on the top of their game, and that shareholders will be watching,” says Richard Ferlauto, director of corporate governance and pension investments at the [American Federation of State, County and Municipal Employees](#).

SHAREHOLDER pressure has led to policy changes in the past. In 2007 the board at [Home Depot](#), smarting from sharp criticism over the pay it lavished on [Robert L. Nardelli](#), its former chief executive, adopted several

new procedures, including a rule requiring approval of C.E.O. pay packages by two-thirds of the board's independent directors, instead of a simple majority.

Now, amid the financial crisis, governance activists are receiving a taste of the type of changes that can be ushered in during an era of intense public scrutiny.

In December, [Morgan Stanley](#) announced that it would start holding onto a portion of its employees' bonuses for three years, and potentially withhold the money for good from workers who cause financial or reputational harm to the company. Directors and the chief executive of [General Motors](#) agreed to work for \$1 this year after the automaker sought a taxpayer bailout.

But the concessions from G.M. weren't enough to save the job of [Rick Wagoner](#), the C.E.O., who resigned last Sunday at the request of Obama administration officials. G.M. now plans to draw up a slate of board nominees consisting of a majority of new directors, to present at the company's next annual meeting.

The reshaping of boards also has been a priority at other recipients of taxpayer aid. The boards of [Fannie Mae](#) and [Freddie Mac](#) were almost entirely dismantled in September when the government took over the mortgage-finance companies. Both boards were reconstituted several months later with mostly new directors.

Citigroup, too, is changing its board amid sharp questions about issues like the company's gargantuan balance sheet and the \$126 million in cash and stock paid to [Robert E. Rubin](#), the former [Treasury](#) secretary, for eight years of service as a director of the bank and chairman of its executive committee. Mr. Rubin has drawn attention for the fact that he was lushly compensated even though the bank he helped steward wound up so deeply distressed that it needed a taxpayer bailout to survive.

Mr. Rubin, along with Win Bischoff, the former chairman, and Roberto Hernandez Ramirez, head of the bank's Mexican operations, will not be standing for re-election. Another two directors are approaching the mandatory retirement age. In all, a third of Citigroup's board will turn over this year.

Directors at Citigroup, A.I.G. and other companies that received bailout funds are in uncharted territory, says Dennis R. Beresford, an accounting professor at the [University of Georgia](#) and one of three Fannie Mae directors asked to rejoin the board after the government takeover.

"We don't really have a lot of history to say how boards should operate in these kinds of circumstances," Mr. Beresford says. "The directors are principally serving shareholders, but they would be foolish not to be thinking about the government's interest, and if nothing else thinking about the public-relations aspects of what their companies are doing."

THE public furor over pay and bailouts is helping to make board service a tough sell at a time when so many candidates, particularly sitting C.E.O.'s, already feel more pressure in their day jobs.

Executives and directors are becoming very cautious not only about how they use their time, but also about what liabilities — legal, reputational and otherwise — they're willing to take on, says Ted Dysart, a managing partner at Heidrick & Struggles, the search firm, who helps run its global board of directors practice.

“I think you’re going to see continuing caution,” he says, “because if the anger over executive compensation continues to push its way out, it won’t be long before people start taking out ads with people’s faces on them.”

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