



Corporate Governance

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Most Recent Board Statistics Reveal Significant Changes in Practices and Pay

Boards at U.S. public companies are becoming more independent, appointing more independent leaders, drafting stock ownership guidelines more frequently, making board retainers the most prevalent component of director compensation, and receiving 25 percent more pay than last year, reports IRRC's new *Board Practices/Board Pay: 2005 Edition*.

IRRC annually undertakes a detailed review and analysis of the structure, composition, and compensation of boards of directors among Standard & Poor's "Super 1,500" companies—i.e., companies in the S&P 500, MidCap, and SmallCap indices—in order to identify the latest practices and emerging trends. This year's study includes 1,275 S&P Super 1,500 companies that held annual meetings between January 1 and July 31, 2004. The vast majority of publicly traded U.S. companies hold their annual meetings during this time of the year.

Key findings of study pinpoint the latest trends in board practices and director remuneration.

Board independence

Board independence levels con-

tinue to rise as companies work toward meeting recently enacted U.S. stock exchange listing requirements and the implementation of the Sarbanes-Oxley Act. Average board independence reached a record high of 70 percent, up from 69 percent last year, and 64 percent five years ago. More notably, the percentage of companies with majority independent boards surged to 88 percent in 2004, up from 83 percent in 2003 and 74 percent five years ago. This is primarily due to the enactment of revised corporate governance listing rules at U.S. stock exchanges, which now require listed companies to have the board comprised of a majority of independent directors. Remarkably, for the first time, the utility companies studied by IRRC all have majority independent boards, the only economic sector to achieve that benchmark.

This increase in board independence is largely a result of what appears to be a deliberate change in board composition. Fifteen percent of directors are new to boards in the last two years, and 83 percent of these new directors are independent from the companies where they now serve.

Committee independence

Key board committee independence levels also are on the rise. Nominating committees have undergone the most significant changes over the past year. Average nominating committee independence now stands at 91 percent, up from 87 percent in 2003. More remarkably, the proportion of fully independent nominating committees now stands at 74 percent, up from 57 percent in 2003. Nearly all companies (97 percent) now have a nominating committee in place. In 1999, only 66 percent of companies surveyed had established a nominating committee. Average independence of audit and compensation committees has also increased, although slightly. The average audit committee is 94 percent independent, and the average compensation committee is 93 percent independent. Similarly, 82 percent of audit committees are fully independent, while 81 percent of compensation committees are fully independent.

Board leadership

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past year, with more companies either designating a non-employee chairman or appointing a lead/presiding director. More detail on this issue is available in the article “Number of Lead Directors Surges” on p. 4.

Classified boards

Both in response to shareholder proposals and to keep up with best practices in governance, the trend toward board declassification continues, specifically at large cap companies. For more detail on this issue, see “Large Companies Lead Movement to Declassify” on p. 7.

Service on multiple boards

As in previous years, the vast majority of directors – 67 percent of those at the companies examined—sit on only one major public company board, while less than 1 percent hold six or more directorships. Yet the figures on multiple board service have changed dramatically over the past year. In 2004, the number of directors holding six or more directorships totaled 46, a precipitous drop from the 78 directors holding six or more directorships in 2003. Nine directors currently serve on seven or more boards, another dramatic drop from the 26 who held seven or more directorships in 2003.

Stock ownership

Many shareholders believe that directors and officers should maintain stock ownership in the companies where they serve in order

to align the financial interests of directors and officers with those of shareholders. The increasing importance of equity ownership is apparent: 22 percent of companies studied now have some type of stock ownership guidelines for directors, up from 15 percent last year. In 2004, directors and officers as a group control, on average, 10 percent of the voting power at the companies where they serve. This represents a decline from the 12 percent of total voting power held by directors and officers last year, perhaps due to the less frequent use of stock options and other large equity awards. The decline might also be due to recent board changes made in response to corporate governance reforms – directors generally accumulate share ownership over time, and the increased rate at which new directors joined boards in the past two years may have resulted in the decrease of the average stock ownership and voting power control of directors.

Board retainers and meeting attendance fees

Board retainers remain the most prevalent component of director compensation with 95 percent of study companies using retainers in 2004, up from 93 percent of study companies in 2003.

While board retainers may be paid in cash, unrestricted stock or a combination of cash and unrestricted stock, the overwhelming majority of companies (80 percent)

pay the board retainers solely in cash. Only 2 percent of companies pay all stock retainers, and 13 percent pay a combination of cash and stock. (The remaining 5 percent do not pay a board retainer.) Given the liquidity of annual unrestricted stock grants, IRRC considers these awards to be part of the board retainer.

The median value of board retainers has increased steadily over the past several years and now stands at \$30,000—a 7 percent increase from 2003. Companies with high market capitalization (S&P 500 companies) generally pay board retainers with greater values (a median of \$40,250 in 2004) than companies with low market capitalization. In 2004, median total retainer values for S&P MidCap were \$30,000 and those for SmallCap companies were \$24,000.

While the statistics show a slight decline in the use of board meeting fees over the past four years (from 78 percent in 2000 to 75 percent in 2004), the value of board meeting fees has steadily increased over the same time period. The median value for all study companies now stands at \$1,500, a 19 percent increase from 2003.

Pay for board leadership

With the significant increase in the number of companies either designating a non-employee chairman or appointing a lead/presiding director, the extra fees that these independent board leaders are receiving also is rising. For

Table 1: Total Director Compensation in 2004

	Base Pay		Long-term Pay		Total Compensation	
	Average \$	Median \$	Average \$	Median \$	Average \$	Median \$
S&P 500	\$76,546	\$70,000	\$90,592	\$74,000	\$167,138	\$150,000
S&P MidCap	\$55,320	\$52,000	\$72,259	\$57,420	\$127,578	\$110,317
S&P SmallCap	\$43,548	\$41,550	\$50,045	\$37,115	\$93,593	\$82,090
All sample companies	\$58,138	\$52,500	\$70,063	\$53,955	\$128,200	\$112,791

details, see “More Companies Pay New Independent Board Leaders Extra Fees” on p. 5.

Pay for committee membership and leadership

Companies that pay additional fees for committee service most commonly pay meeting attendance fees to members and retainers to committee chairs. Given the gravity of recent accounting scandals and the enactment of the Sarbanes-Oxley Act, it is not surprising that audit committee members receive more compensation, on average, than other committee members. For example, the average committee chair retainer ranges from \$6,473 for nominating committee chairs to \$9,510 for audit committee chairs. Meeting fees for key committee members do not vary as much, however, ranging from \$1,209 for nominating com-

mittee members to \$1,292 for audit committee members.

Equity grants, options and restricted stock

Stock options are still the most popular award type when it comes to equity grants. At the same time, IRRC statistics show an apparent trend toward companies utilizing restricted stock awards in lieu of (and in some cases in addition to) option grants.

Total remuneration

An increase in total director compensation was predictable given increasing director responsibilities. But, the size of the increase over the past year outpaced expectations: total director pay has increased by more than 25 percent from an average of \$102,369 in 2003 to \$128,200 in 2004. The median total director compensa-

tion also increased from last year by about 25 percent.

Total director remuneration consists of base pay (comprised of retainers and fees) and long-term pay (comprised of stock-based and option awards). While the average value of long-term pay jumped by almost 20 percent over the last year, the more significant increase occurred in base pay, which rose by 32 percent since 2003. This may be attributable to companies' recognition of increased board and committee responsibilities for directors as a result of newly enacted legislation and stricter corporate governance listing standards. Despite the increase in base pay, long-term pay remains the largest proportion of directors' compensation, as can be seen in Table 1 on p. 3.

—Annick Dunning

Number of Lead Directors Surging

IRRC tracked a remarkable surge in companies designating lead or presiding directors in 2004 based on a review of 1,275 companies' disclosures. Specifically, the percentage of companies with lead directors jumped by 25 percentage points, which constitutes an increase of more than 100 percent in just one year. This remarkable rise even surpasses the 14 percentage point increase in companies appointing lead directors that was seen in 2003. In fact, just two years ago only 3 percent of companies named a lead or presiding director as compared to 42 percent in 2004.

The New York Stock Exchange's governance reforms requiring non-management directors to hold regular executive sessions have, for practical purposes, dictated this significant transfor-

mation in board leadership structures. The current rules require that a non-management director preside over each of the executive sessions, although the same director is not required to preside over each one. If one director is chosen to preside at all sessions, his or her name must be disclosed in the company's proxy statement. If the same individual is not the presiding director at every meeting, the company must disclose the procedure by which a presiding director is selected for each session. IRRC considers a company to have a lead/presiding director as long as one person holds the position for at least one year.

Many companies appoint a lead director when the company's CEO also serves as chair, thereby providing shareholders with an independent director who serves as a

conduit of communication to the board. However, even some companies that separate the roles of chair and CEO have created lead director positions because chairs generally have strong ties to the company. In fact, 13 percent of employee chairmen serve in that capacity alone (i.e. are not also CEOs of the company), and 56 percent of separate chairs are considered affiliated. Only 11 percent of separate chairs are independent. Lead directors, on the other hand, are far more likely to be independent—90 percent of current lead directors are independent. Only one of the 30 companies that have both non-employee chairmen and lead directors—Thermo Electron—has an independent director serving in both positions. Thermo Electron elected independent director Jim P. Manzi to serve as chairman of

the board in January 2004, and independent director Elaine S. Ullian has been appointed to preside over the board's non-management sessions.

When companies appoint both separate non-employee chairs and lead directors, the ambiguity of their roles is underscored. At the National Association of Corporate Directors' (NACD) 2003 annual conference, attorney Ira Millstein spoke on the role of lead director

as being distinctly separate from corporate management, and the position of lead director as being an alternative to splitting the roles of chairman and CEO. Millstein suggested that companies separate the roles of CEO and chair, and, in situations where this is not possible, appoint a lead director charged with the jobs of setting the agenda, bringing information to the board, acting as the CEO's coach and confidante, facilitating communication

among the directors, communicating messages to the CEO and overseeing the committees. "I will never understand how the CEO is supposed to do all of these and run the company at the same time," Millstein told conferees. The position of lead director "is not an honorific job and it requires a different talent than running a company," he emphasized.

—*Jamie Carroll*

More Companies Pay Independent Board Leaders Extra Fees

As more companies choose either to designate a non-employee chairman or to appoint a lead/presiding director (see story on p. 4), a growing number of firms are paying directors in these positions more compensation than other board members. IRRC's latest Board Practices/Board Pay study found that 65 percent of the study companies that have a non-employee chairman pay that individual extra fees, over and above those paid to the company's other non-employee directors. This is an 8 percent increase from the 57 percent of study companies that did so in 2003. This extra compensation may be paid in cash and/or various forms of stock or stock options. Seventy percent of the study companies in the S&P 500 index paid

these board leaders extra pay, while 64 percent of the study companies in the S&P Midcap and Smallcap indices did so.

Non-employee chairmen

Although the median value of a non-employee chair's extra fees actually dropped 13 percent overall from last year, to \$64,625 in 2004, the median value of these fees at S&P 500 companies increased 51 percent from last year to \$192,500 in 2004, as can be seen in Table 1. Non-employee chairmen at S&P 500 companies were paid extra fees for their role (an average value of \$308,698) equivalent to more than three and a half times their counterparts in the other indexes in 2004.

The median value of the extra

fees paid to non-employee chairmen increases with higher revenue groups; from \$31,000 for companies with revenues of less than \$500 million to \$111,438 for companies with revenues of more than \$10 billion. In addition, of the study companies that paid extra compensation to their non-employee chairmen in 2004, companies in the Utilities sector were the most likely to pay these fees, at 94 percent. Companies in the Consumer Discretionary sector were the least likely to pay extra fees, at 45 percent. In terms of median value of the fees, the highest was in the Health Care sector at \$109,500 and the lowest was in the Information Technology sector at \$33,058 in 2004. The greatest one-year increase in median value from last

Table 1: Extra Pay for Board Chairman

Group	Total Sample	# of companies with non-employee chairs	Proportion paying extra fees	Median	1 year change
S&P 500	441	50	70%	\$192,500	51%
S&P MidCap	344	74	64%	\$66,000	-15%
S&P SmallCap	490	124	64%	\$50,000	11%
Grand Total	1275	248	65%	\$64,625	-13%

year was in the Financials sector, with a 52 percent increase to \$68,500 in 2004, and the greatest decrease in median value from last year was in the Industrials sector, with a 22 percent decrease to \$60,000 in 2004.

The graph below shows the differential, by S&P index, between the extra compensation paid to independent versus affiliated non-employee chairmen in 2004. The greatest differential in 2004 was in the S&P 500 index where independent non-employee chairmen were paid, on average, \$210,529 more than what was paid to affiliated non-employee chairmen.

Lead directors

A lead director is responsible for coordinating the activities of the nonexecutive directors. At a minimum, a lead independent director helps set the schedule and agenda for board meetings, chairs meetings of the outside directors, monitors the quality and timeliness of the flow of information from management and has the ability to hire consultants to help independent directors perform their duties more effectively.

Table 2: Extra Compensation Paid to Lead/Presiding Directors by S&P Index

Group	Total Sample	# of companies with non-employee chairs	Proportion paying extra fees	Average	Median
S&P 500	441	230	18%	\$33,862	\$20,000
S&P MidCap	344	156	19%	\$24,694	\$17,500
S&P SmallCap	490	153	21%	\$17,628	\$10,000
Grand Total	1275	539	19%	\$26,237	\$19,000

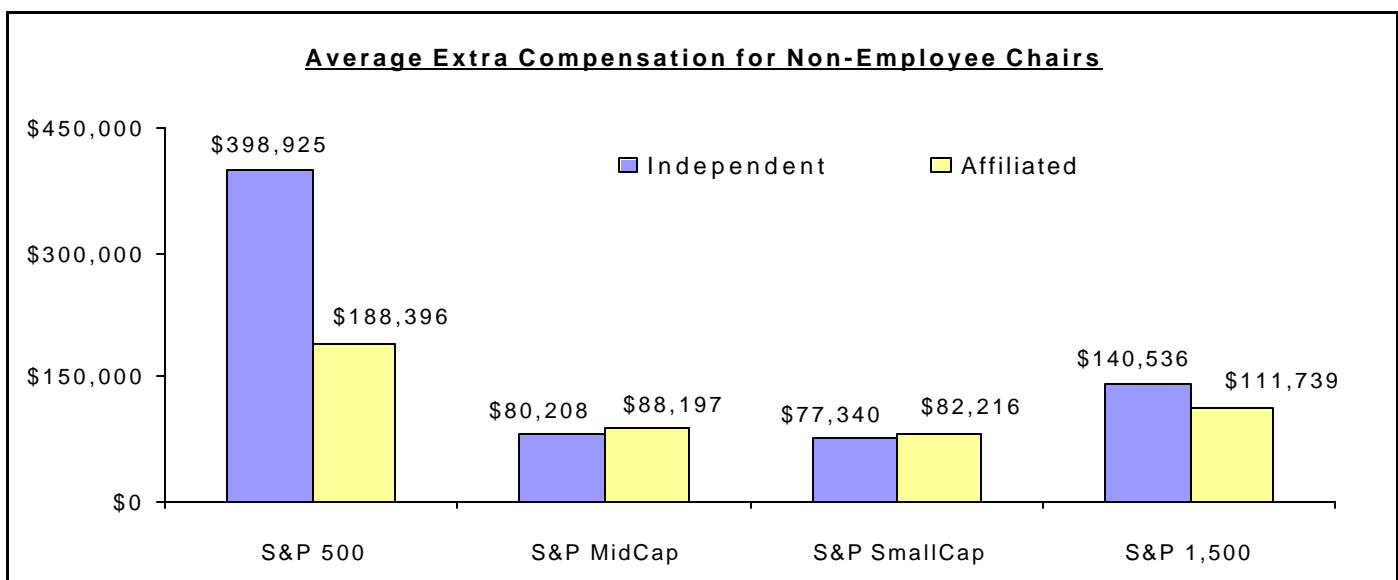
Of the 539 study companies that had lead directors in 2004, 19 percent paid extra compensation to this director, as seen in Table 2. The average value of this extra compensation was \$26,237 in 2004. The median value was \$19,000 in 2004, but was significantly lower for S&P Small Cap companies at \$10,000.

Companies with revenues between \$500 million and \$1 billion are the most likely to pay extra compensation to their lead director, and companies with revenues between \$1 billion and \$10 billion are least likely to do so. On the other hand, among companies that paid such compensation, the

median value was the highest (\$35,000) among companies with revenue of \$10 billion or more, and lowest (\$11,000) at companies with revenue between \$500 million and \$1 billion.

Among the economic sectors, Telecommunications companies were the most likely to pay these fees, with 33 percent doing so. Companies in both the Energy and the Materials sectors were the least likely, with 16 percent doing so in both cases. Companies in the Telecommunication sector paid lead director fees with the highest median value in 2004, at \$30,000. The median was lowest in the Energy sector at \$11,000.

—Robin Cowles



Large Companies Lead Movement to Declassify

In the past six years, large companies have endured the brunt of shareholder lobbying on the issue of classified boards. IRRC has found that from 1999 to 2004, S&P 500 companies faced 199 shareholder proposals to declassify their boards. Shareholders have historically been less inclined to submit similar proposals to smaller companies. MidCap companies faced 38 proposals from 1999 to 2004 and SmallCap companies only faced 14. Shareholder proposals are not only more common at large companies; they are more successful there. In 2004, average support for declassification proposals among S&P 500 companies was 72 percent, compared with 60 percent among MidCaps. (No SmallCap company in IRRC's sample faced a shareholder proposal to declassify in 2004.)

The majority of companies do not put every director up for election every year. Instead, most companies use a staggered system whereby only the members of one

class are elected annually. Typically, members of each class are elected to a three-year term, and members of other classes are elected in subsequent years to terms of equal length. This system preserves continuity by ensuring that, in general, no more than one-third of the board will turn over in a single year. The classified system serves as an anti-takeover device by prolonging the time required for an outsider to wrest control of the board. As such, many shareholders view the classified system as an impediment to maximizing shareholder value and potentially entrenching a poorly performing management. This point of view has become so widespread that shareholder proposals to repeal the classified system now typically receive majority support.

Perhaps because the shareholder movement against the classified system has tended to focus on large companies, IRRC data shows that most of the reform in

this area has taken place at these companies. The graph below, which is based on a sample of approximately 1,200 companies, shows that among MidCap and SmallCap companies, the classified board system actually has a slightly stronger presence now than in 2002, although even at these smaller capitalized companies the prevalence of staggered boards stopped increasing in 2004. The prevalence of classified boards in the S&P 500 has turned downward markedly. At the current rate, the majority of S&P 500 companies will have annually elected boards by 2006.

Shareholder proposals are not the only reason that large companies are choosing to declassify their boards, as indicated in the table on p. 8. Of the 15 S&P 500 companies that repealed their classified boards in 2004, five did not have a history of related shareholder proposals. Some of these companies may have chosen to de-

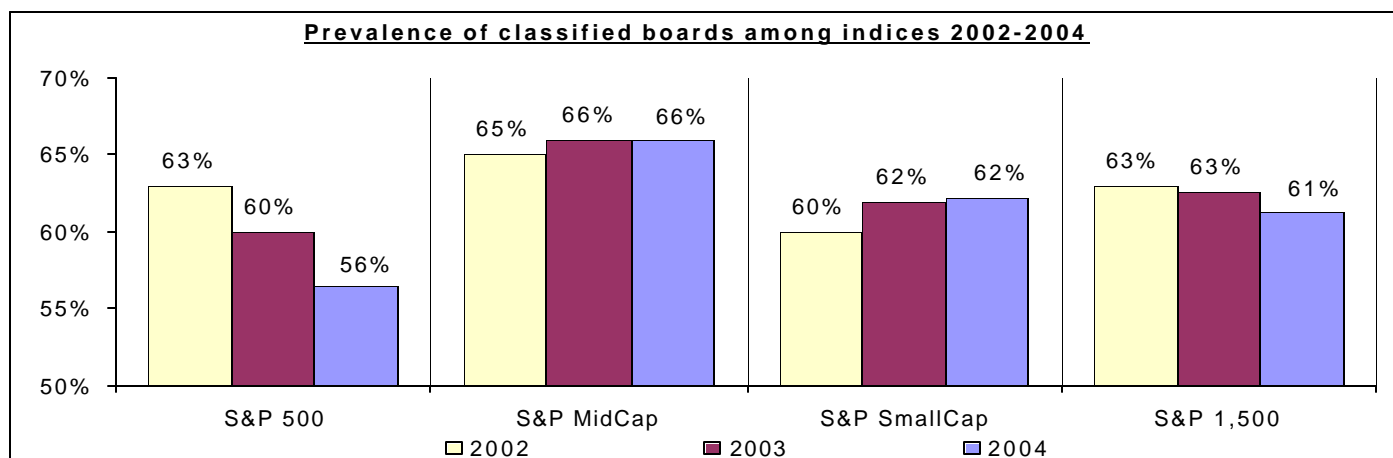


Table 1: S&P 500 companies that declassified their boards in 2004

Company	Number of shareholder proposals (SPs) to repeal classified board
Aetna	No related SPs
Allegheny Energy	SPs received majority support from 2001 to 2004
BellSouth	No related SPs
Bristol Myers Squibb	SPs received majority support from 1997 to 2002
Cendant	SP in 1999 received majority support; management proposals with 80 percent requirement failed in 2000 and 2002, but passed in 2004
Dow Chemical	No related SPs
FirstEnergy	SPs from 1998 to 2003
Lucent Technologies	SPs received majority support from 2001 to 2003
Manor Care	SP received majority support in 2003
Merck	SPs received majority support from 1999 to 2003
Robert Half International	No related SPs
SBC Communications	No related SPs
Safeway	SP received majority support in 2003
Starwood Hotels & Resorts Worldwide	SPs received majority support from 2000 to 2003

classify simply to keep pace with emerging trends in governance. At BellSouth, for example, management submitted its own proposal to declassify the board, and cited that doing so would “further the company’s goal of ensuring that its

corporate governance policies conform to best practices and maximize accountability to shareholders.” As the proportion of S&P 500 companies with declassified boards heads toward 50 percent, observers are anticipating that in com-

ing years, the historical prerequisite for reform—majority votes on related shareholder proposals—may yield to a new era in which boards will assume the initiative.

—Glenn Davis

Responsible Compensation Practices: Tally Sheets and Correcting Past Excesses

Broc Romanek is Editor of CompensationStandards.com, which has 90-plus Task Force members who are among the top “thought leaders” in the area of executive compensation and contribute practice pointers regarding responsible compensation practices.

The increasing scrutiny by the SEC and IRS of executive pay packages and directors’ growing fear of personal liability, which was fueled by the Disney trial, are waking up boards and their advisors to the fact that change is necessary in the area of executive compensation. This is borne out by what The Cor-

porate Counsel believes is record attendance for a corporate law conference that was held in late October on how to implement responsible compensation practices. This conference—and a host of other practical tools and guidance—is archived on CompensationStandards.com.

Putting together the conference was a challenge in itself because initially it was difficult to find expert compensation lawyers or consultants willing to speak out about the fixes that are necessary to undo the excesses of two decades. Eventually we formed an

Executive Compensation Task Force of 90 compensation lawyers and consultants to put together practice pointers for our site.

On the whole, many advisors still appear unwilling to speak out and serve as a moral compass for their clients in the area of executive compensation—but this may very well change because many clients have been exposed to what needs to be done through The Corporate Counsel’s conference and the 12-Step program to responsible practices published in *The Corporate Counsel* earlier this year. For example, Jack Krol, former Dupont

CEO/Chair and now lead independent director at Tyco explained at the conference how he read the 12-Steps and had Tyco implement a number of them because they had “opened his eyes.”

Tally sheets

One of the steps that Krol took to heart was the need to calculate—and tally up—each component of an executive’s compensation. This concept also was just recommended in the updated executive compensation policy for the Council of Institutional Investors. When considering any aspect of a CEO’s (or other senior executive’s) compensation, the compensation committee should start with a sheet that lists each component of the compensation and tally it all.

The concept is basic, but the practice does not appear to be widespread. As made all too clear in the case of former New York Stock Exchange Chairman and CEO Richard Grasso last year, beyond salary, bonus and stock compensation, many boards are in the dark about the quite significant amounts that CEOs are—or will be—receiving through SERPs, deferred compensation, perks and severance payouts that when added up, can easily exceed the combination of salary and bonus.

These numbers have been obscured for several reasons. First, each component is not well understood. Many compensation consultants have confided that these areas are beyond their area of expertise and are handled by other specialists, thus compartmentalizing things so no individual consultant (much less a director) fully appreciates the totality of the pay package. Second, the SEC’s proxy disclosure requirements in this area go back to 1992, when these components (and their potential magnitude)

were not well understood. As a result, the appropriate disclosures for these components that should be provided to shareholders (and, of course, the board) have been largely overlooked. When we spoke to a number of compensation consultants it became clear that tally sheets have been used only sparingly in the past. By posting a number of samples on our site, we hope that this changes.

Correcting the excesses of the past

Of course, the hardest part of the executive compensation mess is fixing the excesses of the past. Most senior executive are locked into lucrative contracts and sitting on mega-grants of stock options. And, the reality remains that compensation consultants, lawyers and other advisors are still paid by the company and can ill afford to alienate the CEO. Even where an advisor is retained separately by the board or compensation committee, the reality is that boards and committees include CEOs of other companies that do not want their compensation to be rolled back. Even newly retained consultants often are reluctant—or can’t afford—to jeopardize their relationships right off the bat.

But, some changes can be made. Although stock options, restricted stock and other similar types of equity are classified as long-term incentive compensation, most recipients treat the cash from selling these shares more as bonuses or windfalls to be capitalized on when the stock price rises. At least for senior executives — particularly where total accumulated stock option and restricted stock gains are substantial — stock compensation should be viewed as solely a long-term vehicle. Indeed, some con-

sultants have said they are concerned that accumulated option and restricted stock gains are not being factored into current compensation decisions at many companies.

At a minimum, the compensation committee should seriously consider requiring top executives to hold the after-tax portion of these shares until retirement so that they truly have a long-term incentive. To avoid unintended effects (e.g., encourage early retirement), retention provisions can require that the shares must be held after exercise or vesting “for the *longer of* X years (the difference between the person’s age at that time and age 65) or retirement.” Compensation committees can take a positive step by implementing this ‘hold-until-retirement policy’ for senior executives, particularly with respect to large outstanding awards. CEOs and boards may find that, in some instances, adding a retirement retention requirement could be a sufficient and more palatable fix than a rollback in compensation.

Another corrective approach is the “internal pay equity check” — following the Dupont and Intel models of checking for “internal pay equity” at various levels within a company to ensure that the CEO’s compensation has not gotten disproportionate. Compensation committees should direct their human resources staff to provide a comparison chart that goes back to the 1980s (when the gaps began to widen) comparing the gaps in compensation levels within the company between the CEO and senior and mid-level executives, down to the rank and file, as a framework to bring the senior executive’s total compensation back into line.

—*Broc Romanek*

Companies Respond to Shareholders by Making Executive Compensation Changes

The wave of corporate governance reform in the last few years changed the landscape of many issues—from board composition and committee make-up to issues related to auditors. Excessive executive compensation was dealt with less directly, but remains an obvious concern for shareholders who voted on 182 proposals related to the issue in 2004. Many companies appear to have gotten the message and have adopted incremental reforms, although often with minimal disclosure.

The issue of golden parachutes makes a good case study of the diverse ways in which companies are responding. At each of the 18 companies where a relevant shareholder proposal passed at the 2003 meeting, the company adopted some policy within the next year. IRRC is tracking nine companies that have amended, adopted or plan to adopt policies as the result of shareholder proposals in 2004, but under a wide variety of circumstances. The filing of a proposal remains the opening salvo of this process, but there are many variations in what happens next as companies and proponents appear to seek a middle ground that will satisfy management and shareholders. In some cases, proponents were satisfied with what the company adopted, and withdrew their proposals before a vote. This was the case in 2004 when proposals were withdrawn at NSTAR and United Rentals by the Amalgamated Bank's LongView Funds and at PMC Sierra by the International Brotherhood of Electrical Workers, for example.

Some policies fall short, say proponents

In other cases, the company adopted a policy and disclosed it in its proxy statement but either did not seek or did not succeed in having the proponent withdraw the proposal. Entergy disclosed in its proxy statement that it had implemented a policy prohibiting the company from entering into employment or severance agreements with a senior executive, without shareholder approval, that provide for cash or stock payments in excess of 2.99 times that executive's base salary plus annual incentive award. The company said that if the board amends, waives, or cancels the policy, its terms require prompt disclosure of the change. The company also amended its retention agreement with CEO Wayne Leonard on March 8, 2004. His agreement now states, "in no event will the cash severance payment exceed 2.99 times the sum of Mr. Leonard's base salary and applicable annual incentive award." The board did not issue a recommendation on a shareholder proposal seeking such a policy, and the proposal passed with the support of 54.4 percent of the shareholders voting.

An AFL-CIO representative told IRRC the policy should go further, and said, "The limits in Leonard's new employment contract do not appear to include accelerated retirement benefits or vesting of stock options, which we believe should also be subject to the 2.99 limitation." Accelerated retirement benefits can indeed be a significant portion of an executive's

exit package, as was evident in information included in Entergy's proxy statement about another departing executive. Most of a payment made in 2004 to retiring Senior Vice President Frank Gallaher was comprised of accelerated retirement benefits. Gallaher, whose average annual compensation for each of the last three years was less than \$1 million, received a \$775,568 severance benefit paid in 2003 based on his employment agreement, in addition to a lump sum distribution made under the System Executive Retirement Plan of \$6.3 million.

In another case, at AMR, the board adopted a policy, effective on the date of the company's annual meeting, that requires shareholder approval for future agreements exceeding two times salary and bonus. The policy is more stringent than many that have been adopted by other companies, which more frequently use 2.99 as the multiple. Many shareholders seem to have been satisfied with the company's actions. The proposal was supported by only 27.7 percent of votes cast, well below the average level of support of 51.8. In other cases, companies adopted policies as a result of shareholder approval of proposals in 2003, but the proponents were not satisfied with the new policies. At Massey Energy and at Verizon, proponents responded to what they saw as lackluster policies by submitting binding bylaw proposals. Verizon ultimately negotiated a settlement with the proponents that

expanded the list of items to be included in determining whether a package exceeded the defined threshold, and the proposal was withdrawn.

The LongView fund resubmitted a proposal at Massey Energy because it was dissatisfied with a caveat in a policy adopted by the company that specified it would be followed only when it was in the best interests of the company to do so. LongView objected to this loophole as vague and likely to undercut the principle of a shareholder vote. The binding proposal went to a vote in May 2004 and was supported by 69.9 percent of votes cast, the highest level of support earned on a binding resolution on any topic in 2004. The proposal did not pass because the required level of support was 80 percent of votes outstanding. In October 2004, however, the company announced that it would not approve severance agreements that provide for benefits exceeding 2.99 times base salary and bonus without first seeking shareholder approval. In a company press release Admiral Bobby Inman, chairman of the compensation committee, said, "The board has decided to follow the direction of the majority of its shareholders in regard to this issue."

"We are pleased that the Massey Energy board has responded to the new policy in the shareholders' vote and adopted a new blanket policy governing severance agreements with its senior executives. By taking this step, the board is aligning its severance payments policy with the consistent recommendation of Massey shareholders," said Melissa Moyer, Chief Economist of the Amalgamated Bank's LongView Funds' Trust & Investment Services Group. "We hope that the recent policy change

reflects a trend at Massey Energy toward greater responsiveness to shareholder' concerns about appropriate executive compensation."

Other substantive changes

In other cases, proposals went to a vote and passed for the first time in 2004, and, consequently, policies were adopted. Corning adopted a policy in July 2004 that it will not approve severance benefits entered into after July 21, 2004 that

"By taking this step, the board is aligning its severance payments policy with the consistent recommendation of Massey [Energy] shareholders," said Melissa Moyer.

provide benefits more than 2.99 times salary and bonus without first seeking shareholder approval. Lucent Technologies adopted what may be one of the most clearly delineated policies. The policy, available at <http://www.lucent.com/investor/severance.html>, lists items included in the definition of severance benefits—including gross-up payments, additional credit granted under retirement programs, consulting agreements of more than one year, the value of some accelerated vesting programs, and the value of perquisites. Excluded from the severance benefits calculation are retirement benefits already earned or accrued. (More information on all of these

policies will be included in IRRC's Background Report on Golden Parachutes, scheduled to be published in January 2005.)

American Electric Power's human resources committee also has approved a policy that will be voted on by the independent board members at an upcoming meeting. The policy says the company will not award severance benefits more than 2.99 times current salary and target bonus without first seeking shareholder approval. The proposal, which passed at 10 additional companies, is currently being considered by boards at other firms.

Other executive compensation reforms also were adopted this year as a result of shareholder proposals. Several were adopted in response to the "common-sense executive compensation" proposals.

Another executive compensation proposal filed at AT&T asked the company to stop using pension fund surplus earnings to generate executive bonuses. AT&T adopted the proposal, agreeing that it was a "best practice" and the proponent withdrew the proposal. Calpers filed a proposal at PeopleSoft seeking increased use of performance-based compensation, but withdrew it when the board agreed to base 50 percent of the options and restricted shares given to its CEO Craig Conway and the four other highest-paid company executives on performance targets set by the board. A proposal on restricted stock at Eastman Kodak was withdrawn after the company issued new corporate governance guidelines that included agreeing to expense options, adopting new board independence standards, implementing a new director selection process and adopting a director code of conduct.

—Rosanna Landis Weaver

Belgium, Norway and Sweden Adopt New Corporate Governance Codes

Belgium, Norway and Sweden all adopted new corporate governance codes in December.

The draft of the Belgian code was presented in June 2004 and was open for comment until September 15. The Corporate Governance Committee received more than 300 pages of comments and published a summary of changes to the original draft. In early December, Committee Chairman Maurice Lippens gave it to Belgian Prime Minister Guy Verhofstadt. Compliance with the code is voluntary but the committee has opted for a combined monitoring system that relies on shareholders, the Belgian Banking, Finance, and Insurance Commission (CBFA) and corporate boards. The code is comprised of three levels: principles, provisions and guidelines. Under the code, all companies must adhere to nine principles, which, among other things, call for transparent management structure, a focus on the interests of the company, fair and responsible remuneration for directors and executives, disclosure of such remuneration and respect for the rights of shareholders. The provisions define how the principles can be put into practice. If a company chooses not to comply with a provision, it must explain why, but it will not have to offer such an explanation with respect to guidelines, which are more qualitative in nature. The guidelines provide guidance as to how companies should implement or interpret the provisions.

The code went into effect at listed Belgian companies on Jan. 1, 2005. It recommends

that corporate governance be an item on the agenda at AGMs in 2005 and that 2005 annual reports include a separate corporate governance chapter. As of Jan. 1, 2006, companies must make public a Corporate Governance Charter outlining their corporate governance structure and policies.

With respect to monitoring and compliance, Chairman Lippens commented: "First the board of directors must ensure that the corporate governance charter and corporate governance chapter in the annual report are accurate and complete. Then it is up to the shareholders to evaluate carefully the company's corporate governance policy. If the company deviates from the provisions set out in the code, it is their [the shareholders'] duty to find out why and assess those reasons, taking account of the company's specific characteristics. Finally, the CBFA will verify the observance by the companies of the 'comply or explain' principle."

The full text of the code, including its appendices, and an overview of the results of the public comments can be found at: <http://www.corporategovernancecommittee.be/en/home/>.

The draft Norwegian Code of Practice for Corporate Governance was presented in December 2003, and the Oslo Stock Exchange published the final version on Dec. 7, 2004.

Oslo Bors Circular NO 8/2004 presents guidelines for implementation of the Norwegian Code of Practice for Corporate Governance. The guidelines are self-

regulatory and were created by a working group of shareholders, companies, and the stock exchange. The group reviewed responses collected during a comment period that closed in May 2004.

The Norwegian code is based on the "comply or explain" principle: companies must produce reports on corporate governance each year and include these in their annual reports. Norwegian companies and other firms listed on the Oslo exchange must apply the new Code of Practice beginning in fiscal 2005. The 2004 reporting year will be a transitional period and the Oslo Bors Circular recommends that companies either follow the provisional code of practice published in December 2003 or the final version of the Code of Practice released Dec. 7, 2004. The exchange is also considering changes to the listing rules to require a corporate governance compliance report be included in all applications for listing.

The code also requires that at least half of a company's board be independent of executive management, the company's core business connections, and that at least two board members are independent of large shareholders. Companies should set up a nomination committee, which will have the authority to nominate candidates to the board and to propose remuneration packages, to be elected by shareholders at the AGM. Norwegian company law stipulates that at companies with more than 200 employees, one third of the board must represent employee interests.

The final code was published in collaboration with the Norwegian Shareholders' Association; the Norwegian Institute of Public Accountants; the Institutional Investor Forum; the Norwegian Financial Services Association; the Norwegian Society of Financial Analysts; the Confederation of Norwegian Business and Industry; the Norwegian Association of Pension Funds; and the Norwegian Mutual Fund Association. For more information on the 45-page code see the corporate governance section of the

Oslo exchange: <http://www.oslobors.no/ob/sirkulaere>.

The Swedish corporate governance code, which was open for comments in April, recommends that board chairmen be appointed by shareholders at the annual meeting rather than by the board, and that the nominating committee evaluate the work of the board and auditors as well as propose board members.

While some provisions are tougher than in other countries, others are much less strict. A ma-

majority of directors would have to be independent of management, but only two need be independent of owners. No limit is proposed on the number of boards a director can sit on. The code is silent on unequal voting rights, long criticized by outsiders. The comprehensive code is a "comply and explain" document, which can be found on the Swedish Justice Department's website at: <http://www.sweden.gov.se/sb/d/574/a/26296;jsessionid=a4x9ITtUknif>.

—Elizabeth Snyderwine

ICGN Conference Focuses on Board Oversight of Executive Compensation

The issue of excessive executive compensation at public corporations emerged as a leading theme at a conference held by the International Corporate Governance Network in Wilmington, De., in October.

Business press shares observations

New York Times business reporter Gretchen Morgenson discussed several problems she sees with the way companies currently compensate executives. First, she said, in several cases, companies have awarded high levels of incentive compensation based on financial targets but later restated their financial reports. In these cases, the officers who received the compensation have resisted fiercely any "claw back" of improperly awarded compensation. She cited the case of Computer Associates as a potential exception where compensation was awarded based on misstated financials, but where, largely due to intervention by regulators, shareholders' interests may be protected by the successful claw back of corporate

funds.

Morgenson also cited problems with current rules on how companies disclose "supplemental retirement plans." Currently, actual amounts of this type of compensation are not disclosed, but companies provide tables that outline what executives may receive based on years of service, salary and bonus. As a result, shareholders can be hurt by earnings reductions due to surprise payouts under these plans. Morgenson cited the case of chemical company, Hercules, which restated third-quarter 2003 results to account for a \$4.7 million benefit paid to its former CEO. As a result, Hercules' net income was cut by 14 cents per share.

In addition, Morgenson noted that executive payouts packaged as payments in connection with mergers have become very large, often including lump sums in an amount of three times an executive's salary. In some cases, payouts to executives can rise to 8 percent of the acquisition price in a merger transaction, Morgenson noted. While share-

holders often have the right to vote on approval of a merger, they may be reluctant to vote against a merger triggering such payments if the shareholder perceives the merger to have benefits to the company that exceed the expenses the company will incur from these "golden parachute" payouts.

Shareholders must be more active on issue

At a panel on institutional investors, panelists said at companies where excessive compensation is detrimental to shareholders, the fault lies not only with overreaching management but also with complacent shareholders. Companies are structured so that directors represent shareholder interests, but, said panelists, in cases where directors have proved negligent in overseeing compensation, institutional investors have done little to react.

Jack Bogle, founder of the Vanguard fund complex, commented that during his tenure at Vanguard, the firm rarely put public pressure on companies in which it invested to make changes. He

said the current era is different, however, because top executives receive compensation that is over 300 times that of the average worker at the same company. In an earlier period, he said, executives received pay of 50 times the average worker.

Ralph Whitworth of Relational Investors commented that even though institutional investors may want certain reforms, they rarely use the tools they currently have available to effect change. Whitworth commented that an important tool shareholders fail to use is their ability to solicit shareholders to elect a limited number of directors to the company's board (as opposed to a more confrontational, full-blown proxy contest to control the company's entire board.) He said that at companies where he successfully had nominee directors elected, even a single new director made a difference by focusing other directors on problem issues.

Delaware judges describe new views on topic

Vice Chancellor Leo Strine of the Delaware Court of Chancery commented that recent amendments to stock exchange listing standards requiring a majority of independent directors on boards may create a structure where problems such as excessive compensation go unchecked. He noted that greater independence comes at the price of less expertise in the boardroom. Independent directors may have little knowledge of the company's business and a greater tendency to rely on management's advice. Strine noted that the greater numbers of independent directors mean that there will be fewer directors with "skin in the game," (i.e., have personal funds invested in the company.) He said where directors have their own funds at risk, they are much more inclined to properly oversee compensation

decisions. Strine indicated he did not think this alignment of director and shareholder interests could be created after-the-fact through grants of stock options to directors. In his view, directors tend to regard such grants simply as windfalls from the company.

Former Delaware Supreme Court Chief Justice Norman Veasey addressed the role of the courts in litigating executive compensation issues. He noted that until recently executive compensation was governed principally by the legal doctrine of "waste." The leading case in the area of waste

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is *Brehm v. Eisner* (as the case was then titled). In that case, Veasey remarked that executive compensation can be considered waste only when no rational person would think that the corporation had received services for the compensation being paid. He said that this waste test, which was the basis for the dismissal of the original *Disney* case, is unlikely to be the focus of future litigation over compensation.

Veasey noted that the courts are shifting the focus of their judicial review on the "process" used by boards to set compensation rather than on the absolute levels of compensation under the waste standard. He cited the Delaware Court of Chancery's recent decision to refuse to dismiss the plaintiffs' repleaded complaint in the

Disney case on the basis that there is the possibility it could be shown at trial that the Disney board failed to act in "good faith" in approving the 1996 severance agreement for then-Disney President Michael Ovitz. He said breaches of directors' fiduciary duties to act in good faith could be interpreted as instances where directors consciously disregarded their duty to make informed decisions.

Delaware Supreme Court Justice Jack Jacobs agreed with Veasey, noting, "process [used by boards of directors] is paramount." He said the factors courts will examine in deciding whether directors used a proper process include: 1) whether directors had adequate information, 2) whether directors verified the reliability of the information, 3) what type of expert advice directors used, and 4) whether directors were "well-motivated" in making their decisions. Jacobs cited a recent decision by Vice Chancellor Noble on the Delaware Court of Chancery in the *Integrated Health Services* case as an example of where a court had found defects in the process used by directors. In that case, he said the court found fault with a CEO's intervention in the setting of his own compensation by the company's board. Jacobs said compensation decisions must be the product of "arms-length" bargaining or else courts will find that the process does not work.

Directors offer advice on keeping pay in check

Jack Krol, former CEO and chair of DuPont, commented on measures directors can take to ensure that they fulfill their role of overseeing executive compensation. He discussed his experience in reforming pay practices at Tyco International, where he serves as a lead director. Krol said the Tyco board had benchmarked Tyco executive compensation at a level two times

that of executives holding positions at the next lowest level of the Tyco corporate hierarchy. He said the Tyco board had tied incentive compensation to internal measures of financial performance that drive corporate growth rather than share price targets.

The Tyco board has limited severance agreements to provide for no more than two times an executive's base salary, Krol said. To focus executives on the long-term success of the corporation, Tyco granted restricted stock compensation rather than stock op-

tions, and to protect shareholders from the dilution of corporate wealth by stock option grants, the board limited the company's stock options to 1.5 percent of its outstanding shares.

—Mark Saltzburg

2005 Edition

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