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Who's Winning?

How the battle between shareholder activists and corporate boards over pay policy is shaping up

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It's too soon to declare victory for either side in the battle over executive pay.

Shareholder activists have scored some points by forcing an increasing number of companies to place compensation-limit proposals on the proxy ballots of annual meetings.

But companies have also scored points by arguing that the limits could hurt their ability to recruit top talent.

It's a battle that has escalated rapidly. Some 265 shareholder resolutions to limit executive pay have been submitted so far this year. Last year, 182 actually came to a vote, up from 163 in 2003 and 25 in 2002, according to the Investor Responsibility Research Center in Washington. The ball got rolling in the fall of 2002, amid a slew of corporate scandals and sinking investor portfolios. "It was obvious that executive-compensation issues were not being addressed in all the post-Enron regulatory reform," says Rosanna Landis Weaver, an IRCC senior analyst.

While most of the resolutions have been defeated, almost a quarter of those voted on in the past three years have won a majority of the votes cast -- a surprising rate of success for proposals that almost always are opposed by management. Of the 370 measures voted on in the past three years, four passed in 2002, 49 in 2003 and 40 in 2004. Most were nonbinding, but for so many to have made it to the proxy stage suggests the issue's increasing importance.

Meanwhile, a small number of other companies targeted for such shareholder activism have agreed to modify their pay-package practices -- though it remains unclear what the real effect on compensation at those companies will be. Some boards have limited salary increases with one hand, for example, while enlarging stock awards with the other.

The measures being proposed by shareholders most often include efforts to change severance-package policies, and calls to require expensing of stock options.

AIMING AT PARACHUTES

Campaigns for severance-package limits make up nearly a third of the resolutions passed since 2002. The reasons are twofold: First, shareholders get particularly upset about the lavish benefits given departing executives, such as golden parachutes for those dismissed after a takeover, says Louis Malizia, assistant director of the office of corporate affairs for the Teamsters union in Washington. Mr. Malizia's office has submitted many such proposals. Adopting severance-pay reform also may be the easiest way for a board to limit executive compensation because it involves deals with future management. "Often the current CEO has a management contract that prevents this proposal from applying" to him or her, Mr. Malizia says.

The next most common proposal is to put the brakes on equity awards in general, and foremost among these is the push to expense stock options.

Last year, 22 of the 40 shareholder proposals that received majority votes involved options expensing, the IRRC says. Requiring companies to count the value of options as an expense against their bottom line, advocates say, would make executive compensation more transparent to outsiders, and discourage pay-plan designers from using excessive amounts of options. This year, out of 28 shareholder resolutions on executive pay submitted by the Washington-based United Brotherhood of Carpenters, nine call for expensing options, the IRRC says.

Many companies, however, fiercely oppose calls to expense options -- particularly technology companies, at which options are widely used. At least 10 companies have successfully lobbied the Securities and Exchange Commission to bar options-expensing proposals from their proxies this year on grounds that the proposals don't meet SEC regulations.

Those who support expensing are encouraged by a ruling from the Financial Accounting Standards Board, the private Norwalk, Conn., group that sets U.S. accounting standards, which says all public companies must begin to expense options. The rule is set to take effect for most companies in third-quarter financial statements. But because of strong lobbying with the SEC and Congress to reject the FASB ruling, the pro-expensing camp hasn't let up. Ed Durkin, director of corporate affairs for the Carpenters union, hopes the efforts of his group and others "will help send a message" that expensing should become the norm.

One of the least-used strategies is calling for caps on executive pay. Six such resolutions were filed in 2004, the IRRC says. None passed, and voter support averaged less than 8% of the votes cast.

"Those kinds of caps are considered hilarious in corporate boardrooms," says Ira Kay, head of the compensation-consulting practice for Watson Wyatt Worldwide in New York. "Corporations can't operate that way because they need to hire talented people from the labor markets."

Some investors continue to push for caps anyway. Last month at Morgan Stanley's annual meeting, a resolution on the proxy statement called for a pay cap. Initiated by a small group of shareholders, the resolution proposed to limit CEO pay to "no more than 100 times the average compensation paid to the company's non-managerial workers in the prior fiscal year, unless the shareholders have approved paying the CEO a greater amount."

The measure received just shy of 15% of the votes cast at the March 16 meeting. Morgan Stanley, which recom-

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mended a vote against the measure, declined to comment on it for this article.

The beauty of this type of proposal is its simplicity, says Dan Steininger, chairman of the Milwaukee-based Catholic Equity Fund, which co-sponsored the resolution at Morgan Stanley and which seeks to invest in companies that promote Catholic values.

"We don't have any problem with the CEO making a lot of money," Mr. Steininger says. "But if you think your CEO is worth more than 100 times the average worker, then explain why and let the shareholders vote on it."

NOT A LOST CAUSE

Though most executive-pay resolutions are rejected, they can sometimes still achieve their purpose. A 1999 study on pay-related resolutions co-authored by Randall Thomas, a law professor at the Vanderbilt University Law School, Nashville, concluded that regardless of whether the proposals won proxy votes, they did moderate executive compensation at companies that had them.

The study looked at executive-compensation proposals submitted from 1993 to 1997, and found that one year after a shareholder resolution was voted on, companies showed an average 2% compensation increase, compared with an average 22.3% increase at companies in the same industry at which no such proposal was voted on. The difference also was present in the second year after a vote, says Mr. Thomas.

The study, which looked at both cash and equity awards, also found that companies with pay-related resolutions tended to shift compensation away from options and into cash sources of income, like salary and bonuses. The amount of stock options awarded fell an average of 3% at companies where pay-related proposals were voted on, and rose an average of 30% at companies that held no vote.

Some investor proposals have attempted to limit cash compensation rather than equity. This can be a controversial approach. Giving shareholders control over cash compensation is good only "for publicity purposes," says Keith Fortier, director of compensation at Salary.com, a compensation consulting firm in Needham, Mass. Any drop in an executive's salary or bonus, he says, "is smoke and mirrors, and is usually made up for with equity compensation."

But Robert Fields, a New York lawyer who specializes in employment contracts, argues that while a board can make up for limits on cash by increasing equity, giving shareholders power over cash compensation is "a reasonable compromise." Cash, he says, is more valuable to managers than equity. Allowing shareholders to control cash compensation also gives them control over real assets of the company, he says, though he adds that such policies may reduce boards' ability to attract new executives.

WHO BLINKED?

Since mid-2003, the New York Stock Exchange and Nasdaq Stock Market have required listed companies to get shareholder approval of any plan that provides stock or options as compensation. The new rule also mandates shareholder clearance of material revisions such as the repricing of stock options. But the prospect of seeing their plans protested -- or defeated -- at the annual meeting makes some boards skittish.

An IRRC analysis found that investor opposition to stock-plan proposals averaged 24.6% for shareholder meetings held during the 12 months ended October 2004, and seven proposed plans failed entirely. As a result, some companies are working with institutional shareholders on plans ahead of time to be sure the investors like a plan before there is a vote.

Other companies are promising to amend their compensation policies rather than face a shareholder resolution on the matter. This year, such companies as Merrill Lynch & Co. Inc., Morgan Stanley, Harley-Davidson Inc. and Pitney Bowes Inc. pledged to change or improve pay practices -- agreements that resulted in shareholders' dropping campaigns to get a proposal on a proxy, says Carol Bowie, the IRRC's director of governance research.

Most of the companies say the modifications were in the works before shareholders raised the issue. Morgan Stanley, for instance, recently said it would start granting executives restricted stock instead of stock options after proponents dropped efforts for a stockholder resolution on the issue. When asked for details on the decision, a spokeswoman referred to the company's 2004 proxy statement, which affirms Morgan Stanley's commitment to link executive compensation with performance goals and to align employee interests with those of shareholders.

Analysts predict that pay-related shareholder resolutions will continue to spread. But many remain skeptical about how much more impact they will produce. "Shareholder action, and sometimes shareholder outrage, do provide some constraints on pay," says Lucian Bebchuk, a professor at Harvard Law School. "But the limited power that shareholders now have makes these constraints rather mild."

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