

WHAT LIMITS EXECUTIVE COMPENSATION?

By William Nicoson

Bob Simon, Reston's founder, noted in his graduation address at South Lakes High School last June that among 12 developed countries surveyed in a recent study, the U.S. ranked first in rewards to corporate chief executives. Second ranking Australia paid chief executives only 60% of U.S. executive largesse. Another recent study concludes that the ratio of U.S. executive pay to worker pay has increased in the last two decades by a factor of ten, from 42-1 to 419-1.

Executives deserve to be paid well for valuable services. The trouble is that the level of CEO compensation all too frequently has nothing to do with the value of CEO services. Particularly doubtful are incentive stock plans limited to senior executives whose stock ownership already provides ample incentive.

A cautionary tale that burst onto front pages last week involved special compensation accorded the 3 highest executives of the third largest software-maker, Computer Associates with world-wide offices, including those in Herndon and Reston staffed by some 1,000 employees. In 1995 a stock plan authorized the grant of 6 million shares to these 3 executives. The grant vested if the price of CA shares stayed above a threshold for at least 60 days. On May 28, 1998, the magic test was met, and CA issued the executives the 6 million shares, plus 9.5 million additional shares as adjustment for stock splits in the interim.

The total award was then worth more than a billion dollars, or close to half of CA's profits over the 3 prior years. This happened just as CA prepared to announce a decline in returns from its Asian operations, which contributed about 5% of total revenue. When the announcement was made on July 22, 1998, coupled with notice of a charge to income for the stock bonuses to executives, the price of CA's shares plunged 31% in the trading day. In hours, \$10 billion in stock value disappeared. It seems likely that stockholders recognized the startling disconnect between executive compensation and executive performance.

In any case, stockholder suits were filed, and last week a Delaware judge found for the plaintiff. Did the court identify corporate looting by executives at the expense of stockholders? No, the nameless lawyer who drafted the stock plan had omitted the clause requiring adjustment of the award for stock splits. The court ruled that the executives must return the split-related 9.5 million shares (now worth \$558 million) but could keep the balance (now worth \$320 million).

CA will appeal, determined to give away half a billion stockholder dollars as an incentive for 3 executives who were already among the company's largest individual holders. It's likely that the outcome will turn on whether the stock-split clause was legally missing or could be implied. That's too bad. The court of appeals has the opportunity to make new law on the uncertain permissible limits of executive compensation. Instead, a lawyer's tiny mistake will likely permit an issue of vast business consequence to be swept under the judicial rug.

Apart from stockholders, middle managers with substantial responsibility may also feel aggrieved by rich incentive bonuses to a few top managers. I asked a CA manager in Reston about office morale following disclosure of the billion dollar award to CA's gang of three. He said he'd call back after contacting headquarters. For some reason he never called back.

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