

AGENDA

THE WEEK'S NEWS FROM OTHER BOARDROOMS

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How Governance Factors In D&O Premiums

Strong governance minimizes liability and cuts rates, new study says

Knowing what a company pays in directors' and officers' liability insurance premiums can be a good way to gauge the strength of its corporate governance practices and the riskiness of serving on its board, new research shows.

"If [a company's] D&O premiums are very large, that's the D&O underwriter saying, 'You're a likely candidate for a big corporate scandal,'" says **Sean Griffith**, co-author of a *University of Chicago Law Review* article that's set to be published later this spring. "And if a company is a likely candidate for a big corporate scandal, that means the directors' names are more likely to wind up on the right-hand column of *The Wall Street Journal*."

D&O insurers underwrite the costs a com-

pany incurs in connection with suits filed against that company's directors and officers. As a result, a company's potential for racking up those costs has a great influence on the terms of its D&O insurance, including the premiums the company pays.

When insurers are evaluating the likelihood that a company will be sued, its corporate governance practices can count for a lot. That's according to Griffith, whose law review article, which he co-authored with **University of Connecticut Law School professor Tom Baker**, draws upon 41 "in-depth interviews with underwriters, actuaries, brokers, lawyers and corporate risk managers."

"Your premium might fluctuate in the

D&O Premiums continued on page 11

Study Quantifies Price of Poor Succession Planning And Hiring Outside CEOs

Newly minted CEOs from outside the company earn far more than CEOs hired internally, and even more than CEOs who have been in place for a while, according to a recent study.

The new research quantifies what some critics of so-called runaway executive pay have been harping on for awhile: External hires push compensation skyward and stem from a failure of the board to groom CEO successors internally.

The study, conducted by executive comp research firm **Equilar**, shows that in 2005, CEOs hired from outside the company earned \$8.9 million in total direct compensation;

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ON THE AGENDA

Comp Disclosure: Clear as Mud?

When it comes to compensation disclosure, more information and greater clarity seem to be mutually exclusive. The SEC intended its new disclosure rules to require more of both, but now even the regulator's top official is criticizing the filings for being too long and confusing.

This year's proxy filings have come in chock-full of new details targeted at making executive pay more transparent. The disclosures are ambitious in that they attempt to offer a lot of information on retirement benefits, potential

Mud continued on page 9

Succession continued from page 1

CEOs who have at least two years of tenure at their companies earned \$7.9 million; and new CEOs hired internally earned \$5.8 million, which is 26.4% less than CEOs hired externally. (Equilar calculates total direct compensation using base salary, bonus, restricted stock awards, long-term incentive plan payouts, value of stock awards granted that year and other compensation.)

Most directors are not as concerned about the discrepancies in salaries. Compensation ranks relatively low on their list of priorities when searching for a CEO successor. The main goal is to find a star performer to take the reins of the company, whether the candidate comes from inside or outside the company.

Experts point out that the difference in compensation levels, at least in the Equilar study, stems mainly from companies' making candidates whole on the equity they leave behind at their old employers. Boards of course can get into trouble when the buyout is too high, or when they make an executive whole on a large supplemental executive retirement plan, or SERP, which Equilar didn't include in its study.

The issue of paying for external hires has gained more attention recently as CEO turnover has hit new highs in corporate America. Last year, 14% of the companies in the S&P 500 appointed new CEOs, according to research by **Spencer Stuart**.

Two such companies, **Autodesk** and **Clorox**, had different succession experiences. Autodesk's CEO stepped down to make way for the internal candidate crowned by the board to be the next CEO. Clorox had to name an interim CEO before the board located and hired a new CEO from outside the company. Directors at both companies agree that compensation should not be a factor in searching for a new CEO.

"If that's what directors are looking

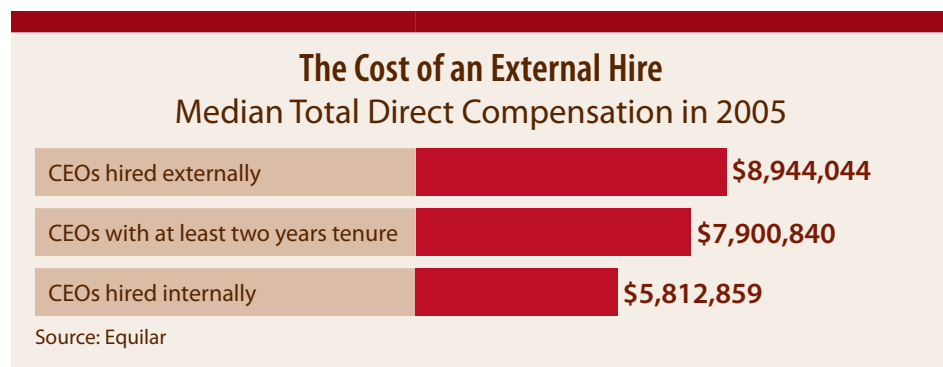
at, then shame on them," says **Carol Bartz**, the executive chairman of Autodesk. Bartz stepped down as CEO last year to make way for **Carl Bass**, the company's former COO, whom the board had tapped to replace her.

"There are candidates who are overpriced and boards can't stomach the demands," says Bartz, who also serves on the boards of **Cisco Systems** and **Network Appliance**. "But if it's a good match, then you make it work."

Making it work goes both ways.

becomes an issue later in the search process. He lists three distinct steps that should precede any discussions boards have about compensation.

Step one involves an assessment of the company's strategic direction and what, if any, changes are needed. With that assessment completed, step two for boards includes a decision on whether it needs to look inside or outside the company. Finally, before the board even thinks about compensation, it needs to check a candidate's



If candidates refuse to be reasonable about their compensation packages, that's a good sign that they may not be a good fit for the company, says **Gary Michael**, lead director of Clorox.

Michael has had plenty of experience with CEO succession at Clorox since joining the board in 2001. Long-time CEO **Craig Sullivan** retired in 2003 and the board named **Gerald Johnston**, president and COO, to succeed him. But last year Johnston had to step down due to health issues. The company named **Robert Matschullat**, presiding director of the board at the time, as interim CEO while it searched for a successor. The board decided that with a young management team it needed to go outside the company to hire new CEO **Don Knauss**.

Michael, who also serves on the boards of **Harrah's Entertainment**, **Idacorp**, **OfficeMax** and **Questar**, says that in his experience compensation

"DNA match," which means making sure the candidate is a good fit for the company's business and culture.

The Equilar study shows that the biggest contributor to the discrepancy in pay between outside hires and inside hires is stock awards. The median restricted stock award value was \$2.6 million for external hires and \$1 million for internal hires in 2005. The median stock option award value for external hires was \$4.8 million and for internal hires it was \$2.8 million.

This difference exists most likely because companies are "buying candidates out of existing stock," says **James Boone**, managing partner of **Windship Partners**, an executive recruiting firm.

This is not an issue under normal circumstances, Boone says. In most cases, it's a small price to pay to bring in a candidate who's the right fit for the company, and therefore "it shouldn't be that big a deal for boards to explain." ■