

EXECUTIVE PERFORMANCE-RELATED COMPENSATION: THE DIFFICULTY IN TRULY ALIGNING WITH SHAREHOLDER RETURNS

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I. INTRODUCTION

Most large publicly traded companies in the United Kingdom and Australia have, for a decade or more, incorporated “performance hurdles” into their executive stock option plans. This has not been common among large U.S. publicly traded companies; however, the massive escalation in executive compensation levels among U.S. executives during the 1990s, followed by the corporate collapses and corporate scandals of 2001 to 2002, led to calls for greater use of performance hurdles by U.S. companies.¹ To some extent, then, the approach in the United Kingdom and Australia may be seen as a panacea for U.S. executive compensation.

The primary aim of this Article is to explain why, even if there were to be widespread acceptance of performance hurdles by U.S. corporations, the Australian experience suggests that an extremely close correlation between executive pay and firm performance ought not to be expected overnight. To set the scene, Part II first outlines why incentive compensation (through stock options and other forms of “at risk” pay) can be regarded as a corporate governance mechanism, that is, a mechanism for helping to bridge the gap between shareholders’ and executives’ interests. Part III develops this issue and describes the ways in which a long-term incentive plan can provide incentives to executives to run the company’s business in a shareholder wealth-maximizing fashion.

U.S. empirical studies indicate a statistically significant relationship—but not a particularly strong *economic* relationship—between the CEO’s compensation and corporate performance. This issue is addressed in Part IV, which also introduces the managerial-power theory of executive pay. Under

¹ See, e.g., Blair Jones & Seymour Burchman, *How to Salvage Stock Options*, FORBES, July 30, 2002, available at <http://www.forbes.com> (follow “work” hyperlink; then follow “Archive 2002” hyperlink; then follow “July 22-31 Forbes.com” hyperlink; then follow “How to Salvage Stock Options” hyperlink).

this theory, the board of directors (and the compensation committee of the board) is “captured” by the company’s CEO, with board and social dynamics discouraging non-executive directors from being overly demanding in formulating executive pay packages.

Part V reveals that, in the United States, it is extremely uncommon for a performance hurdle to be attached to a grant of options. Part VI then outlines the reasons to exercise caution when encouraging U.S. companies to build performance hurdles into their stock option plans. It outlines several characteristics of long-term incentive plans used by Australian companies, which can lead to generous executive rewards despite no, or little, creation of shareholder wealth. Managerial power may, at least partially, account for this. In light of this, Part VII concludes the article by recommending that these factors should be taken into account as commentators and investors call for U.S. corporations to embrace performance hurdles for stock options.

II. WHY INCENTIVE PAY *COULD BE* A CORPORATE GOVERNANCE MECHANISM

Corporate governance is generally concerned with the agency costs that arise when the people running the day-to-day business of large companies (senior executives or managers) do not own all the shares.² The interests of managers and shareholders diverge because managers do not capture all the rewards of their efforts. Corporate governance “mechanisms” are those rules, market forces, and other devices that collectively serve to reduce this divergence of interests.

An executive’s compensation package can be structured with a view to aligning more closely the interests of that executive with the interests of the company’s shareholders. This would typically involve tying some components of the executive’s compensation to corporate performance. If a proportion of an executive’s compensation is placed “at risk” in an appropriate fashion, the executive’s rewards should move broadly in line with shareholders’ returns.

² Michael C. Jensen & William H. Meckling, *A Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976).

Base salary could certainly be contingent on various measures of past company performance, as could the short-term incentive (e.g., annual bonus) and the long-term incentive (e.g., options grant). Pensions and perks, such as use of a motor vehicle, are less easily tied to company performance. In practice, the two components of executive compensation, which are usually contingent on some aspect of company performance, are (a) the short-term incentive and (b) the long-term incentive.

A. SHORT-TERM INCENTIVE

A short-term incentive is an extremely common component of the compensation package of senior executives of U.K. and Australian publicly traded companies.³ Most often, the short-term incentive is described as the “annual bonus” and is paid in cash.⁴ Most large publicly traded UK and Australian companies use performance measures other than share price and dividends in determining the short-term incentive for the Chief Executive Officer (CEO) and other senior executives.⁵ The performance measures are often related to internal performance more than to external measures like share price. For example, in one short-term incentive plan, the performance measures were related to a series of quantitative measures like return on equity, cost management, total operating margins, and value of new business, and qualitative measures such as performance relative to competitors and market conditions, stakeholder perspectives, personal leadership, effective teamwork at senior management levels and strategic positioning.⁶

The fact that performance indicators other than stock price are used is not necessarily problematic from a corporate governance perspective. Whether it is a problem will depend on the nature of the measures adopted—are they rigorous and defensible? It needs to be kept in mind that a sizeable annual bonus could be paid under a short-term incentive scheme even if the company’s share price has fallen during the year in question.

³ ISS PROXY AUSTRALIA, CEO PAY IN THE TOP 100 COMPANIES: 2004 19 (2005).

⁴ *Id.*

⁵ *Id.* at 11.

⁶ AMP LTD., NOTICE OF ANNUAL GENERAL MEETING 16 (2003).

B. LONG-TERM INCENTIVE

1. Traditional Options

The most popular form of long-term incentive among the S&P/Australian Stock Exchange (ASX) 100 companies (the 100 largest publicly traded Australian companies by market capitalization) is the traditional option. The traditional option has an exercise price equal to the market price of the company's shares at the time the option is granted.⁷ As of the end of 2004, 45 per cent of long-term incentive plans at S&P/ASX 100 companies provided for the issue of traditional options.⁸

Under the traditional option approach, if the plan's performance hurdles are satisfied, the executive is required to pay to the company the "exercise price" for each option.⁹ That exercise price is typically the market price of the company's shares at the time the options were granted (say, three years earlier).¹⁰ The executive will, of course, only exercise the options if the share price at the vesting date is greater than the exercise price. The fact that the executive stands to make money—potentially, lots of money—if the share price at vesting is above the exercise price, but stands to make absolutely nothing if the share price at vesting is *below* the exercise price, can be described as the "all or nothing" feature of traditional options.

2. Zero Exercise Price Options

Another popular type of long-term incentive used by U.K. and Australian companies is the zero exercise price option (ZEPO). ZEPOs are usually described as "performance rights," "performance award rights," "performance shares," "allocation rights," "deferred shares," or something similar.¹¹ The term

⁷ Kevin J. Murphy, *Executive Compensation*, in 3 HANDBOOK OF LABOR ECONOMICS 2485, 2507-10 (Orley Ashenfelder et al. eds., 1999).

⁸ ISS PROXY AUSTRALIA, LONG-TERM INCENTIVE PLANS IN THE TOP 100 COMPANIES 2004 6 (2005). 42.5 per cent of plans provided for the issue of traditional options alone, and a further 2.5 per cent of plans provided for the issue of both traditional options and zero exercise price options. *Id.*

⁹ Murphy, *supra* note 7, at 2485.

¹⁰ *Id.*

¹¹ EQUITY STRATEGIES PTY LTD., EQUITY STRATEGIES REPORT 4 (2004).

ZEPO is used only very rarely in incentive plans, company annual reports, and notices of shareholder meeting. In the United States, ZEPOs are usually referred to as “restricted stock.”¹²

In contrast to traditional options, the executive pays nothing to the company when exercising ZEPOs. Under a typical ZEPO plan, the executive is granted a legal right to be issued a specified number of shares on a later date, provided that certain conditions are satisfied. The conditions are typically related to continued employment and corporate performance. If the plan’s performance hurdles are met and the executive is still employed by the company at the end of the vesting period, the company will issue the shares to the executive, who will be able to sell them and make some money.¹³ The amount of money made will depend on how the company’s share price has performed since the ZEPOs were granted. Even if the company’s share price has fallen since the grant date, the executive stands to make something. As of the end of 2004, 43 percent of long-term incentive plans at S&P/ASX 100 companies provided for the issue of ZEPOs.¹⁴ ZEPOs have become increasingly popular, with several companies publicly abandoning traditional options and replacing them with ZEPOs.¹⁵

ZEPOs may provide some advantages over traditional options. Arguably, ZEPOs present significantly lower incentives to executives to “cook the books” in order to increase incentive pay¹⁶ because they do not involve the all-or-nothing scenario

¹² Murphy, *supra* note 7, at 2485.

¹³ EQUITY STRATEGIES PTY LTD., *supra* note 11, at 4.

¹⁴ ISS PROXY AUSTRALIA, *supra* note 8, at 6.

¹⁵ See, e.g., Commonwealth Bank of Australia, *Corporate Governance in the Commonwealth Bank of Australia*, Aug. 21, 2002, available at <http://shareholders.commbank.com.au> (follow “news & information” hyperlink; then follow “archive: 2002” hyperlink; then follow “21 August 2002 – Chairman’s Statement - Corporate Governance in the Commonwealth Bank of Australia” hyperlink; then follow “Chairman’s Statement – Corporate Governance in the Commonwealth Bank of Australia” hyperlink).

¹⁶ There is some evidence that distorted incentives relating to options was one factor in the collapse of Enron. See J.C. Coffee, *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 297-298 (2004). Also, there is U.S. empirical evidence that the nature and timing of earnings forecasts and other information disclosures by management are related to executive options grants. See, e.g., THE CONFERENCE BOARD, INC. – COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, *Findings and Recommendations*

presented by traditional options. Provided that the plan's performance hurdles have been met, and these hurdles may be purely "relative,"¹⁷ the executive will receive full legal and beneficial ownership of shares, even if the company's share price has not moved above the price at the time the ZEPOs were granted.

Both shareholders and executives may benefit from ZEPOs if shareholders are concerned about abuses or if markets are uncertain. In the aftermath of the corporate collapses and scandals that rocked the United States in 2001 to 2002, including Enron and WorldCom, company shareholders appear to benefit by ensuring that executive incentive plans do not lead to distorted incentives. This may justify moving away from traditional options, and their "all or nothing" characteristics, towards ZEPOs. The perspective of the executive, however, should not be overlooked. Why should an executive prefer ZEPOs over traditional options? In a bear market, a ZEPO plan can reward an executive even though the company's share price falls from the time the ZEPOs are granted to the time the executive is entitled to exercise them. In such a market, an executive would get nothing at all from a traditional option plan, under which the exercise price is set as the market price at the time the options were granted. The Australian market was a bear market for much of the period 2000 to 2002 – just as ZEPOs became more popular.¹⁸ The fact that executives may prefer ZEPOs, at least in a bear market, may provide some support for the board-capture theory in Australia.

Part 1: Executive Compensation 1, 6 (2002); David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73, 86-90 (2000); C.M. Yablon & J. Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83, 86-89 (2000); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449, 462-66 (1997) (finding that the patterns of companies' quarterly earnings announcements are consistent with an interpretation that CEOs are granted options shortly before favorable corporate news is released); Kevin Hallock & Paul Oyer, *What Have You Done for Me Lately? Executive Compensation and the Timing of Corporate Performance* (U. of Ill. Coll. of Bus. Bureau of Econ. and Bus. Research, Working Paper, No. 96-0141, 1996).

¹⁷ See *infra* notes 32-33 and accompanying text.

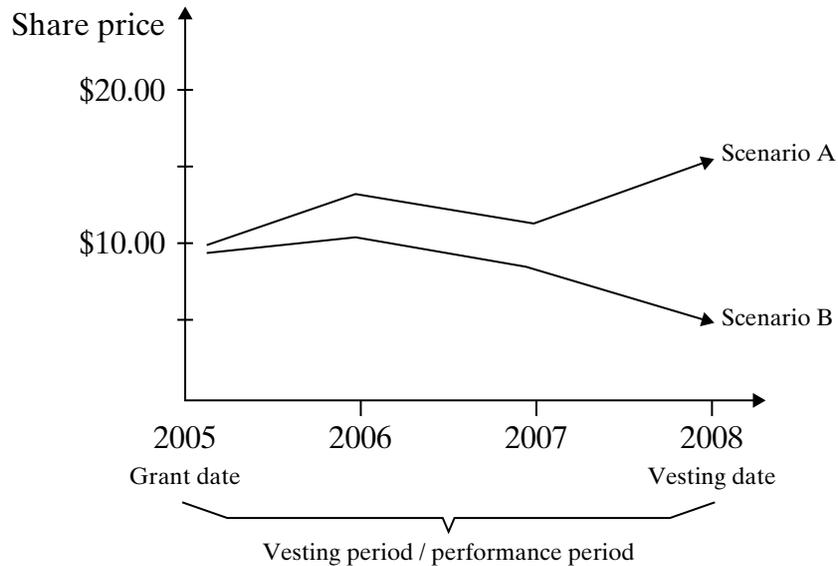
¹⁸ EQUITY STRATEGIES PTY LTD., EQUITY STRATEGIES REPORT 3 (2003).

III. HOW CAN A LONG-TERM INCENTIVE PLAN PROVIDE INCENTIVES?

For most publicly traded U.K. and Australian companies, there are two ways in which a long-term incentive plan can encourage senior executives to work hard and improve corporate performance. First, setting the exercise price equal to the share price at the grant date provides a natural hurdle. Second, additional performance hurdles can be specified.

A. EXERCISE PRICE IS A “NATURAL” HURDLE

Traditional options are only ultimately valuable to an executive if the company’s share price at the vesting date is higher than it was when the options were granted. If the share price at vesting date is below what it was at grant date, a rational executive will not exercise the options and they will lapse. A share price at the vesting date that is higher than it was on the grant date, however, means the executive will profit, and so there is a natural incentive for the executive to work hard and apply her or his skill during the vesting period.



Both scenarios are illustrated in Figure 1. Assume Company X’s share price on January 1, 2005 is \$10, and that it grants

100,000 options to its CEO on that day. The exercise price is set at the prevailing share price: \$10. The vesting period is three years, meaning the earliest date on which the CEO is entitled to exercise the options is January 1, 2008. In Scenario A, the share price of X rises over the three-year vesting period to \$15. Therefore, if the CEO chooses to exercise all 100,000 options on January 1, 2008:

She will have to pay the company $\$10 \times 100,000 = \1 million;
The company will issue her 100,000 shares;
The shares are worth $\$15 \times 100,000 = \1.5 million; and
The CEO has therefore made a gain (before tax) of \$500,000.

In Scenario B, the share price of X falls over the three-year vesting period to \$5. The CEO would not rationally exercise the options on January 1, 2008, because this would entail paying the company \$1 million ($\$10 \times 100,000$) and in exchange receiving shares worth only \$500,000 ($\$5 \times 100,000$). The options are “under water.”

Normally, options are granted with a life—that is, the period from grant date to expiry date—that is several years longer than the vesting period.¹⁹ A ten-year life is not uncommon. This means that, even if the options are under water at the vesting date, the executive may still be in a position to exercise them profitably at a later date if the share price during the subsequent years rises above the exercise price.

In summary, at least as far as traditional options are concerned, there is an incentive for the executive to do whatever is within his or her power to bring about an increased share price. Preferably, of course, the executive will do things that are legal and in accordance with accepted commercial practice. The corporate collapses and scandals of 2001 to 2002 indicate, however, that the incentive to “get the stock price up” can sometimes lead to inappropriate and even illegal conduct.

B. SEPARATE PERFORMANCE HURDLE

The second way in which a long-term incentive plan can provide a performance incentive to executives is through attachment

¹⁹ Murphy, *supra* note 7, at 2485.

of a separate “performance hurdle.” For a plan that uses traditional options, a performance hurdle is designed to function as an additional incentive, over and above the incentive that exists via the need to get the share price above what it was at the grant date. Performance hurdles are defined, and examples of commonly used hurdles outlined, later in this section.

For a ZEPO plan, the performance hurdle is the most significant incentive. While the executive still has an interest in the company’s share price being as high as possible at the vesting date, the executive may still gain full economic ownership of fully paid common stock even if the share price is lower at the vesting date than it was at the grant date. This will only be the case, though, if the performance hurdle is satisfied. Given that an executive who holds ZEPOs can still make money even if the share price at the vesting date is lower than it was at the grant date, it is unsurprising that performance hurdles are de rigueur for ZEPO plans used by publicly traded companies in the U.K. and Australia. All twenty-one ZEPO plans that were voted on by shareholders in S&P/ASX 200 companies during 2003 incorporated at least one performance hurdle.²⁰

Corporate governance guidelines in the U.K. and Australia universally recommend that a long-term incentive plan incorporate one or more performance hurdles. For example, the share and option plan guidelines of the Investment and Financial Services Association, an industry association representing Australian money managers, recommend that executive incentive plans should contain demanding performance hurdles. These performance requirements should provide incentives to executives to bring about “materially improved company performance in terms of medium to long-term growth of the company and resulting shareholder value.”²¹ The guidelines of the Australian Council of Superannuation Investors, an industry association representing

²⁰ EQUITY STRATEGIES PTY LTD., *supra* note 11, at 4.

²¹ INVESTMENT AND FINANCIAL SERVICES ASSOCIATION, EXECUTIVE SHARE AND OPTION SCHEME GUIDELINES 7 (2000), *available at* <http://202.92.75.45> (follow “Information Area” hyperlink; then follow “IFSA Standards and Guidance Notes” hyperlink; then follow “IFSA Guidance Notes Page” hyperlink; then follow “Guidance Note No. 12 – 57.20 KB” hyperlink).

Australian pension funds, recommend that “performance conditions for remuneration and share incentive plans should be designed to reward executives for contributing to long term above average corporate performance.”²² In addition, the guidelines of the Association of British Insurers recommend:

Challenging performance conditions should govern the vesting of awards or the exercise of options under any form of long-term share-based incentive scheme. These should:

- relate to overall corporate performance,
- demonstrate the achievement of a level of performance which is demanding in the context of the prospects for the company and the prevailing economic environment in which it operates,
- be measured relative to an appropriate defined peer group or other relevant benchmark, and
- be disclosed and transparent.²³

The most common hurdle amongst S&P/ASX 200 companies is total shareholder return (TSR), which is, in essence, the growth in the company’s share price plus dividends paid (and assumed to have been reinvested) during the year. As of the end of 2004, 65 percent of long-term incentive plans at S&P/ASX 100 companies used TSR as their principal or only performance measure.²⁴ The next-most-common performance measure (29 percent of cases) is earnings per share.²⁵ Next (6 percent) is a hurdle that requires appreciation in the share price above the market price at the grant date.²⁶ This share-price-appreciation hurdle may be explicit or implicit. It is explicit if the options are market-exercise-price options, and there is a performance condition

²² Australian Council of Superannuation Investors, *Corporate Governance Guidelines: A Guide for Superannuation Trustees to Monitor Listed Australian Companies* 13 (2005), available at <http://www.acsi.org.au> (follow “Research & Publications” hyperlink; then follow “ACSI launches revised Corporate Governance Guidelines” hyperlink; then follow “ACSI Corporate Governance Guidelines” hyperlink).

²³ ASSOCIATION OF BRITISH INSURERS, *PRINCIPLES AND GUIDELINES ON EXECUTIVE REMUNERATION* ¶ 6.2 (2004), available at <http://www.ivis.co.uk/pages/framegu.html> (follow “1 Principles and Guidelines on Remuneration” hyperlink).

²⁴ ISS PROXY AUSTRALIA, *supra* note 8, at 12.

²⁵ *Id.*

²⁶ *Id.*

stating that the company's share price must be at or above a designated level (that would be higher than the exercise price) on the vesting date. It is implicit if the exercise price of the options is set (at the grant date) at a level higher than the market price of the company's shares on the grant date.²⁷ A performance hurdle may be "absolute" (e.g., the company's TSR must grow by at least 10 percent per annum, on average, over a three-year vesting period), or it may be relative (e.g., the company's TSR over a three-year vesting period must place the company at least at the median, when it is ranked against the TSR of a group of peer companies).

IV. IS PAY TRULY ALIGNED WITH SHAREHOLDER RETURNS?

It is not surprising that many shareholders and other stakeholders in a publicly traded company would expect the compensation, or at least part of compensation, of the CEO and other senior executives to bear some relationship to the performance of the company itself. After all, financial economists generally predict this relationship, on the basis that senior executives' pay arrangements should operate as a partial remedy to the agency problem.²⁸ Under this optimal contracting approach to executive compensation, the board, or more specifically, the compensation committee of the board, is assumed to design compensation packages to provide senior executives with efficient incentives to maximize shareholder value.²⁹

The evidence from U.S. studies indicates a statistically significant relationship, but not a particularly strong *economic* relationship, between the CEO's compensation and corporate performance.³⁰ One line of scholarship that endeavors to explain

²⁷ *Id.* at 7.

²⁸ Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 72 (2003).

²⁹ *Id.*

³⁰ See, e.g., John F. Boschen et al., *Accounting and Stock Price Performance in Dynamic CEO Compensation Arrangements*, 78 ACCT. REV. 143 *passim* (2003); John F. Boschen & Kimberly J. Smith, *You Can Pay Me Now and You Can Pay Me Later: The Dynamic Response of Executive Compensation to Firm Performance*, 68 J. BUS. 577, 578 (1995); Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q. J. ECON. 653, 654 (1998); Michael C. Jensen &

why there is not a strong economic relationship between executive compensation and company performance is the “board capture” or “managerial power” theory.³¹ Under this theory, the board of directors (and the compensation committee of the board) is “captured” by the company’s CEO—with board and social dynamics discouraging non-executive directors from being overly demanding in formulating executive pay packages.³² As Bebchuk and Fried explain, under this approach, “executive compensation is viewed not only as a potential instrument for addressing the agency problem—but also as *part* of the problem itself.”³³ It is not the purpose of this article to enter, in a substantive way, the debate about the managerial-power theory of executive compensation. Rather, this article seeks to highlight several factors that could limit the effectiveness of performance hurdles, in the event that there is a push for greater use of hurdles in U.S. companies’ long-term incentive plans. Some of these factors are consistent with the managerial-power theory.

V. THE U.S. DEBATE ON PERFORMANCE HURDLES

In the United States, it is extremely uncommon for a performance hurdle to be attached to a grant of options. There appears to be literally only a handful of companies that use a hurdle

Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 242-43 (1990); Murphy, *supra* note 7; John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, FED. RES. BANK N.Y. ECON. POL’Y REV., Apr. 2003, at 27. *But cf.* Marianne Bertrand & Sendhil Mullainthan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q. J. ECON. 901 *passim* (2001) (evidence that the cash component of executives’ pay increases in line with profit increases – even where the increase in profit has nothing to do with management skill or effort).

³¹ See Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 *passim* (2002); Charles M. Elson, *Director Compensation and the Management-Captured Board – The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 173 (1996); Jennifer Hill & Charles M. Yablon, *Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict*, 25 U.N.S.W. L.J. 294, 319 (2002).

³² Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1173-75 (2004).

³³ Bebchuk & Fried, *supra* note 28, at 72. For critiques of the board-capture theory, see B.J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 58-61 (2003); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 850 (2002); Thomas, *supra* note 32, at 1199-1200.

of some sort. One company that has recently moved towards performance-contingent options is IBM. The company announced in early 2004 that future option grants to senior executives would have an exercise price set at 10 percent above the market price on the date of grant.³⁴ This is known as a “premium” option. Colgate-Palmolive has also used premium options.³⁵

Other corporations use ZEPOs with performance hurdles attached, or indexed options. Chubb Corporation awards ZEPOs with a relative performance hurdle:

TSR awards are generally granted annually and will become earned, if at all, based on the total shareholder return (share price change plus dividends) for our shareholders over a three-year performance period relative to the total shareholder returns over the same period for the companies in the S&P 500 Index on the date the performance period begins who continue to file public reports through the entire performance period. The number of TSRs granted is based on payband level, an assessment of the recipient’s most recent level of performance and anticipated future contributions to our success. The number of TSR shares earned for each three-year performance period can vary from 0% to 200% of the original target award based on attainment of a relative total shareholder return position. Final earned award values are dependent not only on relative TSR performance, but also on the final share price at the end of the three-year period, thus providing a strong link between the interests of employees receiving these awards and those of shareholders.³⁶

³⁴ Press Release, IBM Corp., IBM Announces Significant Changes in Senior Executive Compensation Policies (Feb. 24, 2004), *available at* <http://www-1.ibm.com/press/PressServletForm.wss> (follow “Press Releases” hyperlink; then follow “Previous Year” hyperlink; then follow “February 2004” hyperlink; then follow “IBM Announces Significant Changes in Senior Executive Compensation Policies” hyperlink).

³⁵ Colgate Palmolive Co., Proxy Statement (Form DEF 14A), at 22 (Mar. 30, 2005).

³⁶ The Chubb Corp., Proxy Statement (Form DEF 14A), at 24 (Mar. 25, 2005).

Schering-Plough Corporation also has a ZEPO plan that uses a TSR hurdle.³⁷ Level 3 Communications uses “indexed options.”³⁸ The difference between these and traditional options is that, rather than having the exercise price fixed at the grant-date share price, the exercise price varies based on the change in an appropriate stock market index (e.g., the S&P 500 or a narrower industry index).³⁹

Two explanations are normally provided for why the vast majority of U.S. companies do not attach a performance hurdle to grants of options. First, until recently, under U.S. accounting rules (GAAP), a company that issued traditional options without any additional performance hurdle was not required to include the value of the options in the expense section of the Profit and Loss Statement (P&L Statement).⁴⁰ If the exercise price was “indexed” to the market return or industry return (which in substance is a performance hurdle), however, then the options

³⁷ Schering Plough Corp., Proxy Statement (Form DEF 14A), at 23 (Mar. 14, 2005).

³⁸ Level 3 Comm. Inc., Proxy Statement (Form DEF 14A), at 14 (Apr. 7, 2005).

To date, our Outperform Stock Option program has been the primary component of our long term incentive, stock-based compensation programs. The OSO program was designed so that the Level 3 common stock price must increase relative to the performance of a broad-based, market stock index before OSO holders receive any return on their options. In other words, our common stock price must pass a ‘hurdle’ of a stock index growth prior to the OSO having any value upon exercise. Currently, the broad-based, market stock index used in the OSO program is the S&P® 500 Index, although the Compensation Committee reserves the right to select another broad-based, market stock index for use in this program.

Id.

³⁹ Jones & Burchman, *supra* note 1.

⁴⁰ FINANCIAL ACCOUNTING STANDARDS BOARD, FASB STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123: ACCOUNTING FOR STOCK-BASED COMPENSATION (1995) (superseded); American Institute of Certified Public Accountants, Accounting Principles Board, *Opinion No. 25 Accounting for Stock Issued to Employees*, 1972 OPINIONS ACCT. PRINCIPLES BOARD 467, 470 (superseded); Ross Buckley, *Shareholder Challenges to Executive Remuneration*, 74 AUSTL. L.J. 576, 576 (2000). Under IFRS 2 “Share-based Payment”, published by the International Accounting Standards Board (IASB), the fair value of stock options granted to executives and other employees must be recognized as an expense in the P&L Statement over the options’ vesting periods. The U.S. FASB decided, in December 2004, to implement the approach of IFRS 2. FINANCIAL ACCOUNTING STANDARDS BOARD, FASB STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123 (REVISED): SHARE-BASED PAYMENT (2004). The Australian Accounting Standards Board (AASB) has issued Accounting Standard AASB 2 “Share-

needed (and still need) to be expensed.⁴¹ Second, it would appear to be tax-disadvantageous for a U.S. company to attach a performance hurdle to executive options.⁴²

Despite the structural disadvantages of performance hurdles, there is growing pressure from institutional investors and academics for hurdles to be embraced by U.S. corporations.⁴³ Proponents of the managerial-power theory of executive pay articulate their support for hurdles as follows:

The managerial power approach does not question the desirability of using options to compensate executives. Options provide managers with greater incentive to create shareholder value, and thus the use of options in executive compensation might well be beneficial to shareholders. Rather, the managerial power approach focuses on whether the magnitude and design of a particular option-based pay package is close to that which would arise under optimal contracting. . . . The devil is in these details, which are very important. A badly designed option plan might produce significantly less value for shareholders than a plan constructed to maximize shareholder wealth.⁴⁴

In other words, the managerial-power theory of executive pay is not a criticism of options *per se*. Instead, it is a criticism of the way various components of executive compensation packages are put together. In relation to options, the theory is that options

based Payment”, which reflects IFRS 2. For the case in favor of expensing share options, see Wayne Guay et al., *Accounting for Employee Stock Options*, 93 AM. ECON. REV. 405 *passim* (2003).

⁴¹ See authorities cited, *supra* note 40.

⁴² David M. Schizer, *Tax Constraints on Indexed Options*, 149 U. PA. L. REV. 1941, 1942 (2001).

⁴³ For academic commentary on the pros and cons of U.S. firms incorporating performance hurdles into their option plans, see Bebchuk & Fried, *supra* note 28; Shane A. Johnson & Yisong S. Tian, *Indexed Executive Stock Options*, 57 J. FIN. ECON. 35 (2000); Alfred Rappaport, *New Thinking on How to Link Executive Pay with Performance*, 77 HARV. BUS. REV. 91, 101 (1999); Lisa K. Meulbroek, *Restoring the Link Between Pay and Performance: Evaluating the Costs of Relative-Performance-Based (Indexed) Options* (Harvard Bus. Sch., Working Paper No. 02-021, 2001); Gerald T. Garvey & Todd T. Milbourn, *Market-Indexed Executive Compensation: Strictly for the Young* (May 4, 2001) (unpublished working paper), available at <http://ssrn.com/abstract=272312> (follow “Social Science Research Network” hyperlink).

⁴⁴ Bebchuk & Fried, *supra* note 28, at 72.

without performance hurdles, i.e., those that allow executives to derive financial benefit as a result of market-wide factors over which they have no control, reflect managers' power over compensation consultants and board compensation committees.⁴⁵ Even if there were to be widespread adoption of performance hurdles by large U.S. corporations, however, would this axiomatically mean that U.S. executives' rewards would become more closely aligned to shareholder rewards than they are today?

VI. WHAT CAUSES DIFFICULTY IN TRULY ALIGNING WITH SHAREHOLDER RETURNS?

This section outlines several characteristics of long-term incentive plans used by Australian companies that can lead to generous executive rewards despite no, or little, creation of shareholder wealth.

A. USE OF ACCOUNTING PERFORMANCE HURDLES

In some cases, the long-term incentive plan's performance hurdles do not relate directly to share price or dividends. Some plans have performance hurdles relating to accounting measures of financial performance (e.g., a specified percentage growth in earnings per share or in net profit before tax).

It is possible that these performance hurdles could be achieved without any significant improvement in the company's share price and without any increase in dividends. For example, an increase in net profit before tax could be achieved via an acquisition. If that acquisition was funded wholly or partly with equity (i.e., through an issue of shares), the acquisition may be "earnings per share dilutive." That is, the amount of profit attributable to each share of common stock may be lower after the acquisition because the increase in profit brought about by the acquisition is more than offset by the increased number of shares on issue. Where a hurdle is related to an accounting measure of performance, and that hurdle is met without an improvement in shareholder return, any shareholder who regards "performance" as being first and foremost an impressive share price trend and an increase in dividends-per-share over time would not believe

⁴⁵ Bebchuk et al., *supra* note 31, at 792.

that executives have been paid in line with the company's performance.

B. RE-TESTING OF PERFORMANCE HURDLES

In some cases, the long-term incentive plan allows performance to be tested on multiple dates. Sometimes the degree of latitude involved is very considerable. This may mean that the executive becomes entitled to exercise his or her options even though the company's performance has been sub-standard for all but a short period of time.⁴⁶

For example, one Australian company's plan benchmarks the company's TSR against the companies constituting the S&P/ASX 100 Industrials Accumulation Index.⁴⁷ The hurdle-test regime is as follows: "If on the first performance date [three years after the grant date], some or all of the rights in a particular tranche do not vest, performance will be retested every six months until the expiry date (seven years after Grant) or until the rights become vested, whichever occurs first."⁴⁸ That is, the company could *under-perform* the benchmark during all but one test period, and the executive could still exercise the rights.

This phenomenon is known as "re-testing." Until recently it had not been referred to in corporate governance guidelines in Australia,⁴⁹ but it has become the focus of considerable investor opposition in the U.K. For instance, the guidelines of the Association of British Insurers say re-testing of performance conditions for all share-based incentive schemes is unnecessary and unjustified.⁵⁰ The guidelines of the major UK money manager Hermes state, "Where annual grants [of options] are made there should be no retesting period; if the performance targets are not met the award for that year should be foregone."⁵¹

⁴⁶ ISS PROXY AUSTRALIA, *supra* note 8, at 14.

⁴⁷ AXA ASIA PACIFIC HOLDINGS LTD., CONCISE ANNUAL REPORT 2004 59 (2005), available at <http://www.axaasiapacific.com.au> (follow "Corporate Info" hyperlink; then follow "Annual Reviews, Annual Reports and Analyst Compendiums" hyperlink; then follow "2004 Concise Annual Report" hyperlink).

⁴⁸ *Id.*

⁴⁹ See Australian Council of Superannuation Investors, *supra* note 22, at 19.

⁵⁰ ASSOCIATION OF BRITISH INSURERS, *supra* note 23, at ¶ 8.1.

⁵¹ HERMES INVESTMENT MANAGEMENT LTD., STATEMENT ON UK CORPORATE GOVERNANCE AND VOTING POLICY 7 (2001).

C. USE OF RELATIVE PERFORMANCE HURDLES

In an increasing number of cases, the long-term incentive plan has relative rather than absolute performance hurdles.⁵² With relative hurdles, the company's performance is compared against that of other companies. The hurdle may be satisfied even if the company's share price and dividends have fallen—provided that, in a relative sense, the company has fared well.

The trend towards relative performance hurdles has been accompanied by a trend towards “variable reward.”⁵³ Here, the number of options and/or performance shares that vest is determined by the quality of the company's performance. There is usually a sliding scale, meaning the better the company performs, the more options that vest. The issue in terms of “pay for performance” is that these sliding scales very often provide for 50 percent of options to vest when the company's performance is at the median.⁵⁴

An increasingly common hurdle looks like this: the hurdle relates to the company's TSR. The hurdle is a relative hurdle, and it requires the company's TSR to be measured against the TSR for each other company in a comparator group (e.g., the companies making up the S&P/ASX 200 Index). The number of options the executive can exercise depends on where the company sits compared to the other companies, when they are ranked from best to worst:

- If the company is ranked below the median, no options vest.
- If the company is ranked at the median, 50 percent of the options vest.
- If the company is ranked between the fifty-first and seventy-fourth percentile, the CEO can exercise between 52

⁵² See EQUITY STRATEGIES PTY LTD., *supra* note 11, at 5. “In 2003, in a sample of approximately 200 companies, TSR was used in 39 new, amended or re-approved plans. Only two of these plans used a benchmark of percentage growth in TSR, the rest required comparison with a specified group, either an S&P/ASX index or a selected peer group.” *Id.*

⁵³ *Id.* at 5.

⁵⁴ *Id.*

percent and 98 percent of the options, rising on a straight line basis.

- If the company is ranked at or above the seventy-fifth percentile, the CEO can exercise all the options.⁵⁵

In summary, even if the company's performance is just average, perhaps 50 percent of the maximum number of options will still vest.

D. BOARD DISCRETION TO WAIVE HURDLE

It is not uncommon for the long-term incentive plan of large Australian companies to give discretion to the board's compensation committee to waive performance hurdles.⁵⁶ In some instances, this discretion is limited to situations such as where there has been, or is about to be, a change of control. In other cases, the discretion is limited only by the general duties of the directors on the compensation committee. As with hurdle re-testing, Australian corporate governance guidelines have not, thus far, addressed this issue. It has, however, been debated in the U.K., where the leading guidelines recommend that:

Scheme rules should state that there will be no automatic waiving of performance conditions either in the event of a change of control or where subsisting options and awards are "rolled-over" in the event of a capital reconstruction. . . . Shareholders expect that the underlying financial performance of a company that is subject to a change of control should be a key determinant of what share-based awards, if any, should vest for participants. In the event of change of control, share incentive awards should vest on a pro-rata basis i.e. taking into account the vesting period that has elapsed at the time of change of control⁵⁷

VII. CONCLUSION

This article has highlighted a range of factors that could explain why executive compensation can increase while company

⁵⁵ See, e.g., CSL LTD., NOTICE OF ANNUAL GENERAL MEETING 8 (2003).

⁵⁶ See, e.g., METCASH LTD., EMPLOYEE OPTION PLAN RULES 8 (2005), available at <http://www.metcash.com> (follow "Corporate Governance" hyperlink; then follow "Employee Option Plan Rules" hyperlink).

⁵⁷ ASSOCIATION OF BRITISH INSURERS, *supra* note 23, at ¶ 11.1, 11.2.

performance stagnates or declines. Some of these factors are consistent with the management-power theory that has been debated rigorously in the United States in recent years. For example, the pronounced trend towards ZEPOs during 2000 to 2003,⁵⁸ as a substitute for or addition to traditional options, contemporaneous with a bear market for much of that period, may provide some support for the management-power theory in Australia.

Shareholders, regulators and others who are interested in the potential for performance-related pay to help minimize agency costs should be aware that there are several reasons why performance hurdles are not a nirvana. This article has endeavored to focus on the most significant of these by reference to Australian practice. These factors should be taken into account as commentators and investors call for U.S. corporations to embrace performance hurdles for stock options.

⁵⁸ See EQUITY STRATEGIES PTY LTD., *supra* note 11, at 4.