Fixed or Contingent: How Should “Governance Monitors” Be Paid?

By David F. Larcker and Brian Tayan
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THE COMPENSATION OF GOVERNANCE MONITORS
The primary purpose of a corporate governance system is to reduce agency costs within an organization. Agency costs occur when the individuals managing or working in an organization take self-interested actions to make themselves better off, with the cost of these actions borne by shareholders. Agency costs can manifest themselves in countless ways. Examples include the inappropriate use of corporate assets for personal purposes (such as a corporate expense account, automobile, or aircraft), the bribery of a purchasing agent to facilitate a product sale, the manipulation of financial results to boost the size of a bonus, trading on the basis of material non-public information, the acquisition of a non-strategic asset to increase managerial domain, or the failure to train a successor to increase the perception of one’s value to the organization. Time has shown individuals to be extremely creative in devising new ways to profit from the abuse of their organizational position.

To reduce agency costs, companies—because of both regulation and prudence—hire monitors to oversee various activities. Monitors include the board of directors, the general counsel, and an internal and external auditor. These monitors are paid by the organization, but their responsibilities are (largely) non-managerial. They are not expected to develop or implement the corporate strategy, they do not have direct responsibility for profit generation, nor do they control or allocate company assets. Rather, their job is to safeguard assets, monitor for illicit activity, and discourage management from excessive risk taking. Though difficult to measure, the success of these efforts will manifest itself through an improvement in operating performance, corporate value, and risk levels when agency costs are reduced in the system.

What is the appropriate compensation structure for these individuals? As with all employees, the design of the compensation plan (i.e., its mix of fixed and variable components) is driven by the incentives that the company wishes to impose on its workers. In the case of managerial workers, the company selects appropriate investment and risk taking incentives through a blend of fixed and variable pay elements and a blend of short- and long-term incentives that, in aggregate, encourage management to pursue a corporate strategy that creates shareholder value. Compensation design for corporate monitors is (perhaps) more complicated. On the one hand, the objectives of a corporate monitor are to detect and mitigate agency problems. Success is defined as the prevention of errors, while failure is defined as the allowance of errors. This suggests that monitors should be paid largely on a fixed-salary basis, with failure to detect malfeasance punishable by a substantial decrease in salary or outright termination from the firm. A fixed salary discourages variations in outcomes and encourages risk minimization (see Exhibit 1). From this viewpoint, corporate monitors should receive little to no incentive compensation.

On the other hand, an entirely fixed compensation system might not provide sufficient incentive for vigilant monitoring. With little incentive to “perform,” monitors might grow lax in their oversight. A corporation might also not be able to attract the best monitors. From this viewpoint, the corporation should include variable compensation elements to encourage effective oversight, or to attract highly qualified individuals. The company
might do so by offering cash bonuses or long-term equity incentives to align the interest of monitors with shareholders. Note that this approach explicitly imposes risk (compensation risk) on the monitor, and is diametrically opposed to the fixed-salary approach above. The potential downside from imposing compensation risk on monitors is that they might be co-opted by the very executives and employees they are expected to oversee. With their compensation tied to corporate performance, they have an incentive to turn a blind eye when management operates in grey areas (such as questionable sales practices, earnings management, insider stock sales, etc.), the detection of which would threaten their own bonus. Furthermore, the question arises as to what form the variable compensation should take (cash or equity) and what performance targets should be used (stock price, operating, or other financial and nonfinancial metrics).

There is little research to guide firms on this important choice. One body of literature examines the impact of variable compensation in board of director compensation contracts. Kumar and Sivaramakrishnan (2002) find that incentives encourage directors to expend greater effort to acquire information about the firm, thereby improving their monitoring. Other studies find a positive association between firm performance and incentives provided to directors. Still, these results might have more to do with the dual responsibilities of the board, which include both monitoring and advising management. Furthermore, the monitoring responsibilities of the board are high-level. Directors are not involved in day-to-day oversight of executive and employee behavior.

In a recent study, Armstrong, Jagilizner, and Larcker (2012) examine the compensation packages offered to general counsel and chief internal auditors. They find that these monitors receive a higher proportion of incentive compensation when they are more highly ranked within the organization. They also find a lower frequency of adverse outcomes (class action filings, financial restatements, SEC enforcement actions, and material weaknesses) among firms that offer higher incentive payments. They conclude that “performance-based incentives enhance the internal monitoring function, perhaps by providing incentives for better monitoring efforts or by facilitating the selection of more talented or reputable monitors.”

General observation supports the notion that many companies elect to award variable compensation to corporate monitors. For example, one medical device company offers cash incentives to divisional-level compliance officers. Payments are calculated as a combination of corporate performance (measured by earnings per share), divisional performance (measured by sales and operating margin), and divisional milestones (measured as pipeline development and product launch targets), with a target annual bonus equal to 20 percent of salary. The general counsel of this same company receives a compensation mix that is more heavily weighted to variable compensation: 15 percent salary, 35 percent stock awards, 10 percent option awards, 20 percent long-term performance plan, and 20 percent deferred compensation and other.

Research by Equilar also indicates that general counsel receive compensation with a considerable emphasis on performance incentives. General counsel within Fortune 1000 companies receive compensation that is 43 percent salary, 27 percent annual bonus, and 30 percent cash and equity long-term incentives, on average (see Exhibit 2). When they pay out, performance-related incentives can be highly lucrative, in some cases exceeding $10 million per year (see Exhibit 3). It is quite rare to find examples where the general counsel is paid solely in terms of fixed salary.

**WHY THIS MATTERS**

1. The decision of how to pay corporate monitors can have a significant impact on the motivation these individuals will have to detect and minimize corporate malfeasance. Should corporate monitors be paid strictly on a fixed-salary basis, or should some form of incentive compensation be offered? If so, what form should the incentive component take (cash or equity)? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive? What proportion of total pay should be offered as incentive?

2. Research shows that employees respond to incentives. Do performance incentives enhance
or impede the effectiveness of monitors? Should monitors be paid lower bonuses (or have previous bonuses clawed back) when their companies have governance problems such as earnings restatements, foreign corrupt payment problems, or regulatory violations?

1 In this way, monitors can be thought of as “guardians” under the classifications created by Baron and Kreps (1999). “Guardians” are employees whose success creates minimal upside for the organization but whose failure leads to large costs. Corporate monitors can be thought of as guardian employees because their focus is on cost prevention and not value creation. The opposite of a guardian is a “star,” whose success leads to considerable upside for the organization but whose failure leads to only minimal costs. An example of a “star” employee is a sales representative whose success generates large incremental profit for the firm but whose failure generates minimal incremental cost. See: James N. Baron and David M. Kreps, Strategic Human Resources, (New York: John Wiley & Sons, 1999).


5 Proprietary interviews with the authors and SEC filings (2011).


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EXHIBIT 1 — DISTRIBUTION OF OUTCOMES BY EMPLOYEE TYPE: GUARDIANS V. STARS

Note: Star employees are those whose success creates considerable upside for the organization but whose failure creates minimal loss. Most stars produce performance around the average, while only a few create considerable upside. Sales representatives are an example of star employees because their focus is on value creation rather than cost prevention. By contrast, guardian employees are those whose failure creates considerable downside but whose success creates minimal upside. Most guardians produce average results, while a few fail and allow considerable loss. Corporate monitors can be thought of as guardian employees because their focus is on loss prevention rather than value creation. Compensation systems for each employee type must encourage the “right” behavior: risk-taking in the case of stars and risk-minimization in the case of guardians. The responsibilities of senior executives combine “star” and “guardian” elements, and therefore their compensation structure will balance risk-taking and risk-reduction (i.e., prudent but not excessive risk-seeking behavior).

EXHIBIT 2 — COMPOSITION OF PAY AMONG GENERAL COUNSEL: DESCRIPTIVE STATISTICS (2009)

COMPONENTS OF PAY

PERCENTAGE OF GENERAL COUNSEL RECEIVING EACH AWARD TYPE
EXHIBIT 2 — CONTINUED

MOST COMMON PERFORMANCE METRICS

- Total Shareholder Return
- Earnings Per Share
- Return on Capital
- Cash Flow
- Operating Income/Margin
- Other

Note: Sample includes 275 companies among the Fortune 1000. Options and stock awards listed above have time-based vesting. Performance awards include performance based options, performance based stock awards, and performance based cash.

Source: Adapted from Equilar, Top General Counsel Compensation Report. 2009.
## EXHIBIT 3 — TEN MOST HIGHLY PAID GENERAL COUNSEL: REALIZED PAY (2011)

<table>
<thead>
<tr>
<th>Name</th>
<th>Company</th>
<th>Salary</th>
<th>Bonus/ Non-Equity Incentive</th>
<th>Realized Value Equity Awards</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Donald de Brier</td>
<td>Occidental Petroleum</td>
<td>495,900</td>
<td>5,472,000</td>
<td>28,560,879</td>
<td>34,528,779</td>
</tr>
<tr>
<td>Richard Baer</td>
<td>Qwest Communications</td>
<td>690,000</td>
<td>1,738,800</td>
<td>19,974,888</td>
<td>22,403,688</td>
</tr>
<tr>
<td>Kenneth Siegel</td>
<td>Starwood Hotels &amp; Resorts</td>
<td>634,582</td>
<td>766,188</td>
<td>12,662,928</td>
<td>14,063,698</td>
</tr>
<tr>
<td>Charles Tanabe</td>
<td>Liberty Media</td>
<td>875,500</td>
<td>1,332,073</td>
<td>9,740,432</td>
<td>11,948,005</td>
</tr>
<tr>
<td>J. Michael Hemmer</td>
<td>Union Pacific</td>
<td>455,000</td>
<td>1,100,000</td>
<td>7,530,493</td>
<td>9,085,493</td>
</tr>
<tr>
<td>Bruce Sewell</td>
<td>Apple</td>
<td>650,012</td>
<td>700,000</td>
<td>7,094,250</td>
<td>8,444,262</td>
</tr>
<tr>
<td>David Sorkin</td>
<td>KKR &amp; Co.</td>
<td>300,000</td>
<td>2,045,000</td>
<td>5,939,892</td>
<td>8,284,892</td>
</tr>
<tr>
<td>Laureen Seeger</td>
<td>McKesson Corp.</td>
<td>615,000</td>
<td>2,028,000</td>
<td>4,377,866</td>
<td>7,020,866</td>
</tr>
<tr>
<td>Denise Keane</td>
<td>Altria Group</td>
<td>731,817</td>
<td>5,724,700</td>
<td>552,416</td>
<td>7,008,933</td>
</tr>
<tr>
<td>Alan Schnitzer</td>
<td>The Travelers Companies</td>
<td>687,500</td>
<td>2,200,000</td>
<td>4,080,450</td>
<td>6,967,950</td>
</tr>
</tbody>
</table>

Note: Sample includes general counsel of Fortune 500 companies that are “named executive officers” in the annual proxy. Totals based on realized pay. Totals do not include other compensation, such as the fair value of perquisites and benefits.