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Say-on-Pay Movement Takes Root
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Vern Krishna

In these dark days of economic recession, executive compensation is the hottest issue in the staid world of corporate law. Shareholder activists and government regulators—particularly in the United States—are rethinking corporate management doctrines developed two centuries ago.

As the world slithers, governments are bailing out banks to keep the financial system from sinking. Meanwhile, some corporations have shovelled bonuses out the back door just as quickly as government bailouts came in through the front door.

There are essentially three aspects of executive compensation: how much, who determines and who discloses?

In February, Royal Bank of Scotland (RBS) was set to award its staff £1-billion in bonuses, after the British government—which now owns 70% of RBS—had poured in £20-billion in bailout money to keep the bank afloat. Alistair Darling, the British Finance Minister, announced a hasty review on bonuses: “I expect the review to make recommendations about the effectiveness of risk management by banks’ boards, including how pay affects risk-taking.”

The principles of modern corporate governance evolved from 19th-century concepts. Shareholders contribute money in exchange for shares and own the corporation; directors manage the corporation in the best interests of the corporation, not necessarily shareholders. Thus, shareholders have no direct legal input on executive-compensation policies.

Say on pay may be slow in coming, but has the potential to radically shift the principles of corporate governance in North America. Corporations are under increasing pressure to allow shareholders some input into the amount, form and disclosure of executive compensation.

Canadian banks set a good example and exercised leadership early. Canadian Imperial Bank of Commerce, Royal Bank of Canada and others passed resolutions that shareholders should be permitted non-binding votes on executive compensation. The banks acceded to the requests in light of impending shareholder revolts on corporate compensation. Manulife Financial Corp. initially resisted allowing shareholders any say, but capitulated under peer pressure and changed its policy to allow non-binding shareholder input. We should reasonably expect similar demands on governmental and regulatory bodies.

Some may see a non-binding vote as an oxymoron. But for others it is the first step to shareholder participation in corporate decisions. In public corporations, the issue is whether shareholders have any input into management and board decisions. In regulated industries, the issue is whether shareholders have any “right to know” before they have any “right to say.”

In light of the erosion of corporate earnings and equity values, some senior corporate executives have voluntarily renounced their performance pay. In the absence of stellar performance, there has been mounting pressure to “claw back” past bonuses.

Some corporate boards introduced innovative ways of conceding executive bonuses. They channel what would have been the executive’s bonus to a charity of the chief executive’s choosing. Presumably, the charity issues a charitable donation receipt and the corporation—not the CEO—gets a deduction.

Charitable donations to divert executive compensation can be a minefield. If the donation actually diverts the executive’s compensation at the executive’s direction, it may be an indirect payment to him or her. The Canada Revenue Agency can challenge indirect payments and tax the executive on the amount diverted. There are no easy answers to these structures and they should be carefully reviewed.

Another aspect of executive compensation that warrants scrutiny is the practice of “grossing-up” of corporate perks and benefits. The “grossup” payment covers the tax bite of perquisites, such as club memberships or the use of corporate cars and jets. In some cases, gross-up payments even extend to differentials in tax rates between countries.

The most expensive grossup is payment on golden parachutes payable upon voluntary or involuntary severance. The amount of the gross-up for taxes payable is itself taxable as a perquisite. Hence, the grossup requires a further gross-up and the cycle continues.

Assume that an individual receives a $100 benefit that is taxable at 35%, leaving a net of $65. To restore the individual to the $100 net of tax benefit, the corporation must gross up the amount of the perk by 54% to $154, which will leave a net after-tax benefit of $100. For example, Tiffany & Co. disclosed in its 2008 proxy statement that Michael Kowalski, its chief executive, would have received a gross-up of US$7.7-million on his severance valued at US$20.8-million if the company had been acquired.

As the recession grinds on, corporate boards and shareholders are taking a closer look at gross-ups. At least 43 companies in the Standard & Poor’s 500 stock index had already decided by April 2009 to stop paying gross-ups for taxes on executive perquisites and benefits.

It is too early to predict whether shareholder activism is merely transient and will abate when we climb out of the recession and equity values improve. At the very least, CEOs of responsible companies will disclose more information to their members. In corporate governance, sunlight is the best disinfectant.

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