

## Feature Story

Working Without a Net: Should Your CEO Have a Contract?  
by Randy Myers

*Lots of them don't, which gets board members off the excessive-severance hook if they have to give the boss the boot.*

Kenneth D. Lewis has thrown away his safety net. The Bank of America chief executive took home salary and performance-based bonuses totaling \$6.9 million in each of the past two years, plus stock awards worth over \$27 million more. Had the Bank of America board deemed Lewis's well-paid services no longer necessary, he would have gotten a lot of money anyway—he had an employment contract that would pay him at least his base salary and bonus until the agreement expired on September 30, 2004. But last December Lewis asked the board to cancel that “golden parachute,” and with it the millions he'd collect if he got pushed out of the corner office.

He says he knows of no precedent for his preemptive action, and compensation experts and executive recruiters polled for this article couldn't cite any either. Nonetheless, Lewis says that giving up his employment agreement was not a difficult decision. “First of all, we have a stated philosophy of pay for performance, and I thought a contract was inconsistent with that,” he says. “Secondly, I make a lot of money, and I don't think I should have a safety net when others don't.”

Thirdly, the heat was on. Nineteen months before Lewis's dramatic move, a majority—50.7%—of Bank of America shareholders passed a resolution calling on the board to seek their approval for any future severance agreements that would more than double an executive's base pay. Though the motion was nonbinding, the directors subsequently adopted a similar policy, one that put severance packages of more than twice base salary plus bonus to a shareholder vote. The new policy wouldn't have affected Lewis, who had a preexisting contract, but he took action anyhow. As board members are quickly realizing, executive employment contracts, particularly those with generous severance arrangements, are becoming lightning rods for shareholder energy.

Last year restive investors at 36 companies proposed that severance packages be subjected to a vote by the shareholders, according to the Investor Responsibility Research Center in Washington, D.C. And in June shareholders of Coca-Cola Co. howled when Steven J. Heyer, Coke's second-in-command, prepared to leave the company with almost \$24 million in severance after failing to get the top job. Even some directors of the Atlanta-based beverage company were reportedly unhappy at the potential size of the payout—but given the terms of Heyer's employment contract, they felt obliged to okay it.

The Corporate Library, a governance watchdog, found that one-third of chief executives have a formal contract, usually stipulating annual base salary as well as short- and long-term bonus arrangements for a set period. Equilar, a compensation-research firm in San Mateo, California, discovered that the proxies of 42 of the 100 largest corporations in the Fortune 500 contain an employment agreement for the CEO, while another 28 of those companies offer severance or change-in-control provisions protecting a CEO who has to go. So the proxies of 70% of America's largest companies contain some kind of agreement relating to CEO compensation.

When a contract deals with severance, it typically covers an involuntary “without cause” departure, “with cause” termination, and voluntary resignation. The crucial severance issues include the number of

years the exiting executive will continue to collect salary and bonus, plus the vesting of various long-term stock incentives. The contract might also provide for relocation, transportation, housing, home security, a pension, and a life insurance payoff should the CEO die while wearing his (or her) Hermès necktie (or scarf).

As with everything else in board-member life, directors should pay attention to the details of those agreements. “If it’s just a simple contract that says the CEO is serving at the pleasure of the board, that you’re not promising any particular level of compensation except that if you fire the person you’ll give them three years of pay, there’s nothing wrong with that, because you probably would have done that anyway,” says compensation expert Graef Crystal. If, by contrast, the contract promises a massive base salary, millions in options, “use of the company jet for the CEO’s dog, and God knows what else,” he says, the board might want to reconsider the deal.

Case in point: Tyco International chairman and CEO Dennis Kozlowski worked for many years without a contract. Then, in January 2001, he got one—with a clause stipulating that a felony conviction would not necessarily be grounds for firing him. Though the word “felony” should have aroused board members’ concern—Kozlowski is awaiting retrial in January on corporate corruption charges—they okayed the agreement. He did not, however, benefit from the contract, since he resigned under heavy fire in 2002.

Whether your CEO has a contract or not is likely to be dictated more by circumstance than by board principles. Executives recruited from the outside almost always get them, while those promoted to the top job from within seldom do, unless such agreements are company policy. Says executive recruiter Tom Neff, chairman of Spencer Stuart US: “I can’t remember the last time I recruited a CEO who didn’t get a contract.” And sometimes a signing bonus too. In 2001 Gillette’s new chairman and CEO, James M. Kilts, received \$250,000 (in addition to a contract, which has twice been renewed) to sharpen up the razor-blade company.

Compensation consultants see a certain logic in the dearth of contracts among people who have climbed their way to the top of the corporate ladder. They already know the company, are secure in their position, and are thrilled to be getting a chance to lead. As Jeffrey Immelt, the 22-year General Electric veteran who became chairman and CEO of the company in 2001, said in the second annual letter to stakeholders on his watch: “I am more than willing to be judged on the quality of my ideas and the impact of my decisions. Just to make sure I never lose my way, I work without a contract, serving meeting to meeting at the will of the board.”

Some insiders do get formal agreements. Tom Neff, who sits on the boards of ACE Ltd., a Bermuda-based insurance firm, Exult Inc., a human-resources concern in Irvine, California, and Lord Abbett Affiliated Fund, a mutual fund, points out that some executive-merry-go-round businesses are particularly partial to contracts. One is the retail industry, he says, where “people move around a lot from company to company over time.”

Adding to the confusion, some top executives have employment agreements while their colleagues do not. Though Kenneth Lewis has forgone his contract, his vice chairman at Bank of America, James H. Hance Jr., has one, as do three senior executives who came aboard in the 2004 acquisition of FleetBoston Financial Corp. At Citigroup, CEO Charles Prince, a longtime insider, has no employment contract. But at least three other Citigroup leaders do: chairman and former chief executive Sanford I. Weill; Robert E. Rubin, former U.S. Treasury secretary, who chairs the executive committee; and Sallie Krawcheck, chairman and CEO of the company’s Smith Barney unit, who previously ran Sanford C. Bernstein, a research firm. At General Motors, chairman and chief executive Rick Wagoner works without an employment agreement, but vice chairman Robert Lutz, who heads product development,

and John Devine, vice chairman and chief financial officer, both have them. “Misters Lutz and Devine were hired from outside GM and have contracts,” a company spokesman says. “After 2005 they will be treated like Mr. Wagoner and will have no contracts, per GM’s policy for its senior executives.”

At some point, then, top managers hired from the outside become insiders. That point came for Hewlett-Packard chairman and CEO Carleton S. Fiorina in 2002, when the three-year contract she got after leaving Lucent Technologies to join HP expired. “Historically, Hewlett-Packard employees, including the CEO, have not had employment agreements,” says company spokeswoman Monica Sarkar. “Carly Fiorina was an exception for a time, as she was an external hire. When that agreement expired, we agreed to revert to standard company practice.”

So should your CEO have a contract? Conventional wisdom and a lot of boardroom practice argue against it, on the theory that such agreements tend to favor executives rather than employers by locking companies into paying what many shareholders think are exorbitant salaries or by guaranteeing lucrative severance payments under all but the most egregious circumstances. “Many employers would prefer not to have contracts, because the contracts often benefit the executives disproportionately,” says compensation consultant Dan Ryterband, managing director of Frederic W. Cook & Co. “Unless there’s some special reason to have it, a contract could be dysfunctional,” observes Paul Brunswick, a director of The Pantry Inc., which operates convenience stores in the Southeast. “If the relationship turns out to be not good for both parties, neither party should want to be tied down by a contract. It probably ends up with more severance being paid out.”

The strongest argument for contracts is that they help get and keep the best person for the job. Those hot hires recruited from outside have not only good reason to want a safety net but also the leverage to demand one. “It’s one thing if you’re recruiting someone who’s on the beach,” says Bob Damon, North American president of the executive recruiting firm Korn/Ferry International. “But why would a supersuccessful leader in one company want to leave to go into another situation where there was not some sort of security? It just doesn’t happen.” Bank of America’s Kenneth Lewis agrees: “I think in some cases a contract is necessary to get a particular individual. And if the only way you can recruit the person is to do that, I can see the merits.”

Employment contracts may also include protections for employers, such as covenants that preclude departing executives from going to work for a direct competitor, soliciting subordinates to follow them, disparaging the company publicly, or disclosing confidential information. For example, Coke’s contract with Heyer (and other top executives who preceded him out the door) requires him to keep trade secrets to himself.

An employment contract might also help focus an executive’s mind on the job at hand. “To the extent the executive is comfortable with his employment and feels protected in the event of some adverse circumstance,” Dan Ryterband says, “he or she is less likely to be looking for better opportunities. So it serves to stabilize the organization and enable orderly management succession.”

Daniel Altobello is a director who endorses that view. A private investor, he sits on the boards of four public companies—Friedman Billings Ramsey Group, an investment bank; Mesa Air Group, which operates regional airlines; GVI Security Solutions, a provider of video surveillance systems; and World Airways, a U.S. carrier. “When I was chairman and CEO of a company that was being sold, I knew I could act in the best interests of the shareholders because the members of the management team and I would be well protected by our employment agreements,” says Altobello, who in 1995 oversaw the sale of an airline catering company, Caterair International, to Onex Food Services. “We all believe as CEOs we want to act in the interest of shareholders. But the question of ‘What happens to me?’ always comes up in any merger, acquisition, or disposition.” (It’s worth noting here that boards can adopt change-in-

control provisions—inside or outside employment contracts—to cover these situations.)

Some governance experts favor employment contracts on the ground that if the CEO is sent packing without one, his or her severance package may actually end up costing more. Ryterband, for instance, says he very rarely sees a CEO terminated from a major organization without a significant severance benefit. “Even if the benefit didn’t exist on the day he was terminated, it’s negotiated,” he says. “It’s shut-up money, it’s be-a-good-guy money, it’s we-don’t-want-to-be-sued money.”

Jean-Marie Messier, the executive who turned a French water company into media giant Vivendi Universal, argued passionately against giant severance agreements in his autobiography. But when his grand plans and lavish spending were about to cost him his job, Messier managed to arrange a E21 million severance package, worth about the same in dollars at the time. He didn’t get to keep it, however. In a settlement with the Securities and Exchange Commission over a civil fraud complaint, he agreed to relinquish his claim on the money and pay the SEC an additional \$1 million in penalties.

Compensation expert Graef Crystal attributes this kind of big last-minute payout to the company’s desire not just to buy a quiet exit by the departing CEO but also to temper the guilt directors often feel about dispatching one of their own. “You have certain directors who feel tremendously uneasy about doing something like this,” he says. “It’s the ‘Et tu, Brute?’ scenario: We’re all colleagues, and now you’ve turned on me. And so the natural instinct is to try to find some way to assuage the guilt, and that usually occurs in the business world with the transfer of money.”

In the beginning of a relationship with a CEO, the board may very well use a contract to entice an outsider to join the company. But in the end, especially if the end is an unhappy one, the directors know there will be a transfer of money. Probably a lot of money—whether the executive has an employment agreement or not. If the CEO does not have a contract, prepare for potentially contentious, shareholder-spooking negotiations. If he or she does have one, directors should make sure they know what the fine print says. Otherwise they may end up having to explain to shareholders why the ex-CEO’s dog is riding on the company plane.

### **Corporate Board Member**

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