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Letting Go of Norm: How Executive Compensation Can Do Better Than “Best Practices”

by Marc Hodak, Hodak Value Advisors*

Widespread criticism of CEO pay packages has spurred directors to engage more directly with management and their advisors on compensation issues, and to seek advice from investor groups and various experts in a search for “best practices.” This new vigilance is transforming the process of executive compensation design, administration, and oversight at many major public companies. But have all these *process* changes improved the output—that is, the compensation plans themselves?

The effectiveness of most aspects of compensation plans is difficult to verify by direct observation. Conflicting opinions and counterexamples can be found for most of what is claimed to be “best practice,” but until recently there has been little empirical research to support or refute such claims. This paper explores some of the more concrete trends in executive compensation, evaluates those that lend themselves to testable assertions of their value, and derives some conclusions based on an examination of detailed data on executive compensation plans for S&P 500 companies. These conclusions also reflect my conversations with hundreds of executives and consultants, as well as my own research and experience advising dozens of firms.¹

Unlike many critiques of compensation governance, this evaluation is not concerned with the reasons that compensation structures look the way they do (such as “executive greed,” “board capture,” “market for talent,” and so on), nor is it concerned with the issue of high CEO pay *per se*. My principal focus here is how compensation structures *in their current form* work for or against shareholder value creation. Against this standard, the evidence indicates that certain practices prove favorable, some have questionable value at best, and some are clearly counterproductive.

A Process Guided by Conflicting Opinion Toward a Norm

For people familiar with corporate governance, it will come as little surprise that better compensation committee practices may have little discernible effect on corporate performance. Seasoned directors, senior partners of major consulting firms, and experienced top executives all tend to agree that, although incentives can be a powerful motivator of behavior, specific compensation practices are very difficult to relate to specific company results. Company results are driven by a myriad of factors, many of which are largely beyond management’s control. Therefore, any conclusions about the effects of incentive policies on corporate performance and value must be derived from large-scale, long-term studies.

The clearest trend one finds from a detailed study of compensation structures over the last ten years is the prevalence of the typical three-part plan among S&P 500 companies. These parts consist of: (1) an annual plan largely based on accounting or non-financial metrics; (2) a long-term plan based on accounting or stock-based performance; and (3) a separate program for awarding non-performance-based equity grants. Long-term and equity grant plans have undergone some changes over the last few years, mostly in the direction of restricted stock instead of options, and toward an increase in performance-based equity grants.

One unintended result of all the scrutiny provided by corporate governance critics on the compensation committee process is the homogenization of compensation plans across corporate America.² As a senior Mercer consultant recently noted, compensation committees must now account for “optics” as a factor in almost every decision. What does “optics” mean? In practice, it means that you want your plan to be invisible to the outside world, attract-

* The author wishes to thank Jonathan Abraham for his extensive assistance in developing the S&P 500 database of compensation practices, Rapidan Capital for providing other data supporting the analysis, and Scott Olsen of PricewaterhouseCoopers for reviewing early drafts of this paper and for helpful comments.

1. Many of the results cited in this paper are the result of my fourth-generation research into compensation structures begun in 2001 with the Shareowner Alignment Index (SAI) study co-sponsored by Stern Stewart & Co. and Hackett Benchmarking and Research (a division of Answerthink). The SAI study was based on an in-depth survey supplemented by management interviews of 62 companies from around the world. Key findings from that

study formed the basis in 2002 of a second study focused on the global chemical sector. Findings from the 2002 study, in turn, formed the basis for a 2004 study of the global basic materials sector (see my article entitled “Alignment Exposed” in the Fall 2004 issue of this Journal). This fourth iteration encompasses the entire S&P 500 for 2004, 2005 proxy seasons, plus sample data going back to the 1999 proxy season.

2. One of the earliest and most widely ignored recommendations of the NACD Blue Ribbon Report on executive compensation is that “reliance on competitive precedent set by other companies should not drive the decision-making process.”

ing as little attention as possible, while you pay what you must to attract, motivate, and retain your talent.³

Apparently, compensation committees are not looking for a plan that is distinctive enough to function as a source of competitive advantage (aside from the ubiquitous desire to award 75th percentile pay for 75th percentile performance). The more typical mandate is to “confirm that [our] philosophy and practices are comparable to those of similar companies,”⁴ and to have the consultant “advise us on competitive market compensation levels, long-term compensation practices, trends in executive compensation, and other executive benefit programs.”⁵ And so we observe the continued spread of already popular practices, such as establishing bonuses based on “business strategy,” equating equity with “long-term incentives,” or the proliferation of multiple incentive plans covering a given employee.

The aim of the discussion that follows is to better inform this process with data about the net effects of these policies, and to offer the possibility of more effective, and probably simpler, incentive plans that promise excellence instead of mediocrity, and greater rewards for shareholders as well as managers.

Seven Compensation Trends of Dubious Value

Shareholders benefit greatly from a well-structured variable compensation package. But many incentive plans lose their effectiveness because they fail to distinguish between motivation and alignment.⁶ Practitioners often assume that the two are the same. However, greater alignment may create very little additional motivation when, for instance, employee stock options are given to division vice presidents. In such a case, the VPs’ personal wealth will certainly vary with shareholder returns; but they may feel that they have little personal influence on the resulting reward. Conversely, there are any number of possible incentives that will affect managers’ behavior while having no beneficial effect on shareholder value. In fact, some features of popular incentive plans, as I will illustrate, effectively pay managers to destroy value.

The problems caused by the failure to make such distinctions (as well as other sloppy uses of the language, such as “competitive” as a code word for equalization and “incentives” to describe rewards not driving any particular behavior) are compounded by the inherent trade-offs of compensation plan design, including:

- the need to trade off a plan’s attractiveness to employees and the degree of alignment it creates between managers and owners against its cost to shareholders;
- the need to trade off the accountability provided by objective standards against their vulnerability to “gaming” by managers; and
- the need to encourage long-term thinking versus the requirement to evaluate managers each year, quarter, and month.

No bonus plan is immune from these trade-offs, and the optimal plan will not be the same for any two companies. But that doesn’t mean that anything goes when it comes to compensation. Certain practices have become widespread simply because someone besides the shareholders stood to gain from their adoption, and the board had no reason to doubt their value. It’s time to reexamine those practices in the light of the evidence.

Compensation Trend 1: Motivation Without Alignment

Many companies have moved toward the “best practice” of more objective evaluations of senior executive performance in determining compensation awards.⁷ Do objective standards for compensation create stronger incentives? They certainly do, especially if managers are consistently held to those standards in their pay.⁸ Do those stronger incentives create value for the shareholders? Not always.

Early in my consulting career, an executive told me, “You know the saying ‘what gets measured gets managed’? Around here, we say that what gets rewarded gets repeated.” And so it does. Companies that pay their managers for revenue growth, for example, tend to see impressive revenue growth. Companies that pay for return on capital tend to have well-above-average returns on capital.⁹ The managers of these companies and their boards earnestly believe their incentive plans are working. The question is: Are these plans working for the shareholders?

One answer might be found in the wreckage of a client’s subsidiary that I worked with some years ago. Management was in the midst of reorganizing the business where, as I learned, executives had been rewarded almost exclusively based on sales growth. Top-line growth had somehow been determined (by the previous management) to be the main driver of value in their business.¹⁰ The operation succeeded in getting sales growth, but its profits went down the tubes.

3. Clearly, the midwives for this homogenization are the compensation consultants, especially the major human resource and benefits consulting firms with brand names in the corporate world. But that doesn’t mean they’re exercising independent power in all this; they, too, are acting within the significant constraints of corporate conservatism in the face of media and investor scrutiny. And, like their audit counterparts, most of the major firms have had a client or two whose plans blew up.

4. From CenturyTel’s 2005 Proxy.

5. From Dominion Energy’s 2005 Proxy.

6. A more accurate term for alignment, in this context, would be “wealth leverage,” a term coined by Stephen F. O’Byrne to define the degree to which management wealth varies with shareholder returns.

7. For instance, NACD guidelines recommend specific metrics “selected in advance and documented so that all parties understand what constitutes success,” and that “once determined, the metrics and the performance standards should be honored.”

8. Michael Jensen and William Meckling have extensively surveyed and reported research on the impact of incentives on behavior.

9. See my January 2003 case study relating the metrics used by chemical companies around the world to their shareholder returns, “Experimenting with Volatile Metrics in the Chemical Industry,” which is available upon request.

10. Confusion of correlation with causation is a common error in business and compensation design. The more likely relationship was that value-creating peers tended to grow their sales, rather than the other way around.

In the forensic stage that followed, it became clear how many clever ways a determined employee could “buy” sales and undermine profit.

And this story appears to be a representative one. According to my research, 66 companies in the S&P 500 used revenue as a main driver of bonuses in 2002-2004.¹¹ These firms grew their sales over seven percentage points faster than their peers over that period, but their total shareholder returns underperformed by 3.5 percentage points per year.¹² Profitability is obviously related to revenue, but the opposite is not necessarily true. Shareholder returns ultimately depend on firm profitability; there is little benefit from revenue *per se*. Paying for, and getting, revenue or sales growth is a good example of motivating managers without achieving alignment with the shareholders. The same could be said for paying for cost-cutting, market share, customer satisfaction, or any other worthy corporate goal apart from profit.

This illustrates the broader problem of “gaming the system,” which attends the use of any objective measure, even profit. For example, when I was a manager in a major transportation company, my operations counterparts were fond of budgeting significant amounts of capital for terminals as a way of reducing operating costs. Unfortunately, there was not enough discipline to prevent operations from spending a million dollars to get \$30,000 per year in after-tax operating cost savings. It doesn’t take much finance training to figure out that 3% is a lousy return on investment, but the operating unit got away with buying profitability with too much capital.¹³

Incentive experts know that when you pay for performance against an objective standard, you will usually get the primary, intended effect—that is, improvement in the result being measured. But you are also likely to get unintended effects, the most common of which are:

Manipulation of results. As any golfer will tell you, an incentive to perform is an incentive to cheat. Accounting is not a hard science. Judgments are inevitable, and the line between aggressive accounting and fraud is very fine. Many corporate governance critics lay at least part of the blame for recent accounting scandals on strong incentives to promise and achieve challenging (many would say unrealistic) earnings targets.

Short-term behavior. Even when Al Dunlap wasn’t messing with the numbers, he was practicing “scorched earth” management, the evisceration of a business to create

large apparent profit gains that were bound to be short-lived. He gutted R&D, squeezed his vendors, and engaged in channel stuffing and other practices that eventually alienated his employees, suppliers, and customers. This management style is notoriously hard to detect in large companies where being “tough” with vendors, employees, and even customers can be the path to higher near-term profits and promotions, as long as it doesn’t catch up with you.

Wishful thinking. To a certain extent, any “bottom line” is likely to be buffeted by non-management factors. I polled a group of CFOs from industrial companies about the percentage of profit variance that they believed was due to factors beyond their control. The median response was about 50%. In other words, managers can have a year where they do everything right and still have little to show for it in their results. The perception that one’s compensation is only loosely related to one’s efforts can undermine motivation. It can also foster risky behavior, where gains can be magnified for higher rewards, while losses get blamed (plausibly) on bad luck.

The point is definitely not that management should avoid objective, accounting-based measures for compensation purposes. Even with all the challenges cited, paying for profit can be a rewarding strategy for shareholders.¹⁴ The point is that companies have enough going against them in paying for objective measures; there is no point in compounding those challenges by tying pay to a measure that is not closely related to value.

Compensation Trend 2: Paying for Inputs Instead of Results

Many companies wary of paying for a focal metric are adopting the “best practice” of tying incentives directly to a company’s business strategy.¹⁵ In practice, this means paying for multiple financial or non-financial metrics, sometimes by identifying “leading indicators” of value creation, such as customer satisfaction, employee safety, or diversity. The most sophisticated version of this idea is to reward managers for meeting various goals associated with a balanced scorecard. How well do these plans work?

I have heard from managers that being paid for multiple measures reinforces the nominal benefits of a balanced scorecard. They feel they’re rewarded for things that are under their control (as opposed to some remote “profit” number), and that the measures and rewards help them maintain a clear “line-of-sight” on how their initiatives relate to the

11. Defined as companies with “revenue” or “sales” as either the sole measure or one of two measures upon which bonuses were paid for each of the three years.

12. These return results, like all the others cited in this paper, are based on company total shareholder returns relative to their sector average returns. These return results have a standard error of two percentage points ($p < 0.05$).

13. This problem can be somewhat alleviated if a business is measured on economic profit, which accounts for capital in the profit result. But economic profit is also subject to “gaming” in different ways.

14. About a third of S&P 500 companies pay primarily for profit on an objective basis, and these companies tend to outperform their peers in total shareholder returns on aver-

age, though with considerable variation across firms.

15. Mercer advertises that they will “align rewards with value-creating business strategies.” Towers Perrin advertises “advising boards and management on executive compensation programs that align pay with critical business goals.” Hewitt, Frederick W. Cook, and others claim in both their public and private discussions of compensation philosophy to build incentive plans around specific company strategies or plans. The Conference Board’s Commission on Public Trust and Private Enterprise even absorbed this philosophy by recommending “performance-based incentives that support and reinforce the corporation’s long-term strategic goals...and whose award is linked to achievement of specific strategic goals.”

strategy and vision of the organization. Nevertheless, the vast majority of what one hears in frank accounts about such plans raises doubts about their link to shareholder value. Here is a sampling of such comments:

I think I know what's expected, but it changes each year, and that makes it confusing.

Our system was designed to get rid of short-term behavior. As far as I can tell, it's just channeled that behavior in several directions instead of just one.

The plan (that is, the original "stretch" bonus targets) may have made sense at the time [when the targets were set in the budget cycle, about 11 months prior to this conversation] but it doesn't now. Still, the plan is the plan. We can't go around changing everything in mid-stream, or else where's the discipline?

We have to adjust our goals and targets all the time. The world hasn't looked like last year's budget almost since the time it was approved.

The main benefit of having KPIs [key performance indicators, the basis for this company's compensation targets] is that by the end of each year, you can always find some area where you can really nail it to justify a decent bonus. You learn how to accentuate the positive.

I feel like a rat in an elegant maze. Our compensation plan lends new meaning to 'who moved the cheese.'

The general sense one gets from discussions with managers about such plans is that multiple measures translates into "no priorities," with different people being pulled in different directions or, worse, in inappropriate directions based on poor forecasts. "Leading indicators" don't always lead to valuable results, and paying for them often means little accountability for results that owners would care about.

Consider Home Depot, a company whose bonuses are based on various financial and non-financial objectives plus certain qualitative factors. Their management team has received rich bonuses from this plan in each of the last four years that the current CEO has been at the helm.¹⁶ But those achievements have not translated into returns for shareholders, which have lagged in each of those four years. Whenever I hear of a company basing its incentives

on a "balanced scorecard," I look up their total shareholder returns and invariably find them trailing their peers. My research identified that 14% of S&P 500 companies had objective, multi-metric executive incentive plans (though not all of them derived from formal balanced scorecards) during the years 2002-2004 and, on average, these companies underperformed their peers by 3.2% per year.¹⁷

Whatever the virtues of balanced scorecards, or the plausible reasons for building "elegant mazes," they don't pan out as a useful basis for executive compensation. It turns out that—for all their problems—objective, profit-based incentives are simply not as bad as what companies give up in a less focused, or less profit-driven, plan at the top.¹⁸ Nevertheless, more and more HR departments are building bureaucracies around the premise of aligning compensation with strategy all the way up the organization rather than aligning executive pay with actual profit results. Even institutional investors have pulled this distorting brand of pay-for-performance from the "best practices" bin. In response to the recent Morgan Stanley pay scandal, a \$26 billion fund wrote a letter to the Morgan Stanley board urging that their firm institute "compensation incentives...linked to the achievement of specific strategic goals."¹⁹ And many boards are going along with this scheme, until bonus payouts over significant periods provide too stark a contrast with actual returns, and they begin to restore the old focus on profit.²⁰

Compensation Trend 3: Alignment Without Motivation

If you want to bypass all the pitfalls of paying for accounting results, you can reward managers directly for stock price performance. Many companies do this by requiring managers to hold a substantial amount of equity, and giving them *lots* of stock and options to enable this ownership interest. Some companies use other mechanisms that translate changes in share price into cash or equivalent awards, such as stock appreciation rights. Most boards believe "that long-term incentive compensation in the form of stock options can be an extremely effective incentive for superior performance leading to long-term stockholder value."²¹

Equity ownership, by definition, aligns managers and shareholders, at least for the portion of their personal wealth tied to shareholder returns. But "effective incentive" implies a motivation to do something, as opposed to a simple desire to see the share price go up. Most senior executives, right up to the CEO, will tell you that movements in their stock price over periods as long as five years usually have more to

16. Home Depot CEO Nardelli's minimum bonus is \$3 million per year, regardless of performance. The fact that his actual bonus has been substantially higher in each year suggests that he is, in the eyes of his board, achieving the "objectives established at the beginning of each fiscal year."

17. Based on compensation disclosure and total shareholder results for 2002-2004, with a standard error of 1.8 percentage points ($p < 0.05$).

18. Michael Jensen, "Value Maximization vs. Stakeholder Theory," *Journal of Applied Corporate Finance*, Vol. 14, No. 3 (2001).

19. From a July 21, 2005 Pennsylvania State Employment Retirement System press release. Ironically, Morgan Stanley's board got into the trouble prompting this response by following compensation norms in awarding huge bonuses in the severance agreements of outgoing executives. Their lead director, Miles Marsh, noted that the terms of the agreements were "meticulously modeled on packages that had been given to departing executives closely resembling their situations."

20. Arguably the case with Honeywell and Pactiv, for example.

21. From the 2005 Proxy of Citrix Systems, whose long-term performance has been far less than superior.

do with exogenous factors than the decisions and actions of management. Below the most senior levels, managers describe equity-based wealth enhancement as something akin to a crap shoot.

The reality of equity is that management actions do matter, but they matter indirectly, over a long period of time, and often in unpredictable ways. Will that two-year investment in Product X pay off, or prove to be a waste of money? Will this focus on an emerging threat prove to be a key to our survival or a huge distraction? The uncertain, long-term relationship between actions and stock price make equity ownership *per se* a weak motivator. On top of that, most managers have only the most general idea about how their decisions and actions relate to their stock price. Many managers, for instance, are convinced that EPS is all the market cares about in valuing their company, misinterpreting the market's reaction to the concentrated amount of information in an earnings disclosure.²²

Not only is equity a weak motivator when it's owned, it is also a terribly inefficient reward when it is granted. Managers tend to apply a much lower value to equity grants than do the shareholders granting it. The typical manager probably values options at about half of what shareholders could have gotten for them in the open market.²³ This "managerial discount" on options works against shareholders in that the company must give up a larger value of equity relative to the cash it could have paid to gain the same retention or alignment benefit. Stock is only slightly more efficient than options in this regard. That is, restricted stock has less of a perceived discount than options, but the restrictions we all like to see on them to ensure long-term alignment, such as ten-year vesting or premium threshold share-price targets, make that stock less valuable to the employee versus just saying, "Here are some shares. Do what you will."

The bottom line, then, is that ownership provides weak motivation, especially in the near term and for employees below senior corporate management, and equity grants provide an inefficient reward. That's not to say that managers shouldn't own stock or options. The alignment that comes from significant ownership among top management clearly provides enough motivation for them to seek out and act upon the major drivers of shareholder value. But equity by itself, especially options, is an expensive form of reward from a shareholder's perspective, and inherently unable to provide a sufficiently detailed guide for value creation to managers—like trying to use a globe to navigate between cities.

Equity as a reward can be every bit as powerful as its

cash equivalent. But to the extent that grants are based on achievement of accounting or stock price goals, the critiques and recommendations noted above with regards to cash awards would also apply to equity awards.

Compensation Trend 4: Equity Grants That Achieve the Opposite of Alignment

Time-vested equity grants remain, by far, the most common manner in which equity is awarded. A typical example would be a tranche of options in which one fourth of the options vest in each of the next four years. This is sometimes derisively referred to as a "reward for showing up," and, in fact, there is little principled basis for considering such a reward any differently than salary. But providing a portion of executive compensation as a guaranteed minimum, whether as cash or equity, is a perfectly acceptable compensation structure. The critique that follows proceeds on an entirely different track: Non-performance equity, when granted on a *fixed value* basis over time, creates a positive incentive to tank the stock price in the short term. Fixed-value grants are based on a target level of pay designed to keep the overall compensation package "competitive." For example, if competitive considerations mean \$100,000 worth of options per year (on top of salary, target bonus, and so on), then that's the value of options we would seek to provide each year, backing into the number of options we would need to grant. Paying a certain amount of the annual compensation in equity like this may look as benign as paying cash, but it's not. The practical result of fixed-value equity grants is to penalize managers for increases in the stock price and to reward them for drops in the share price. If the stock price goes up, then providing the same value in options as the prior year would mean granting *fewer* options.

For example, when McCormick & Co. was trading at about \$20 per share, it took far more options to achieve a target grant value than when their share price was \$30 per share. Their compensation committee reacted to a year of exceptionally good performance as follows:

Because McCormick stock has performed very well, the value of McCormick stock options has risen. As a result, in 2004, the number of options granted to the top management group was reduced to maintain the value of McCormick's long-term incentive programs at market competitive levels.

You get the opposite effect when the price goes down. Calpine provides an annual grant of options to its executives based on a similar fixed-value policy.²⁴ Consequently, when

22. An excellent study of the non-economic behavior of managers trying to manage earnings was done by John Graham, Campbell Harvey, and Shivaram Rajgopal, "The Economic Implications of Corporate Financial Reporting," *Journal of Accounting and Economics* (forthcoming 2005).

23. Lisa Meulbroek, "The Efficiency of Equity-Linked Compensation," *Financial Management*, Vol. 30, No. 2 (Summer 2001). This study estimated the value of stock options to undiversified managers in Internet firms to be only 53% of their cost to the firm. The aver-

age company is less volatile than Internet companies, which would presumably make the options worth even less. See also Brian Hall, "Six Challenges in Designing Equity-Based Pay," *Journal of Applied Corporate Finance*, Vol. 15, No. 3 (2003).

24. The typical rationale for grants under this policy is "recent performance, his or her potential for future responsibility and promotion, and total remuneration made to individuals in similar positions with comparable companies," which is basically code for fixed value grants with some adjustment for individual performance and retention.

the stock price dropped by two-thirds from 1999 to 2004, Calpine tripled the rate at which they granted options to managers to remain “competitive.” Today, top management has accumulated so many additional options as a result of the cumulative price drop that if their stock simply got back to where it was at the end of 1999,²⁵ the CEO alone would be ahead by \$20 million—that’s \$20 million more than if the stock price had been flat across those five years.

Thus, the net effect of a “competitive” annual equity grant policy over time is the opposite of alignment. To varying degrees, about two-thirds of S&P 500 companies grant non-performance equity in this manner. One alternative to fixed-value grants is front-loaded equity with long vesting periods. Unfortunately, many boards shy away from such “mega-grants” even if they are well structured to provide incentive and retention because accounting rules make such grants appear very expensive, inviting scrutiny from outside critics. Other alternatives to fixed-value grants are a more level number of shares over time or indexed options.²⁶

Compensation Trend 5: Long-Term Plans That Undermine Long-Term Performance

A growing practice (whether it constitutes a “best” practice or not depends on the institution you’re asking) is the adoption of long-term incentive plans, called LTIPs, as distinguished from purely competitive equity grants. This is another way that companies try to overcome that devilish short-term, long-term problem associated with objective metrics. About a third of the S&P has LTIPs. These plans come in many flavors; their design is one area where compensation consultants get to exercise their creativity. Most LTIPs are simply novel mechanisms for granting performance-based equity to management. But many companies also offer LTIPs based on stock price movements that settle in cash. Although they exist in a wide variety of designs, the key distinctions of LTIPs versus annual plans are that (1) they are generally the second or third incentive plan from which a given executive can derive rewards and (2) they generally pay for achieving multi-year goals, which may or may not be the same goals as in the short-term plan. The typical LTIP cycle is three years (yes, that’s what compensation consultants call “long-term”).

The first question one might ask about LTIPs is this: If their *raison d’être* is the need to offset short-term behavior reinforced by a short-term plan, then why not have *only* a long-term plan? Many experts would answer that bonus

plans lose much of their retention value if they are not based on annual performance. Even so, there is no reason that one can’t pay annually for “in process” performance over time, with cumulative rewards “trued up” or “clawed back” as the sustainability of results becomes clearer. A more likely reason for an LTIP as a second or third plan is that, as one senior Mercer consultant put it, “Long-term targets are more difficult to set than annual targets. No one knows where net income, for example, should be in three years.” The unstated premise here is that targets based on management forecasts are the best way to set compensation targets. More on that later.

For now, it’s enough to note the profound lure of LTIPs, as Eaton Corporation’s deliberations illustrate: “In 2003 and again in 2004, the Committee commissioned this second independent compensation consultant to conduct separate detailed studies of evolving market practices involving long-term incentive compensation plans.”²⁷ As a result of these deliberations, Eaton has a fairly typical set of long-term plans consisting of annual equity grants (options granted on a fixed-number as opposed to a fixed-value basis—not bad) and a cash LTIP based on earnings and returns, the same measures that determine Eaton’s annual bonuses (also not bad), with the main difference being that the LTIP operates on a three-year cycle. But as if to underscore the difficulty of setting LTIP targets, Eaton has had to modify its prior budget-based goals for three of its last four LTIP cycles.

So, how does this distinction between short and long-term plans motivate managers and serve the shareholders?

I have spoken to hundreds of managers over the years about their incentives, from division managers to CEOs, many with decades of experience, and have yet to find a *single one* whose short-term behaviors are motivated by their short-term plan and whose long-term actions are motivated by their long-term plan. Nobody even roughly accounts for those plans’ respective target bonus levels and compensation leverage.²⁸ As a former engineer working in finance at an aerospace defense firm once told me, “Hey, it’s not like I do the math.”

In fact, when the short-term and long-term plans use the same measures, all other distinctions between the plans quickly fall by the wayside in terms of behavior. As a manager with both short- and long-term plans based on EPS tells it, “What difference does it make to me *when* the targets were set? It’s still about earnings.” When different plans have different metrics, managers tend to focus on the

25. This would still be one-third of Calpine’s peak value reached in mid-2001.

26. Indexed options are not costless relative to standard options, however. Front-loaded and level number grants pose greater risks of retention (if the price drops) or cost (if the price goes up). Indexed options have an even greater managerial discount than standard options, so you have to grant a very large value of options relative to cash for a given level of attractiveness to management.

27. From Eaton’s 2005 Proxy.

28. Compensation leverage is the degree to which the incentive payout varies for a

given level of performance. For example, a given improvement in EPS might create a much higher award in the LTIP than in the annual plan for companies that use EPS as the compensation metric in both plans. If one is using EPS for the short-term plans and another measure, say revenue or ROC, for the LTIP, it’s easy to see how hopeless it would be to figure out trade-offs between the impact of those various measures on bonuses. Generally, each type of plan—short-term, long-term, medium-term, cash, restricted stock, option, and so on—has its own target compensation levels, vesting, payout thresholds, and compensation leverage.

ones they have the best chance of making look good, and forget the rest.

LTIP awards based on stock price, as many of them are, have a little more incentive effect than they would in annual plans because the managerial contribution to three-year total return is estimated to be about twice as much as their impact over a single year, but the overall impact is still dwarfed by non-management factors. As one fairly senior telecom executive told me, “It’s a little like the lottery. Over any three-year period, the stock price can do anything.” And that was *before* the bursting of the Internet/telecom bubble. Another manager in the same organization, but one level down, was blunter in commenting about the impact of their TSR²⁹-based plan upon his behavior: “The LTIP is invisible. At least I have some effect on our AIP [their annual plan]. That’s what really has our attention.”

So, if it doesn’t matter to managers that accounting targets were set two or three years ago, and their perceived impact on three-year shareholder return doesn’t provide a lot of additional motivation, then what good is a separate LTIP? When we look at the S&P 500, there is no apparent advantage. According to my research, nearly two-thirds of companies with LTIPs based on three-year cycles did worse than their peers *over the last three years*.

Between the anecdotal and empirical evidence, LTIPs seem at best harmless and at worst a needless complication. Yet according to a recent Equilar survey, nearly 35% of companies are considering an LTIP plan in the next planning cycle.

Compensation Trend 6: Paying Managers to Lie

Jack Welch called the budget process “an enervating exercise in minimization” in which business teams work hard “to develop the case for the minimum number they think they could ‘sell’.” Perhaps the most common practice in compensation is the derivation of incentive plan targets from annual budgets.

There are many reasons why budget-based compensation targets create perverse incentives. Aside from the “minimization” process described above, budgets also discourage performance significantly beyond one’s “maximum” goals since such goals almost always represent performance at which bonuses are capped. It’s bad enough that one doesn’t get rewarded for exceeding maximum performance goals, but blowing by them raises difficult questions about how much one sandbagged the budget last year, questions often answered with much higher targets assigned for the next year. An irony of “stretch targets” is that they are often hailed by corporate leaders as an effective way to get the best out of their people (“C’mon—show me what you can

do!”). To those who see the folly of it all, the very need for “stretch” targets is just another illustration of the failure of the negotiated budget model.

Why does the potential for excellence have to be dragged out of otherwise aggressive, high-powered division chiefs? It’s the incentives, clearly. But this way of doing things is here for a reason. The budget process maintains control (or the illusion of it) firmly in the hands of corporate executives. The success of the LBO movement and most corporate spinoffs, as well as the growth of private equity-backed firms, is due in part to their liberation of significant assets from the corporate budget process. Any company that has wrestled with providing more entrepreneurial incentives to their divisions has had to contend with the constraints of the budget process. Google, e-Bay, or Microsoft could simply not have emerged from any corporate budget.

All this is not to say that budgets don’t serve a useful purpose. You can’t run a business without a budget. The point is that the use of annual budget targets as compensation targets corrupts the budget process and encourages mediocrity. The limitations of budget-based targets are a likely driver of the growth of long-term incentive plans. As the Mercer consultant mentioned earlier said, it’s easier to create targets one year out than three years out. But that assumes that targets must or should be derived from budget forecasts. That attitude makes sense from the perspective of central planners using their human resource experts to ensure that their plans are taken seriously, but not from the perspective of business leaders seeking to exceed shareholder expectations. Managers can, if they want, infer the market’s profit expectations from a combination of the stock price and current operating financial performance; and such expectations are, in fact, *easier* to infer over longer periods of time. For example, the higher a company’s price-to-earnings ratio, the higher the market’s expectation of that company’s earnings growth. The approximate rate of growth can be estimated over various time horizons from a few years to decades. It’s the near-term pattern of earnings growth that is most uncertain—and can often be inferred from consensus analyst forecasts.

It’s difficult to quantify the penalty paid by companies that engage in budget-based target-setting because the practice is so prevalent. One place to look might be firms that base their bonuses on avowedly subjective factors. In other words, they don’t derive their targets from budgets. The compelling pattern of superior performance by such companies can perhaps be interpreted as indirect evidence that budgets inhibit significant growth.³⁰ Fortunately, we don’t need to resort to subjectivity in lieu of budgets to set appropriate targets. A number of companies skillfully set targets based on year-over-

29. Total shareholder return.

30. Firms that subjectively reward their senior managers significantly outperform their peers, on average, but the results are skewed toward a relative few who perform exceptionally well while the majority underperform to varying degrees. Perhaps some firms use

subjectivity to reinforce fine distinctions among those who create the most value—which objective, budget-driven plans cannot do nearly as well—while most firms use subjectivity in a way that does not inspire great performance, as much experience with subjectivity would suggest.

year improvement,³¹ or expected improvement derived from market data.

Compensation Trend 7: Incentives to Limit Performance

When Tyco brought on Ed Breen and a new board to clean things up, one of the first things they did was to dramatically reduce the caps on executive bonuses. The bonus “now caps out at 200 percent of base salary,” noted Breen, “whereas before it was more like 600 percent or 700 percent.”³² As “best practices” go, caps on bonuses are almost universal.

It’s easy to see why. If you approach any bonus plan as something to be “gamed” by management, or as something driven as much by luck as skill, then a cap seems like a logical control.³³ It’s a defense against poorly designed or poorly calibrated bonus plans, or plans whose targets were sandbagged by management. If the measures that are driving management pay don’t make complete sense—like revenue or cost containment—you certainly don’t want management maximizing such metrics. Also, there are certain businesses where the short-term, long-term trade-offs make current-year maximization an unsafe practice. For example, I had a real estate client that ended up firing a property manager who was driving up current profits by deferring maintenance on high-end property, which would eventually undermine their ability to re-lease their space at Class-A rates. If you’re going to take the caps off of bonuses in such a situation, you better have some other controls in place to prevent unwise behavior.

As a counter to all this, I often ask CFOs or HR heads why their firm has a cap on performance. They generally look at me for a moment as if I meant to ask a different question—namely, why do they cap their *bonus plan*—but then think about it a moment and say, “Hmm.” With just this much reflection, anybody can agree that a cap on incentives is tantamount to a cap on performance. Most boards are convinced that caps are good for shareholders because they realize they don’t have incentive plans that can safely be uncapped, and they can’t imagine how it could be otherwise.

But in fact there are companies that operate without bonus caps. They overcome the rationale that one shouldn’t reward “gaming” or good luck by effectively deferring a portion of bonuses arising from exceptional performance with mechanisms that can claw them back if that performance turns out to be unsustainable. Evidence shows that such efforts are well worth it; companies without caps on their bonuses (that have presumably taken care of the preconditions for safely removing them) perform far better than their peers.³⁴

The Entrepreneurial Model

As one can see, there are many ways to compromise the effectiveness of an incentive plan. While there is no such thing as a perfect plan, everyone is familiar with at least one plan that provides legendary wealth for both managers and shareholders—the entrepreneurial model. The entrepreneurial model is very straightforward. Management gets a fixed share of the profits generated by the business, or a fixed percentage of the value of the business. It’s easy to understand the claim of a Bill Gates or a Warren Buffett on their companies’ profits. Their personal wealth is a direct reflection of the profitability of their businesses. Nobody misunderstands the source of that wealth, and few begrudge it.

The downside to the entrepreneurial model is the risk. Neither corporate managers nor typical large-company shareholders tend to be comfortable with truly entrepreneurial risk. Fortunately, it isn’t difficult to modulate the risk of an incentive plan to be consistent with the risk profile that shareholders are comfortable with. Consistent with an entrepreneurial model with stepped-down risk, the most effective plans appear to be profit-based, objective, and stable (often with some subjective element in the distribution, if not the funding, of bonuses).

An excellent example of such a plan was the Nucor plan instituted by Ken Iverson in 1965. The plan was as straightforward as the man; it funded a bonus pool based on a share of the profits above a threshold level of profitability (what we would now call an economic profit, or EP, plan).³⁵ The plan’s integrity came from three sources. First, there was a discipline for setting the threshold profit, which was based on invested capital and past performance. This provided accountability for new capital, and ensured that management was paid extraordinary bonuses only for extraordinary achievement. Second, Nucor had *one plan* for senior executives, and it paid out in cash and stock. There was no opportunity to make up with a second plan what they failed to achieve in the first. Third, and perhaps most important, the plan was incredibly stable. That fixed share of profitability was there whenever the profits materialized, whether it took one year or ten. This plan survived in its basic form for 37 years. As a result, Nucor’s managers didn’t consider their annual bonus plan to be a “short-term” plan. As far as they were concerned, it motivated and rewarded long-term performance.

The plan paid out handsomely as they took a struggling joist company and turned it into a uniquely profitable steel maker. The company went through several years in the late ’80s with flat profits while they built their first, revolution-

31. The method preferred by GE’s Welch, with consideration for relative performance against competitors.

32. Geoffrey Colvin, “Have They No Shame?,” *Fortune*, April 14, 2003.

33. One firm, EOG Resources, recently added a feature to cap *stock option gains*. It limits the potential gain that can be realized by requiring vested options to be exercised if the market price reaches 200% of the grant price for five consecutive trading days. If such options are not exercised upon attainment of the cap, they are forfeited.

34. This was the key finding of the 2001 Shareowner Alignment Index study cited earlier. Nearly three-quarters of the outperforming “value-aligned” firms in the study had uncapped bonuses.

35. From Nucor’s proxies of 1994-2002, and other Nucor documents.

ary mini-mill, after which their profit growth (and bonuses) came roaring back. In its fairness, simplicity, and integrity, it may be the most successful incentive plan ever created.

Ironically, Paul Hodgson, senior compensation analyst at the Corporate Library, a well-regarded corporate governance critic, gushed over Nucor's compensation system shortly before their board changed it in 2002. He gave Nucor his highest "CEO Compensation Score."³⁶ Such praise unfortunately turned out to be premature. Nucor's mostly new board, on the recommendation of their nationally recognized compensation consultant, replaced the old plan with the familiar triad: an annual plan based on revenue growth and return on equity, an LTIP based on three-year return on capital, and fixed-value option grants.

Elements of Integrity

Today, many companies have various elements of the old Nucor plan. Worthington Industries, for instance, clearly appreciates the simplicity of a single plan based on profit, stating that "bonuses paid under the Bonus Plan provide a balance between incentives for current and long-term profitability. Since the payment is based on current year performance, the incentive to boost current profitability is obvious. However, since future compensation for officers will continue to be based in large part on the Bonus Plan, the existence of the Bonus Plan also provides the incentive to assure the continued long-term profitability of the Company."³⁷

Many critics argue that paying managers on the basis of objective measures, whatever they may be, induces them to steal from tomorrow or to fudge the numbers. But this is far more likely to be true for incentive plans that are subject to change each year. With profit-based plans, such as Worthington's and Nucor's, that persist in a stable fashion for many years or decades, there is little point in gunning it for the short term. The integrity of the plan rewards the integrity of management.

The same could be said of Proctor & Gamble's "Additional Remuneration Plan," which has funded their corporate-level bonuses based on profit results for decades. According to a P&G exec, "This is more or less the same program that's been around since 1949. The expectations are pretty clear." When I asked if short-term behavior existed at P&G, she responded, "It's not likely. And if someone tried it, it wouldn't last."

As UPS is fond of noting, "Throughout its history, UPS has been owned by its employees and managed by its owners." For nearly all of that history, bonuses have come from a pool funded by corporate profit, with the CEO and other executive officers participating on the same basis as all

other managers.³⁸ UPS managed to maintain its incentive plan structure after going public in 1999. Only in this last year has the compensation committee begun talking about exercising "its judgment on the level of incentive payments" by considering more financial and non-financial criteria.

Bed, Bath, & Beyond, which has no annual plan, pays out options in a fixed number every year, undiminished by the rise in stock price over the last five years (of course, the strike price on the options has gone up, too). A few other companies like Carnival Cruise Lines, Costco Wholesale, and Sara Lee follow a similar level-option policy.

Ball Corporation provides an example of a more modern, corporate version of the entrepreneurial model. A distinctive feature of their plan is the manner in which profit targets are set. To begin with, they measure profit net of a capital charge, or EVA.³⁹ This measure automatically accounts for the level of capital on which they must earn a return to get any payouts. Furthermore, their EVA performance targets are set by an improvement formula that is separate from the budget. Ball accounts for the year-to-year vagaries of objective results with a sophisticated deferral system that allows for unlimited upside while providing a "claw-back" mechanism if the high performance upon which they have accrued bonuses proves unsustainable. This plan has been in place, essentially unchanged, for over a decade now, through ups and downs in their business cycle.

Unfortunately, only a handful of companies in the S&P 500 have incentive plans that properly motivate and align their managers in a way that avoids the seven aforementioned pitfalls. Like their peers, these firms are subject to the whims of the economy. Within their industries, they occasionally find themselves with the wrong assets at the wrong time, and their technical innovations may not always pan out. The difference is that they hold themselves accountable for the downs as well as the ups. Consequently, their downs aren't quite as bad, and their ups are spectacular, consistent with the behavior of people without limits.

Nevertheless, their boards are always under pressure to modify their incentive plans to conform to the norm. It's not normal to set targets based purely on improvement regardless of what the budget calls for. It's not normal to offer bonuses without limit in years of exceptional performance. It's not normal to have one incentive plan that pays for everything. Their compensation consultants constantly whisper that they should consider a more "sophisticated" plan, one aligned with their strategy, with a distinct long-term component, like so many of their peers. Some companies, like Nucor or UPS, in the throes of unprece-

36. Paul Hodgson, "A Compensation Policy Comparison," The Corporate Library (May 2002).

37. From Worthington Industries Proxy statements from 1994 to the present.

38. From UPS's 2004 proxy.

39. EVA, which stands for "economic value added," is a registered trademark of Stern Stewart & Co., which was responsible for implementing the plan. EVA is a variant of economic profit or residual income.

dented board turnover, eventually succumb. Most of these companies, however, will stick with their quirky plans. They have adopted every element deliberately and are conscious of the implications (because they have had them modeled by financially sophisticated HR consultants, or HR-sophisticated financial consultants). And such companies have the ultimate answer to the critics who accuse them of being behind the times, or profligate, or worse: Companies with objective, profit-focused, and uncapped bonus plans as the sole basis for both cash and equity awards, according to my research, outperformed their peers by an average of 6.4% to 8.4% per year in total shareholder returns over every two-, three-, and five-year period since 1998.⁴⁰ This elite constitutes less than 5% of the S&P 500.

Five Lessons for Better Practices

Anyone who has worked with companies to develop compensation plans knows that there is no such thing as a perfect, one-size-fits-all template. Incentives can be complex and unpredictable, like the people subject to them. But many compensation “experts” think they understand selected truths like “objective plans improve accountability” or “any plan can be gamed,” and they begin recommending or adopting features that may or may not, on net, actually improve performance. That is why it’s useful to look at the experiences of hundreds of companies over recent history, as opposed to an anecdotal few, to test some of the accepted trends with actual data. Having looked at various “best practices,” we can suggest some better ones:

- *Pay for profit:* Incentive plans based on an objective profit measure—that is, profit with a specifically defined threshold—beat out multi-measure plans and plans focused on measures other than profit.
- *Keep plans simple:* You don’t need three of them. You may not even need two. One plan with the proper target bonuses and a deferral mechanism can fund all your incentives.
- *Use equity as a reward, not as a motivator:* Your accounting-based plan can pay out in equity as well as cash.

Shareholders benefit from having managers own equity.

- *Avoid fixed-value grants:* If you offer equity to supplement salary (for instance, to get around IRS Section 162(m) limits on guaranteed pay), offer equity on a front-loaded or fixed-share basis, or as indexed options.

- *Avoid using planning targets for any executive compensation purposes:* Instead use improvement, peer-based, or market-derived targets for incentive plans.

This last point suggests perhaps the most valuable area where boards can safely and competently exercise their authority in compensation decisions. Currently, most boards are content with being at the top of the budget negotiation, asking the CEO if *that* is the best the corporation can do, signing off on targets when they can’t argue otherwise, then certifying at the end of the year that the targets were met or not in order to authorize bonuses, and sometimes exercising discretion to protect themselves from poorly designed or calibrated plans. This hardly reinforces compensation integrity.

Directors belong at the intersection of management and the shareholders, not in the bowels of a planning discussion. Instead, public-company boards can independently determine whether the financial results promised by long-term plans are consistent with observable shareholder expectations. This now tends to be treated as a finance issue independent of the budget, not an HR issue that can inform incentives. By combining the financial and incentive implications of shareholder expectations with a well-defined, fixed share of profits for management, the board can provide a high level of accountability without intruding on management’s prerogatives to manage, and without excessive reliance on what everyone else is doing in designing their mediocre incentives.

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40. Standard error for the two-year periods was 4.9 percentage points; standard error for the three- and five-year periods was 3.4 percentage points ($p < 0.05$).

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