Compensation constraints at public companies could be helping undermine performance, say some experienced boardroom figures who note that private equity, free from public pressure on its pay practices, outperforms public markets.

Mark Hodak, managing director of the compensation and governance consultancy Hodak Value Advisors, explained in an interview that public company boards sometimes take economically irrational steps in order to avoid criticism from shareholder advisory groups and other constituencies.

In a recent article for the Journal of Applied Corporate Finance entitled The Growing Executive Compensation Advantage of Private vs. Public Companies, Mr. Hodak outlined several of the pay levers available to privately held companies but apt to draw fire at publicly held companies, including tax gross-ups, subjective bonuses, mega-grants of options, rewards pegged to a single
performance factor, and similar features disfavored by proxy advisors. Then there are perks. “Perks are almost indefensible,” he said. Yet some of the most heavily criticized perks, such as corporate jets, “are probably worth much more to executives than the cost to the company.” In this respect, such perks are like child care, which also costs companies less than it is worth to employees, so the company gets more than a dollar’s worth of compensation value for the dollar spent.

Mark Florman, chairman of the London investment bank Spayne Lindsay & Co. and a previous head of the British Private Equity and Venture Capital Association, said, “The beauty of being in private equity hands is that you have a starting point and a finishing point: the starting point is when investment is made by the private equity group and the finishing point is the exit.” So it is possible to design a plan that will compensate executives for focusing on one big goal before the exit. One tactic, he explained, is “sweet equity, where the CEO and management team would be invited to make an investment in the company themselves to get alignment. They have to pay for the equity but sometimes the terms can be more attractive to them so they get a bigger upside.”

“I think there’s more flexibility in a privately held company. I think you have more ability to adjust as you go along because you have fewer constituencies overlooking what you are doing,” said Larry Zicklin, former managing partner of the investment firm Neuberger Berman and now a professor at the New York University Stern School of Business. He explained that notwithstanding the formulae used to guide compensation at his former firm, the final decision on pay was subjective and his own. “I would look to see if there was some logic to the whole thing. There’s got to be judgment, reason, fairness,” he said.

Subjective pay plans and sweet equity “would be very difficult to implement at a public company,” Mr. Hodak said, because of the high likelihood of criticism.

Researchers have demonstrated that private equity funds outperform public markets by about 3% annually.

Meanwhile, academics have also demonstrated that public companies that change compensation plans in order to better tailor them to demands of shareholder advisors seem to underperform. Compensation authorities have explained why public companies may act against the real economic interests of shareholders in order to win say-on-pay votes.

But don’t look for the situation to improve. “The constraints on CEO pay are not going away. If anything, they’re likely to get worse,” Mr. Hodak said.

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