

A Better Look At The Boss's Pay

New SEC rules require greater disclosure, but don't expect CEOs to take a hit

By Jane Sasseen
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No topic inflames the passions of business leaders and shareholders like executive pay. Companies and compensation consultants argue that, in a free market, they'd be foolish not to pay the going rate for top talent. Investors demand that compensation be tied to performance and complain loudly when pay rises while share prices don't.

The perennial battle is about to reach a new level of contentiousness. The proxy season, just getting started, will be the first under new Securities & Exchange Commission reporting rules that force companies to disclose more about executive pay than ever before--from the hundreds of millions some executives stand to gain in severance, pensions, and deferred pay, to any perk worth more than \$10,000. Golden parachutes and sybaritic benefits such as club memberships and personal use of company jets won't score many points against a backdrop of the options-backdating scandal and increasingly empowered activist investors.

Thanks to recent blowups like that at Home Depot, shareholder-rights groups hold a distinct advantage in the public-relations war. Former Chief Executive Robert L. Nardelli walked away from Home Depot Inc. (HD) in early January with a \$210 million severance package, shocking shareholders unhappy with the company's flagging stock. And the timing couldn't have been worse for companies nervously preparing to reveal their own pay practices. "Home Depot is a preview of things to come," says Michael S. Melbinger, a compensation lawyer with Winston & Strawn in Chicago. "It's the perfect example of the rich payout that would have been buried before, but which everyone now must disclose."

Governance advocates and politicians gain even more public support when they point out that in 2005 the average CEO in the Standard & Poor's 500-stock index took home 369 times the pay of the average worker, up from 28 times the average in 1970. The counterargument, that the ratio is down from the 514 multiple in 2000, doesn't get much traction.

THE LITTLE THINGS

Some boards have been looking hard at executive contracts and even tried to renegotiate them. Such minor perks as the personal driver and financial planning services are often on the table. But most boards plan to do little more.

In many cases, they can't. Almost all CEOs have contracts guaranteeing their big payouts. And the fear of angering a CEO over a pay issue has made directors reluctant to push harder. "No one wants to be responsible for seeing the CEO walk," says Jannice L. Koors, a managing director of pay consultants Pearl Meyer & Partners. In a survey of 110 companies at yearend, Mercer Human Resource Consulting found that 70% planned only minimal changes to their executive compensation programs as a result of the new SEC rules; just 15% said the impact would be more substantial. Cutbacks in executives' packages are "just not terribly widespread," says Mark A. Borges, a former SEC official who is a principal at Mercer. Chicago lawyer Melbinger, who has sat in on recent board meetings, echoes Borges' view: "Yes, there's pressure to get rid of these deals, but I have not seen a single situation where an executive was willing to

give one up."

To avoid provoking shareholders, companies are most commonly shifting pay out of categories that raise questions. Late last year aerospace giant Lockheed Martin Corp. (LMT) said it would stop paying for a car and driver as well as club dues for CEO Robert J. Stevens. Instead, it hiked his \$1.48 million salary \$40,000. A spokesman says ending perks was in the company's best interests.

Some items, however, are too large to move or obscure. The biggest fights are likely to be over multimillion-dollar deferred pay and retirement accounts, as well as guaranteed payments for executives who are fired or who leave when the company is acquired. Such items have been focal points of recent firestorms, from the Nardelli flap to the \$82 million pension Pfizer Inc. (PFE) paid outgoing CEO Hank McKinnell last year.

The surprise this proxy season, predicts Shekhar Purohit, a principal of pay consultants James F. Reda & Associates, will be just how common, and lucrative, these severance packages are. Typically they include a payment of three times salary and bonus, immediate vesting of options and restricted stock awards, and, in many cases, payment of taxes owed. Purohit says dozens of executives could have payouts of \$100 million or more.

Revelations of extra-sweet deferred-compensation deals are sure to raise eyebrows, too. Such plans usually allow executives to sock away money tax-free, often with a company match--much like 401(k) accounts, only with no limit on the contributions. And some companies guarantee better-than-market interest for executives. American Express Co. (AXP) gave CEO Kenneth I. Chenault \$1.1 million in above-market returns on his deferred compensation account in 2005. The company won't divulge the rate it gave that year, but in 2006 it paid 13% on executives' deferred balances. In late January, AmEx said it would continue to pay 13% to 16% on money they set aside between 1994 and 2004 if the company meets or beats financial targets, and will pay 9% to 11% on money deferred after 2005. A spokesman says the plan is consistent with industry practice.

RICH RETIREES

Pension plans will likely draw attention, too. Whereas regular workers typically retire on one-half to two-thirds of their average salary in their last three to five years, some CEOs get far more. Pfizer's deal with McKinnell was unusually rich: In calculating his final pay, Pfizer counted not only salary and bonus, but stock awards that vested through 2004. That notched his annual pension up from roughly \$3.5 million to \$6.6 million. The company says it stopped including new stock awards in pension calculations in 2001, but earlier grants were grandfathered in. Huge bonuses issued just before retirement can also pump up pensions. "It's the gift that keeps on giving," says Kevin J. Murphy, a professor at the University of Southern California's Marshall School of Business.

Governance activists are already targeting such practices. The United Brotherhood of Carpenters has identified 14 companies, including AT&T (T) and Johnson & Johnson (JNJ), where it believes the inclusion of large incentive bonuses in pension calculations has led to excessive benefits. So far, the union can claim one small victory. In January, American Express also announced further limits on retirement benefits. Rather than basing them on total salary and bonus--which for Chenault were \$1.1 million and \$6 million, respectively, in 2005--earnings used in calculating retirement will be capped at twice the annual salary. The AmEx spokesman says the changes, long in the works, stem from the shift away from traditional defined benefit pensions to 401(k)-type defined contribution plans.

As for the smaller perks, companies maintain that some are born of legitimate need. For example, many argue that use of a company jet even for personal flights is a must in the post-9/11 era. Ditto home alarm systems and other security measures. The practice isn't universal. Intel Corp.

(INTC) and Goldman Sachs & Co. (GS) both forbid personal use of company jets.

Even so, in a study of 2005 proxies filed by the 100 largest U.S. companies, compensation research firm Equilar Inc. found that the median value of personal travel on corporate jets rose 21.7%, to \$109,000, while execs got roughly \$37,000 to safeguard themselves, up 69%. The numbers for individuals can fly much higher. United Technologies Corp. (UTX) chief George David ran up a \$581,396 tab for "personal use of the corporate aircraft for security reasons," according to SEC filings. The company declined to comment. FedEx Corp. (FDX) gave CEO Frederick W. Smith \$833,000 in jet use and security services on top of his \$1.3 million salary in fiscal 2006. FedEx, which requires the CEO to use the jet for all travel, says an independent security consultant determined the need for the benefits.

Still, jet travel irks some. Richard C. Breeden, a former SEC chairman who runs a hedge fund, criticized restaurant chain Applebee's International Inc. (APPB) over the issue. He found that, over a 10-month period, Applebee's jet made 29 trips to Galveston, Tex., where Lloyd Hill, who stepped down as CEO in September but remains chairman, has a beach house. A spokeswoman for Applebee's, which said on Feb. 13 it will explore a sale, says its plane policy is disclosed.

One thing is clear: It is increasingly tough for boards to keep everyone happy. Retired General Hugh Shelton, the former chairman of the U.S. Joint Chiefs of Staff who heads the compensation committee of software maker Red Hat Inc. (RHT), says boards are focused more on finding the right balance between shareholder demands to link pay to performance and the company's need to ensure good executives have the right incentives. "You try to be fair, and give appropriate rewards for performance," he says. But ultimately, "you compensate them so that they're not desperate to go to work for someone else."