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Extra Pay: Many CEOs Receive Dividends on 'Phantom' Stock

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Amid the drive to tie executive pay more closely to company results, a little-known and poorly disclosed practice is allowing many executives to receive hundreds of thousands of dollars a year in dividends on performance stock -- shares that they may never earn.

The money involved isn't huge by the standards of overall executive pay, but it can add up. **General Electric Co.** Chief Executive Officer Jeffrey Immelt, who gets a growing share of his compensation through what GE calls "performance share units," received more than \$1 million last year in dividends on unearned restricted and performance shares.

Gary Neale, chairman and former CEO of **NiSource Inc.**, a Merrillville, Ind., utility-holding company, is in line to receive more than \$827,000 in dividends this year on performance shares he hasn't yet earned.

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Reaping Gains

Many companies pay dividends on restricted stock before executives earn the shares. Others pay accumulated dividends only after the shares are earned, and a few never pay the dividends.

Pay currently

- Altria Group
- Bank of America
- Duke Energy
- General Electric
- Heinz
- Occidental Petroleum
- Temple-Inland

Pay after shares earned

- DuPont
- Lehman Brothers
- PepsiCo
- Sara Lee

Never pay

- Avaya
- Intel
- Microsoft Corp.

Sources: SEC filings; the companies

Performance, or "phantom," shares are a form of restricted stock paid to an executive only if the company meets certain performance targets. Dozens of other CEOs are paid dividends on unvested restricted stock, which typically requires the recipient only to wait several years before actually receiving the shares, regardless of performance.

Bank of America Corp. CEO Kenneth Lewis is in line to receive \$2.89 million in dividends on restricted stock this year. **Altria Group Inc.** CEO Louis Camilleri received more than \$2 million in dividends on restricted stock last year, even though he won't earn some of the shares until 2011.

All told, among the 50 large-company CEOs who received the largest dollar grants of restricted stock over the past three years and whose companies pay dividends, 37 are paid dividends in cash before the shares vest, according to an analysis for The Wall Street Journal by Equilar Inc., a

San Mateo, Calif., compensation-research firm.

Corporate-governance watchdogs and executive-pay consultants say the dividends on performance shares undermine the effort to link pay to performance. "It's more stealth compensation," says Paul Hodgson, a senior research associate at the Corporate Library, which monitors corporate governance.

"There's a sleight of hand there that's frustrating" when companies tout pay-for-performance plans but pay executives dividends, says Brian Foley, managing director of pay consultancy Brian Foley & Co. in White Plains, N.Y.

The dividend payouts typically aren't well-disclosed in corporate proxy filings with the Securities and Exchange Commission. Companies usually state whether they pay dividends on restricted or performance shares, but totaling an executive's holdings in unvested stock can require hunting through the proxy, or multiple proxies. Dividend payments usually aren't included in proxies, so investors in most cases have to track those down and do their own math.

Dow Jones & Co., publisher of The Wall Street Journal, pays dividends to the holders of "contingent stock rights," a form of performance shares. Dow Jones does not disclose the total amount of dividends paid to executives who hold contingent stock rights.

Disclosure could soon become more transparent. As part of its overhaul of compensation-disclosure rules, the SEC has proposed that companies detail dividend payments to top executives. The new rules could take effect in time for next year's proxies.

Meanwhile, the number of executives eligible to receive dividends on unvested shares likely has been rising as performance and restricted shares become more popular. For one thing, new rules that require companies to record stock options as an expense have made the shares a preferred alternative. And in response to criticism that too many CEOs are paid big bucks for lousy performance, a growing number of restricted-stock awards are linked to profit or share-price performance. At the same time, a 2003 tax cut spurred many companies to increase dividend payments.

In a study last year, Frederick W. Cook & Co., a compensation-consulting firm, found that 90% of the 250 largest companies were awarding stock options, down from 99% in 2003. But 66% of those companies gave restricted stock, up from 49% two years earlier, and 40% awarded executives some form of performance shares, up from 26% two years earlier.

Some companies that use restricted and performance shares withhold payment of the accumulated dividends until an executive earns the shares. That group includes **PepsiCo Inc.**, **Sara Lee Corp.**, **DuPont Co.** and **Lehman Brothers Holdings Inc.** Ownership is "about being accountable for business results, in good times and bad," PepsiCo's compensation committee says in its most recent proxy. "It's about pay for performance," a spokesman adds.

A few companies, including **Microsoft Corp.** and **Intel Corp.**, never pay dividends on restricted stock.

To see how dividend payments can erode the pay-for-performance ideal, consider the tenure of Richard Goldstein, who is retiring next week, as chief executive of **International Flavors & Fragrances Inc.** In 2002, the New York company awarded Mr. Goldstein 200,000 performance shares, tied to how well IFF's stock fared compared with rivals through 2007.

Mr. Goldstein became eligible for the first chunk of shares last summer, but IFF stock failed to beat the designated rivals, and so he didn't receive them. With his pending retirement, he won't receive any of the others, either. In the interim, though, he was paid \$506,000 in dividends on the shares. Overall, IFF shares have outperformed market averages during Mr. Goldstein's nearly-six-year tenure, rising 4.7%, compared with a 7.6% drop in the Standard & Poor's 500-stock index.

Dennis Meany, IFF's general counsel and secretary, says the dividend payments were part of a compensation package for Mr. Goldstein recommended by an outside consultant in 2002. "Whether or not it would be recommended today, I do not know," he says. But Mr. Meany notes that the company has subsequently granted executives restricted-stock units that do not include dividend payments before the shares are earned.

At **Duke Energy Corp.**, James E. Rogers became CEO last month after Duke completed its acquisition of Cinergy Corp., where Mr. Rogers had been CEO. Under his Cinergy contract, he received compensation valued at roughly \$24.7 million as part of the Duke takeover.

At Duke, he agreed to a contract with no base salary and no bonus. His compensation, the company said in a news release, is "stock-based and tied directly to the performance of Duke Energy." But at current rates, he will nonetheless receive dividends on unvested performance shares totaling more than \$700,000 a year.

Mr. Rogers's no-salary, no-bonus, all-equity contract follows a similar deal struck by former CEO Paul Anderson when he took over in 2003. Duke shares rose more than 60% under Mr. Anderson, making his equity grants very valuable. Mr. Anderson was paid \$700,000 in dividends on unvested shares in 2004, the most recent year for which Duke has disclosed such payments.

A Duke spokeswoman says in an email that the dividend payments "tie Mr. Rogers's compensation directly to the interests of long-term shareholders -- growing earnings and the dividend." She notes that Mr. Rogers will stop receiving dividends on any shares that don't vest, either because he leaves the company or because Duke doesn't attain the earnings targets.

A NiSource spokeswoman confirms that the company pays dividends on performance shares issued in 2003 and 2004, but notes that Mr. Neale did not receive any restricted shares last year and won't receive any this year.

At GE, the board's compensation committee says in its most recent report that it awards Mr. Immelt performance units rather than stock options or conventional restricted stock so that the CEO's equity-based compensation is "focused entirely on incentives for performance and alignment with investors." Mr. Immelt received 430,000 performance units last year. He'll receive half of those in two batches, after two years and then five years, if GE's cash flow from operations increases 10% annually; he'll receive the other half only if GE shares outperform the S&P 500 over the same periods.

GE spokesman Gary Sheffer says Mr. Immelt receives dividends on his performance shares because they largely replaced restricted-stock units in his compensation package. Dividend payments on unvested shares are "intended to further align the interests of executives with the long-term interests of shareowners," he says.

GE has been paying dividends on restricted-stock units since it started issuing them in 1990. Like other companies, GE has been issuing more restricted stock and fewer stock options. Mr. Sheffer

says the board's compensation committee debated whether to pay Mr. Immelt dividends on the performance units and "felt it was appropriate to award dividends."

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