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NEWS: ANALYSIS & COMMENTARY

Fat Merger Payouts For CEOs

Top execs at companies being acquired are reaping windfalls. Whose interest is being served?

As Gillette's CEO, James M. Kilts had reason to expect a lucrative 2005, with annual pay likely exceeding $23 million. But this turned out to be an especially eventful year: The razor maker, one of America's best-known brands, agreed to be acquired by consumer-products giant Procter & Gamble Co. (). For selling Gillette Co., Kilts received even more than his anticipated pay -- a lot more. The companies promised him a package valued at $165 million, including stock options and severance. On top of this, P&G has said it will give him stock and options worth $23 million in return for serving as its vice-chairman for one year and agreeing not to join a rival before 2009. Excluding $6.5 million he stands to earn during his year as vice-chairman, Kilts could eventually pocket an astounding $188 million.

As mergers roared back in 2005, so did CEO payouts triggered by the deals. In Boston, where Gillette is based, the Kilts bonanza heightened local outrage over a major hometown company surrendering its independence. "It is obscene what he is getting paid," says retired Gillette Vice-Chairman Joseph E. Mullaney.

BURIED IN THE FINE PRINT

Kilts held his fire until after Gillette shareholders had given the acquisition their overwhelming approval. Then in September, he let loose in a speech to the Boston Chamber of Commerce. Complaining that he had become "Boston's piñata," he argued that he had earned his handsome pay by creating billions in shareholder value since arriving at Gillette in 2001. The P&G deal "will be the greatest merger in consumer products history," he said. "We make no apologies." Given his success at Gillette, "Kilts had become the Michael Jordan of corporate executives," says Arthur F. Golden, an outside lawyer for the company. "He was a very scarce and desirable superstar, and that is why he gets paid so much."

Unlike the public clash in Boston, payouts to CEOs and their top lieutenants typically attract little attention amid the merger swirl -- beyond often-opaque references in company filings. Georgia-Pacific Corp.'s () CEO, A.D. "Pete" Correll, will receive a $92 million package when the company's sale to Koch Industries is completed, according to an estimate by executive-pay consultant Delves Group. Toys 'R' Us Inc. CEO John H. Eyler is set to receive cash and benefits worth about $63 million as part of the struggling toy retailer's purchase by an investment group that includes Kohlberg Kravis & Roberts & Co. And Bruce L. Hammonds, the CEO of MBNA Corp., was promised compensation valued at $102 million in connection with the credit-card company's acquisition by Bank of America Corp. (), according to Delves Group. MBNA shareholders approved Hammonds' payout on Nov. 3 during a meeting on the merger at the company's Wilmington (Del.) headquarters. Not a single question was asked during the 10-minute gathering.

Kenneth D. Lewis, CEO of Bank of America, says he generally opposes special bonuses, though his company has paid them to Hammonds and others. "Why should I as a CEO have a safety net that my teammates don't?" he asks. Several years ago he dropped such protections for himself when he chose to work without an employment contract. But he's resigned to doling out merger windfalls. "I just think of it as a price you have to pay" to get a target company's CEO to submit to being taken over, he says. "My wife asks me after some of these deals: 'Tell me again -- who won?'"

Even as many investors assume that they've seen the end of the executive-pay excesses that flourished during the late-1990s bubble, a new Gilded Age is under way. The explosion of merger-related payouts raises the question of whether CEOs are doing deals more for their own benefit than for their shareholders, says James P. Melican, president of Proxy Governance Inc., which advises pension funds and other institutional investors. "Mergers are

tarnished when it appears that managements have negotiated lucrative employment contracts for themselves with the acquiring company."

Companies that provide the payouts dispute that, of course, and some contend that the extent of their largesse is exaggerated. Georgia-Pacific and a number of others point out that the bulk of their CEO packages consists of unvested stock and options from which top execs eventually would profit regardless of whether there is a merger. But Delves Group and most other executive-pay experts say that to get a full picture of how some CEOs benefit from mergers, it's appropriate to include stock and options whose vesting is accelerated. Eyler of Toys 'R' Us and Hammonds of MBNA declined through spokespeople to comment.

The roots of this latest twist in lavish executive pay can be traced to the 1980s. In response to threats of hostile takeovers, many companies promised CEOs "golden parachutes": special payments if control of the company suddenly changed hands. Corporate boards defended the arrangements as necessary to prevent executives from resisting reasonable deals to protect their turf and paychecks.

SERIAL DEALMAKERS

Today, though, most merger-payout provisions look like golden bungee cords. They apply to friendly deals, and CEOs often bounce right back to the newly merged combination, where they continue to earn impressive annual paychecks. In addition to Gillette's Kilts, who is staying with P&G through next fall, MBNA's Hammonds will remain at Bank of America to run its credit-card unit. Providian Financial Corp.'s CEO, Joseph W. Saunders, oversees credit-card services at his company's acquirer, Washington Mutual Inc. (), while collecting an estimated $14 million in merger-related compensation. Without confirming that figure, Washington Mutual said in a statement that "the former Providian board put in place a compensation package designed to reward the management if they created a lot of value for shareholders. Saunders and his team did add a lot of value to Providian."

Some skeptics suggest that supersize payouts perversely benefit CEOs whose companies' weaknesses made them vulnerable to takeover. "The company [that has been acquired] is not doing well. Why would you reward someone for that?" asks Bank of America's Lewis. "Philosophically, I don't believe in it." But he goes along with it to get deals done.

Others see the tendency as spawning a generation of serial dealmakers whose specialty is dressing up companies for sale. Kilts received his Gillette payout just five years after pocketing benefits worth $70 million in connection with selling Nabisco Holdings to Philip Morris (now renamed Altria Group ()). Michael D. Capellas will receive a $39 million package for selling MCI () to Verizon Communications () earlier this year, just three years after he collected a $14 million package for selling Compaq Computer to Hewlett-Packard (). Patrick S. McGurn of Institutional Shareholder Services, another adviser to institutional investors, says the availability of such payouts could influence CEOs to think: "What am I doing running the business for the long term when I can just flip it and make a lot more money?"

The Capellas MCI payout "reflects his success in engineering the largest corporate turnaround in history and fulfilling his fiduciary duty of maximizing stakeholder value," a company spokesman said. Altria declined to comment.

To gauge the scope of the merger-payout trend beyond this year's activity, *BusinessWeek* asked compensation-research firm Equilar Inc. to scour filings by America's 100 largest corporations and determine which have promised merger packages to their CEOs. The study shows that roughly half have done so, providing for an average of $28 million if the company is acquired. The Equilar estimates include how much CEOs would receive in cash, as well as stock and options that would vest on an accelerated schedule. The figures don't include vested stock or options or benefits from companywide equity incentive plans.

THE LAST TO KNOW

Corporations tend to issue mixed messages about merger payouts. In language typically buried in annual proxy filings, they say potential payouts reassure CEOs and keep them focused on shareholder interests. But once a merger gets under way, companies often concede in different filings that the same payouts create a potential conflict of interest between shareholders and CEOs who now have a huge incentive to complete the deals. Shareholders often don't pay attention until too late in the process, at which point companies that have agreed to be acquired usually face steep breakup fees if deals are killed.

Some CEOs are quite persistent about negotiating their payouts. Cinergy Corp.'s () James E. Rogers discussed his merger compensation, among other topics, with Paul M. Anderson, CEO of acquirer Duke Energy Corp. (), during at least nine meetings last spring, according to Duke Energy filings with the Securities & Exchange Commission. Asked about his pursuit of the estimated $23 million payout, Rogers says: "To keep management ahead of the game [and] to get ultimate shareholder value, you want a management team that's economically indifferent to whether or not they will have a job when the deal is done. This is the way to compensate them for putting the shareholders in front."

The wave of colossal rewards for CEOs is beginning to generate a reaction from shareholder activists and government. The SEC is weighing new disclosure requirements for CEO pay that would oblige companies to make change-in-control provisions easier to decipher in proxy materials. And some institutional shareholders are pushing resolutions seeking to rein in certain payout provisions.

Typical of investor resentment were the reactions of some AT&T shareholders to word that the company's ex-CEO, David Dorman, would walk away with an estimated $55 million in cash, stock, and other benefits as a result of this year's merger with SBC Communications Inc. (). California Public Employees' Retirement System, the big state pension plan, earlier had obtained a majority of shareholder votes for a proposal to limit executives' pay packages. Referring to AT&T's slumping fortunes under Dorman's leadership in the last three years, Christy Wood, a senior investment officer at CalPERS, says: "We're not anti-pay. We're anti-pay for failure."

Dorman counters that he forged a merger approved by shareholders and applauded by Wall Street. "We think that we got a good price and a good agreement," he says. AT&T added that, independently of the shareholder resolution, it has pared its merger-payout plan. The company says its benefits are comparable to those of its rivals and that the promise of payouts helps retain talented executives.

By Emily Thornton, with William S. Symonds in Boston; Amy Barrett in Wilmington, Del.; Dean Foust and Brian Grow in Atlanta; and bureau reports

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