2

Curbing CEO Pay

Is Executive Compensation Out of Control?

Thomas J. Billitteri

Getty Images/Erik S. Lesser

Robert L. Nardelli was handed a $210 million severance package when he was fired in January as chairman, president and CEO of The Home Depot. Some experts say corporate compensation is out of control, but others say most highly paid CEOs deserve what they get.

From *CQ Researcher*, March 9, 2007.

The door had barely slammed on Robert L. Nardelli, the deposed CEO of The Home Depot, when the howls of indignation began.

The company's board ousted Nardelli in January over poor performance and other issues, but not before handing him a stunning $210 million severance package. The "golden goodbye" was in addition to the almost $64 million Nardelli had reaped in his six years running the big retailer — a period in which the chain's stock price stagnated and its competition gained ground.[1]

"The departure package is an outrage," said Nell Minow, editor of The Corporate Library, a corporate-governance research firm. "He should be giving money back to the company, not taking anything more."[2]

"Obscene," an Atlanta columnist declared.[3]

Nardelli is far from alone. Dozens of big companies have come under fire recently from shareholders, politicians and the media for lavishing their CEOs with colossal pay and severance packages, sometimes despite serious management failures. Meanwhile, scores of companies are being probed for possible manipulation of stock-option grants to enrich corporate officials and directors at sometimes mind-boggling levels.

Often inflated by stock options, the median total compensation among roughly 2,000 CEOs was $2.9 million in 2005, up about 180 percent since 1999, according to The Corporate Library. Meanwhile, at the nation's 100 largest companies, median CEO compensation was $17.9 million in 2005, according to *USA Today*, and a half-dozen chief executives hauled in more than

Several CEOs Earned More Than $100 Million

A handful of American chief executive officers earned more than $100 million in 2005, led by Capital One Financial's Richard D. Fairbank, who took home a phenomenal $280 million. Stock options played a major role in the huge compensation totals.

USA Today

Karatz

AFP/Getty Images/Mandel Ngan

Fuld

Getty Images/Justin Sullivan

Ellison

AFP/Getty Images/Prakash Singh

Chambers

Company/ Executive	Total Compensation	Salary	Bonus	Option Gains
Capital One Financial Richard D. Fairbank	$280,083,843	$0	$0	$249,267,658
KB Home Bruce Karatz	$163,934,209	$1,091,667	$5,000,000	$118,370,799
Cendant Henry Silverman	$133,261,147	$3,300,000	$12,316,600	$117,644,547
Lehman Brothers R. S. Fuld Jr.	$119,539,850	$750,000	$13,750,000	$74,958,627
Genentech Arthur D. Levinson	$109,431,444	$975,833	$2,000,000	$66,268,100
Occidental Petroleum Ray R. Irani	$106,524,159	$1,300,000	$3,640,000	$37,562,444
Oracle Lawrence J. Ellison	$92,137,389	$975,000	$6,500,000	$66,891,118
Valero Energy William E. Greehey	$89,450,243	$1,400,000	$3,500,000	$55,269,605
Cisco Systems John T. Chambers	$80,707,753	$350,000	$1,300,000	$61,329,110
Morgan Stanley John J. Mack	$68,187,675	$337,534	$0	$30,030,934

Total compensation: includes salary, bonuses, stock and incentives, the potential value of stock options and gains from stock options exercised; excludes "other compensation" such as use of company aircraft

Salary: CEO's base pay

Bonus: incentives and performance awards, usually cash

Stock-option gains: Profits realized after exercising options; an option allows the holder to buy shares at a predetermined price

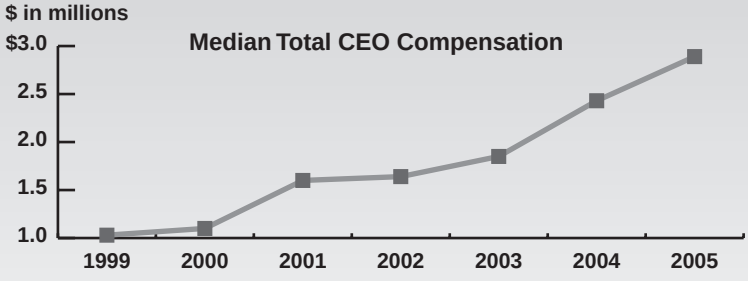
Source: "Special report: Executive compensation," USA Today*, April 10, 2006, based on Aon Consulting's eComp Data Services, www.ecomponline.com*

$100 million each. (*See chart, p. 26.*) The biggest paychecks went to Richard D. Fairbank of Capital One Financial ($280 million-plus, $249 million of it in stock-option gains); Bruce Karatz of KB Home ($163.9 million, with more than $118 million in option gains) and Cendant's Henry Silverman (more than $133 million, with nearly $118 million in option gains).[4]

Compensation experts offer numerous explanations for the windfalls, including competition for executive talent, the influence of corporate-pay consultants, tax-policy incentives that encouraged stock option grants and the effect of hostile takeovers on the growth of "golden parachutes" for fired executives.

CEOs' Compensation Nearly Tripled

Median compensation for American chief executive officers (CEOs) rose from about $1 million in 1999 to nearly $3 million in *2005.*



Source: The Corporate Library, 2006; a sample of around 2,000 CEOs was used.

Indeed, intense debate rages over whether corporate compensation is excessive or simply a product of market forces. But most Americans, apparently, have definite opinions: Four in five respondents to a *Los Angeles Times*/Bloomberg poll last year — including 84 percent of investors living in households making at least $100,000 — said most CEOs of large U.S. companies are paid too much.[5]

Experts in business and academe, however, are deeply divided over corporate compensation. Charles M. Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware, thinks it is out of control. "Absolutely, and in a variety of measures [ranging from] the relationship to overall shareholder return to pay equity within the organization," he says. "It's basically a large-scale asset transfer from shareholders to the managers, and it has consequences for the health of the organization and of the investors."

But Roy C. Smith, a professor at New York University's Stern School of Business, contends executive compensation "isn't the sinful overindulgence of greedy executives that it's made out to be. There may be some abuse . . . but most of the CEOs who receive those huge pay packages not only earn them but also, yes, deserve them."[6]

The sparks flying over executive pay promise to ignite a firestorm of activism in coming months. Beginning with this spring's annual proxy season, new Securities and Exchange Commission (SEC) rules require companies to give investors an unprecedented, plain-English look at how much executives are paid. "A lot of things that have not been disclosed before are ending up on proxies, particularly [executives'] perks," Elson says. "It's going to get a lot of people very mad."

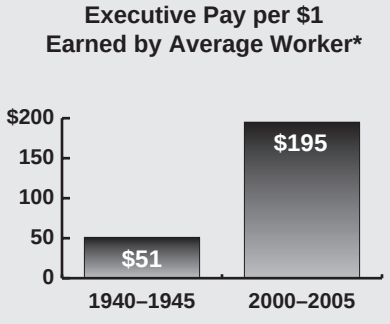
Critics have accused the SEC of retreating on the new disclosure rules under pressure from big business. In December, just before the rules took effect, the SEC said companies could spread the value of stock-option grants over a number of years rather than show the much bigger lump-sum value. Even so, the new rules, coupled with simmering dissatisfaction over golden parachutes and outsized CEO paychecks, are expected to help make executive compensation one of the most incendiary policy and political issues of 2007.

In January a broad mix of institutional investors, from the American Federation of State, County and Municipal Employees to the Benedictine Sisters of Texas, announced they were filing a non-binding shareholder resolution — informally called "say on pay" — asking more than 50 U.S. companies to give stockholders an annual advisory vote on executive-compensation packages.

Similar pressure to curb corporate pay is building in the new Democrat-controlled Congress. Rep. Barney Frank, D-Mass., now chairman of the House Financial Services Committee, introduced a bill and scheduled a hearing in March designed to give shareholders a bigger

Executives Earn 195 Times the Average Worker's Wages

The highest-paid American executives made $195 for every $1 earned by the average worker in 2000-2005. The pay gap was four times smaller in 1940–1945.



* Total compensation composed of salary, bonuses, long-term bonuses and stock options.

Source: Carola Frydman and Raven E. Saks, "Historical Trends in Executive Compensation," November 2005; updated in interview

voice on executive-compensation plans, an approach used in Britain and Australia that Frank has been championing. Frank has been among the most vocal Democrats on corporate compensation, calling Nardelli's simultaneous dismissal and severance package as "further confirmation of the need to deal with a pattern of CEO pay that appears to be out of control."

The Democrats have linked the pay issue to their appeals for economic relief for working-class Americans. Earlier this year the Senate, in a measure to raise the minimum wage, voted to cap the amount executives can put into tax-deferred plans at $1 million — a move widely seen as an attack on corporate pay practices.

Yet even President George W. Bush, often viewed as friendly to big business, admonished corporate boards this year "to pay attention to the executive-compensation packages that you approve." He added: "You need to show the world that American businesses are a model of transparency and good corporate governance."[7]

Taken together, such developments suggest that corporate pay will be a dominant issue on both the shareholder and policy scene for some time to come. "Anger over pay is at an all-time high in the institutional community and on Main Street," says Patrick McGurn, executive vice president of Institutional Shareholder Services, a Rockville, Md., company that advises investor groups on proxy and corporate-governance issues. "There's no better target right now than fat-cat CEOs at underperforming companies."

Some of the sharpest criticism over pay has been aimed at huge severance packages given to executives pushed out for not delivering on expectations. In addition to Nardelli's deal, the former CEO of Pfizer Inc., forced into early retirement amid a drop in the company's stock price and shareholder anger over his pay, got an exit package worth more than $180 million, including an estimated $82.3 million in pension benefits and about $78 million in deferred compensation.[8] J. C. Penney Co.'s chief operating officer got a severance deal worth $10 million after her termination — and she had been on the job for only about five months.[9]

Some have argued that even though pay and severance packages have soared in recent years, they still represent a fraction of the overall economy and thus have little real impact on the nation's corporate health.

But skeptics say the growth in executive pay has had significant economic repercussions. In a major study of 1,500 top U.S. corporations, Harvard Law School Professor Lucian Bebchuk and Cornell University management Professor Yaniv Grinstein found compensation paid to the top five executives at each firm totaled $350 billion in the 11 years ending in 2003. That compensation, they found, took a bigger and bigger share of total company earnings as the period progressed — about 10 percent in the later years, compared with 5 percent in the early years.[10]

Citing that data, Rep. Frank argued in January that criticism of pay and severance deals isn't just based on jealousy but reflects concern for the nation's economic

well-being. CEO compensation "has reached a point where it has some macroeconomic significance," Frank said. "When Lee Raymond gets $400 million when he leaves Exxon Mobil, and the pension [fund] is shorted . . . we're not just talking about envy."[11]

As Congress, corporations and shareholders consider reining in CEO compensation, here are some of the questions they are asking:

Is compensation out of control?

Last year the average CEO of a big company made 411 times the wages of an average worker, according to the Institute for Policy Studies, a liberal Washington think tank. That's roughly 10 times the proportion in 1980, says Sarah Anderson, director of the institute's Global Economy Program.

American CEO pay, she says, "is way out of line compared to what we see anywhere in the world." Typical CEO pay in the United States exceeds that in 25 other locales, according to the latest annual study by the international consulting firm Towers Perrin. In 2005 U.S. chief executives received about $2.2 million compared with roughly $1.4 million for CEOs in Switzerland, $1.2 million in France, the United Kingdom and Germany and less than $550,000 in Japan. (*See sidebar and chart, pp. 36-37.*)

But not all compensation experts agree with Anderson that executive pay in the United States is out of line."I definitely don't think pay is out of control," says Don Lindner, an executive at WorldatWork, formerly the American Compensation Association and the main trade group for compensation and benefit specialists.

"We see a lot of egregious behavior because it makes the papers, and it should be exposed. But there are a lot of companies that do a very good job of designing plans and building pay packages for the right reasons — to help grow shareholder value and help companies meet their objectives. Most companies do that, and some very well."

The issue turns partly, of course, on which yardstick is used to measure reasonableness of pay. For example, some observers — most notably stockholders — look at the issue in terms of performance: Does the growth in pay track the changes in market value of company shares over time? Trade unions may look at CEO rewards and contrast them with job and benefit cuts at big corporations. Populists may see the issue in terms of social equity, arguing that those at the bottom of the economic ladder deserve some of the riches going to those at the top. Some may reject outright the notion that any job is worth millions of dollars a year, no matter the circumstances.

Getty Images/William Thomas Cain

Union protesters call Home Depot's then-CEO Robert L. Nardelli an "over paid CEO" during the annual shareholders' meeting on May 25, 2006, in Wilmington, Del. Trade unions oppose high compensation packages for poorly performing CEOs at corporations that are cutting benefits and wages.

Even issues of corporate social responsibility play a role in the pay debate. Recently, big shareholders in the oil giant British Petroleum demanded that a court in Alaska stop Lord Browne, the company's outgoing CEO, from collecting $140 million in pension benefits, bonuses and other compensation while they pursue claims against him and other directors over environmental and safety matters.[12]

While excesses in corporate pay make easy fodder for pundits, some experts stress that compensation defies easy prescription.

"It's a more complicated, more textured story than just saying, 'Gee, aren't they paid a lot compared with what average workers make?' " says Randall Thomas, a professor of law and business at the Vanderbilt University Law School. While acknowledging cases of overpaid CEOs, he says, "You have to differentiate between what's happening on average vs. what's happening at the extreme."

For instance, a 2006 study concluded that the sixfold increase in CEO compensation between 1980 and 2003 "can be fully attributed" to a sixfold increase in market capitalization — the value of outstanding shares — at big U.S. companies during that period.[13]

"Yes, there are numerous examples of corporate malfeasance," Tyler Cowen, an economics professor at George Mason University, wrote in reference to the study. "But it is not obvious that the American system of executive pay — taken as a whole — is excessive or broken."[14]

Last year the Business Roundtable, an association of 160 chief executives of major U.S. companies, found that between 1995 and 2005 CEO compensation at 350 big companies rose 9.6 percent annually, below the 9.9 percent growth in stockholder returns at those companies during that period.[15]

"We wanted to try and promulgate a consistent set of facts because a lot of what we have seen in the media on executive pay we felt was misleading," said the Roundtable's director of public policy, Thomas J. Lehner.[16]

The Roundtable study drew harsh criticism, however, for excluding certain types of compensation, such as dividends on executives' restricted stock, gains from cashing in stock options and restricted stock over the 11 years of the study, pension benefits, deferred compensation and severance pay. The study's author defended his methodology, but another compensation expert called the analysis "disingenuous."[17]

Other researchers have found that not only has executive pay spiraled upward but also the pace of growth has been accelerating sharply.

Carola Frydman, an assistant professor of finance from MIT's Sloan School of Management, and economist Raven E. Saks at the Federal Reserve Board studied the compensation of the three highest paid officers in the 50 largest firms in 1940, 1960 and 1990. They found that the executives' average compensation didn't surpass its Depression-era level of about 63 times average wages until 1987. After that, it exploded, peaking in 2000 at about 317 times average wages.

Frydman noted that the peak was somewhat lower when measured not by the average but by the median, or midpoint, which tends to filter out executives with extremely high or low salaries. The median compensation of the three highest paid officers passed its Depression-era level in 1989 and peaked in 2000 at 119 times average wages.[18]

David Swinford, senior managing director of Pearl Meyer & Associates, a compensation consulting firm, says CEO compensation levels "have been pulling away not only from the masses but from other members of the executive team" as well. Over the last 15 or 20 years, CEO compensation has increased about 9 percent per year, he says, while other executives within large companies saw their compensation increase at more than 3 percent "but certainly less than 9 percent."

Is the link between CEO pay and performance broken?

Some pay experts believe the link — often measured by such things as growth in stock price and earnings per share — is sound. "If you go back 15 years and look at CEO pay and at the wealth that's been produced, it's not way out of balance," says Lindner of WorldatWork.

Others say the link is broken. "I see very few examples of companies where I could say, 'You've got it right in terms of the link between pay and performance,' " says Paul Hodgson, senior research associate for executive and director compensation at The Corporate Library. "Compensation committees need to go back to the drawing board and redesign their pay policies."

Adds McGurn of Institutional Shareholder Services: "There is no question that to a large degree executive compensation is decoupled from companies' performance."

Harvard's Bebchuk and Jesse Fried, a law professor and co-director of the Berkeley Center for Law, Business and the Economy at the University of California, Berkeley, wrote in their influential book *Pay Without Performance* that "most compensation contracts ensure that executives receive generous treatment even in cases of spectacular failure."

They point to Mattel CEO Jill Barad, who "received $50 million in severance pay after being employed for only two years, during which time Mattel's stock price fell by 50 percent, wiping out $2.5 billion in shareholder value." Another example they offer: "Conseco provided $49.3 million to departing CEO Stephen Hilbert, who left the company in a precarious financial situation. The Conseco board then gave incoming CEO Gary Wendt a guaranteed package worth more than $60 million in compensation, even if he failed."[19]

Stock-option gains, in particular, can either tie an executive's fortunes to those of the company or, as Hodgson points out, have little to do with performance at all.

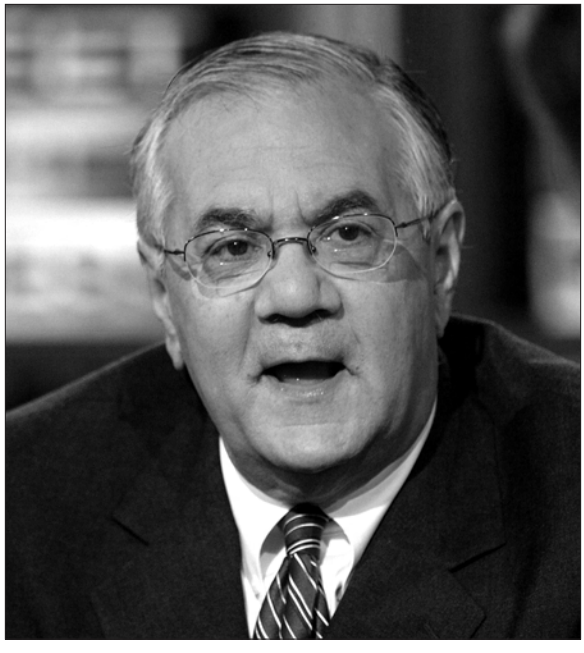
"If you awarded a stock option and your stock price increases in line with the market for seven years, you will make money out of it," he says. "But how much of a company's stock price was due to your running the company, and how much was due to a general rise in the market in that period? In many cases, up to 80 percent of a stock price can be due to a general rise in the market. It is inappropriate for executives to be rewarded for that, particularly when there are tools around that can be used to reward them solely for their input."

In their most elemental form, option grants give the recipient the right — but not the obligation — to buy shares in a company at a set "exercise" price sometime in the future. Typically, that exercise price is the market price of the shares on the day the options are granted. A CEO might receive the option to buy shares of his company's stock four years from now at the $75 per share exercise price it trades at today. If the stock trades at $125 per share four years from now, the CEO can make a tidy profit by selling the stock. The idea, of course, is to give the CEO an incentive to manage the company in a way that its stock price grows, rewarding both the CEO and shareholders.

Options have become controversial, however, partly because they can dilute the value of stock owned by investors by adding to the pool of available shares in a company. In addition, stock options can be manipulated, as evidenced by the unfolding investigation of backdating abuses in which scores of companies are suspected of granting options to executives and backdating the grants to days when their companies' share price was at or near a low, boosting the likelihood of a profit when the options are cashed in.

Options also have come under close scrutiny for their potential to reward executives not for performance but for being lucky during strong bull markets on Wall Street. Indeed, options turned out to be a gold mine for CEOs in the 1990s, when the overall stock market soared far beyond rational expectations.[20]

A Financial Accounting Standards Board rule that took effect last year requires companies to subtract the cost of stock options from their bottom line, something they didn't have to do before. Some observers believe the rule change is inducing companies to shift from options toward other compensation methods, such as performance-based restricted stock, which requires executives to meet specific business targets before they can cash in the stocks.



Getty Images/Alex Wong

Rep. Barney Frank, D-Mass., chairman of the House Financial Services Committee, introduced a bill and scheduled a hearing in March designed to give shareholders a bigger voice on executive-compensation plans. Earlier this year, the Senate voted to cap the amount executives can put into tax-deferred plans at $1 million.

One thing is clear: The explosion in options in recent years has been widely viewed as a prime culprit in the disconnect between pay and performance.

A solution advocated by some compensation critics is to give executives indexed options, which are calibrated against a broad market basket of stocks. They can filter out the effects of an overall rise on Wall Street and diminish windfalls.

Yet other experts on corporate compensation contend that regular, garden-variety options have been an efficient way of rewarding executives for the value they bring to shareholders and for the risks they take as captains of highly complex enterprises.

"If you want to incentivize managers to worry about what matters to stockholders, which is stock price, you give them options as a way of doing that," says Vanderbilt's Thomas. "What we've done over this period of 1980 to 2006 is try to tie more carefully CEO pay to stock price. CEOs not only are getting paid more but they also are taking on a lot more risk, because stock options don't always pay off."

Moreover, in a complex theory laid out in some of his academic writing, Thomas argues that indexing stock options to the broad market gives executives no greater incentive to perform well than using regular options.[21]

"It would be just the same," he says. "You'd have to pay [the CEO] more to make up for the fact that indexed options are riskier. It's not going to reduce executive pay."

Are new laws needed to regulate executive pay?

When the SEC imposed new disclosure rules on companies beginning with the distribution of corporate proxies this year, it was the most sweeping effort since 1992 to push executive compensation into the sunlight.

The rules require companies to explain to stockholders in plain English the details and rationale for their executive and director compensation plans and to provide a revised summary compensation table. The new law is intended to give investors a more complete picture of what executives are getting than at any time in the past.

Still, the debate continues over whether additional laws are needed to curb the growth in compensation. Not even the harshest compensation critics seem to want to cap pay outright, but many want the full value of compensation to be reported.

Among the critics' targets is a controversial revision to the new SEC disclosure rule adopted in December, which allows companies to spread the value of their options over years rather than showing a lump-sum value. The SEC said it changed the rule in order to better conform to accounting standards governing how stock-option costs are counted on corporate books. But critics said the amendment, announced right before the long Christmas holiday, was little more than a giveaway to big business.

Besides seeking full disclosure of pay practices, some critics also want to limit executives' tax-deferred compensation plans, which typically shelter their income from taxes until retirement. Earlier this year, the Senate approved a provision that would prevent executives from putting more than $1 million a year into deferred-compensation plans.[22]

"For the vast, vast majority of families, there's a limit on [untaxed] deferred compensation . . . of about $15,000" a year, said Finance Committee Chairman Sen. Max Baucus, D-Mont.[23]

If average wage earners can live with a $15,000 deduction, Baucus says, high-earners ought to be willing to accept the $1 million limit on deferred compensation.

It was unclear what would become of the Senate effort to cap deferred compensation because it was not included in the House version of the main bill, which would raise the minimum wage.

Rep. Frank's idea of giving shareholders a vote on executive compensation would also help regulate pay. He has been highly vocal on the issue, complaining that corporate boards "do not provide any real check on CEOs."[24]

In early March Frank introduced a bill (HR1257) that would allow shareholders a non-binding vote on executive compensation plans.[25]

Frank spokesman Steve Adamske said the bill would leave it "up to the corporation to respect" a "no" vote on a pay package "and alter the compensation package or ignore their shareholders."[26]

While Frank's bill calls for an advisory vote, earlier versions ran into stiff opposition from business groups. "In our view, legislative proposals . . . calling for shareholder approval of compensation plans are unwise and ultimately unworkable," Lehner of the Business Roundtable told a House panel last year. "If we adopted a system where small groups of activist shareholders used the process to politicize corporate decision-making, the consequences could very well be destabilizing."[27]

Others in Congress have tried to rein in pay, and even to cap it. Former Rep. Martin Sabo, a Minnesota Democrat who retired in January, promoted a bill that would have prohibited employers from deducting as a business expense any compensation that equaled or exceeded 25 times the lowest compensation paid to any other full-time employee.

Some companies voluntarily regulate their compensation. Last year Whole Foods Market, for example, capped cash compensation for top executives at 19 times the

average pay of its full-time workers, or $607,800. What's more, CEO and co-founder John Mackey cut his own salary to $1 beginning this past January and said he would forgo future stock-option awards. Whole Foods' salary cap had risen from a multiple of 10 (or $257,000) in 1999.

But Whole Foods' approach to self-regulation is unusual among corporations. Walter Scott, a professor at Northwestern University's Kellogg School of Management, says it is something "many more could embrace."

While some compensation experts advocate tighter government laws on corporate pay, others — like Smith, the business professor at New York University — reject such an approach. "This essentially is an issue between stockholders and their boards, and it isn't really a concern of government," he says. "This is a private-property issue."

Besides, he says, most stock is owned by institutional investors who already have power over compensation decisions when they elect corporate directors — the people who set the compensation levels. "This is not necessarily a game between little sheep and vicious wolves," Smith says. "This is a game between corporations and sophisticated, well-informed investors."

BACKGROUND

CEO Cult

Big executive paychecks — and the controversy they stir — go back a long way. In 1929 the president of Bethlehem Steel hauled in a $1.6 million bonus on top of his $12,000 salary, becoming the first million-dollar CEO.[28] In 1933 angry stockholders filed what is thought to be the first lawsuit over executive pay after the president of American Tobacco pulled in $1.3 million.[29]

After World War II executive pay gradually rose, and in the 1980s it began climbing sharply. A number of factors account for the meteoric rise.

A wave of hostile takeovers and leveraged buyouts occurred in the 1980s, sweeping aside many old-line executives who had been promoted from within during the 1960s and '70s. Pushing out the old guard was a phalanx of aggressive, risk-taking corporate captains who thought they could provide better returns to shareholders.

The new breed not only negotiated golden parachutes and other big pay deals but also created a mystique of the super-talented CEO — the notion of a rare, highly skilled executive who could move from industry to industry, turn around floundering companies and generate big returns for shareholders. That perceived scarcity of talent helped escalate the level of executive rewards and encouraged the use of performance-based compensation such as stock options and bonuses, say compensation experts.

Other forces have contributed to the boom in executive pay, including the rise of compensation consultants. As the cult of the CEO took hold in the 1980s and '90s, outside pay specialists came on the scene in a big way. Sometimes boards of directors or their compensation committees hired pay consultants, but often it was the CEOs themselves who retained the consultants, putting board members in the position of negotiating with the CEOs' advocates on compensation matters.

Experts say the widespread use of compensation consultants helped raise both the level and complexity of executive pay packages. "Consultants bear some of the blame," says McGurn of Institutional Shareholder Services, adding that he had seen many packages that "look more like a menu in a French restaurant, where you don't know what they are and there's no price tag attached."

"Most compensation specialists use a quartile-ranking system," says Douglas Branson, a law professor at the University of Pittsburgh who studies corporate board and compensation issues. "They ask the compensation committee, 'Do you want your executive to be in the highest [quartile]? Most say 'yes.' " That has created "a constant ratcheting effect" on compensation levels, he explains.

A ratcheting effect also occurs when executives are recruited from other companies. To attract a new CEO, boards often must agree to cover the executive's existing compensation contract — including anticipated proceeds from stock options and other pay deals that the executive might not even have received yet.

Golden parachutes also help ratchet up compensation. CEOs typically negotiate their severance deals before they even walk in the door at a new job, and once they're hired the company may have no choice but to make good on the agreement — even if the CEO stumbles.

That's what happened with Home Depot's Nardelli. Joining the home-improvement retailer in late 2000

CHRONOLOGY

1930s *Growing power of U.S. corporations and their top executives prompts criticism and new calls for oversight.*

1934 Congress creates Securities and Exchange Commission (SEC).

1940s-1950s *Executive compensation declines steeply during the war years and then grows modestly afterwards.*

1950 Revenue Act affords favorable tax treatment for stock options, giving rise to their use as a way to bolster executive compensation.

1960s-1980s *Stock options lose their luster, the result of changes in tax policy, high inflation and Wall Street decline, but corporate takeovers push up CEO compensation.*

1979 *Business Week's* best-paid-executive list marks a first: All 25 earn more than $1 million.

1984 Congress imposes a tax on "golden parachutes," a move that inadvertently encourages higher executive pay packages.

1990s *Booming equity markets and mushrooming use of stock options push CEO compensation to record levels.*

1991 Compensation consultant Graef S. Crystal comes out with his influential book ***In Search of Excess: The Overcompensation of American Executives.***

1993 New law prohibits corporations from deducting taxes for executive compensation over $1 million unless it is performance-based.

1995 AT&T plans to cut more than 40,000 jobs, while Chairman Robert E. Allen receives a $16 million compensation package, including stock options valued at more than $10 million.

2000s *Corporate scandals lead to calls for stronger shareholder rights, while growing gap between rich and poor puts new focus on executive pay.*

Sept. 11, 2001 After terrorist attacks on the World Trade Center and the Pentagon, 91 companies that normally did not grant stock options in September did so amid the post-attack market decline, according to a 2006 ***Wall Street Journal*** analysis. . . . Enron files for bankruptcy in December.

2002 United Kingdom requires annual shareholder votes on executive pay. On July 30, President George W. Bush signs sweeping corporate anti-corruption bill known as the Sarbanes-Oxley Act. . . . On Aug. 29 the law's new two-day filing requirement for stock-option grants takes effect.

2004 New federal rules require companies to subtract the cost of executive stock options from their earnings.

2005 University of Iowa finance Professor Erik Lie publishes a paper in May suggesting some companies might be backdating stock options. . . . In November Rep. Barney Frank, D-Mass., introduces The Protection Against Executive Compensation Abuse Act proposing, among other things, that shareholders be empowered to vote on executive compensation plans.

2006 Federal prosecutors in San Francisco file the first criminal charges on July 20 in a growing scandal over manipulated stock options. . . . SEC unanimously adopts new rules on July 26 requiring greater disclosure of executive compensation. . . . Senate Committee on Banking, Housing and Urban Affairs holds a hearing on Sept. 6 on stock-option backdating. . . . On Dec. 22, SEC amends rules adopted on July 26, giving companies more leeway in how they report stock-option grants.

February 2007 Senate approves measure limiting executives' tax-deferred accounts to $1 million. . . . Aflac becomes the first major U.S. company to voluntarily give shareholders a non-binding vote on executive pay. . . . House Financial Services Committee, led now by Rep. Frank, plans March hearings on empowering shareholders to challenge executive compensation.

from a high-level perch at General Electric, he was a hot property in the CEO talent search. "Nardelli would have been fought over by dozens of companies," says Smith of New York University "but he negotiated a pretty slick deal" with Home Depot. When shareholders sought to block the former CEO's huge exit pay early this year, the company's lawyers said the severance package had been set by Nardelli's employment agreement. A state judge refused to go along with the shareholders, though he gave their lawyers time to collect additional information in the case.[30]

After Nardelli's departure, Home Depot hired from within. The new CEO, Frank Blake, had served as vice chairman of the board and executive vice president of the company. This year he was expected to earn $8.9 million, less than a quarter of Nardelli's $39.7 million paycheck.[31] But it's rarely that easy or cheap to find a replacement for an ousted executive.

"When a stumble happens," says Northwestern University's Scott, "people begin looking outside their organizations to replace that superstar, and to get a superstar they have to pay lavishly to move the person" out of an existing job.

And turnover happens frequently, Scott notes. The average CEO tenure these days is 48 months, compared with a tenure of seven or eight years a decade or two ago, he says.

Undue Influence

Salaries also have shot up, according to Harvard's Bebchuk and UC-Berkeley's Fried, because powerful CEOs have exerted inappropriate influence over boards and compensation committees. "Flawed compensation arrangements have been widespread, persistent and systemic, and they have stemmed from defects in the underlying governance structure that enable executives to exert considerable influence over their boards," they wrote.[32]

"Executives have had substantial influence over their own pay," they wrote. "Compensation arrangements have often deviated from arm's-length contracting because directors have been influenced by management, sympathetic to executives, insufficiently motivated to bargain over compensation or simply ineffectual in overseeing compensation."[33]

Other compensation experts take issue with that view, arguing, for example, that highly skilled managers have so many opportunities open to them that it is reasonable for them to command extraordinarily high salaries.

Pay experts also point out that the role of the corporate CEO has become much more demanding so it is only natural that compensation has grown in step with the increasing complexity of the CEO's job. Others also argue that pay has risen over the years in lockstep with the increase in shareholder value.

But others say market forces are not the main engines driving executive pay.

"I think boards of directors and their compensation committees have been rigged by CEOs," says Branson of the University of Pittsburgh. "Compensation committees generally have been a failure partly because of the excessive size of executive compensation packages. When you look at how the system has been rigged, it tilts the debate against executives and those who say it's just the market at work."

Many cite the recent saga of the Walt Disney Co. as an example of excessive executive influence over board members. In 1997 Disney shareholders went to court to try to recover a $140 million severance payment to former president Michael Ovitz, who had been hired by his then-close friend, CEO Michael Eisner — and then forced out 14 months later by Eisner.

In 2005 a Delaware court upheld the severance payment, dismissing the shareholders' charges that the board had breached its fiduciary duty in Ovitz's hiring and dismissal. But the judge sharply chastised Eisner and his influence over Disney's board.

Eisner had "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom," the judge wrote. Eisner, he added, had "stacked his (and I intentionally write 'his' as opposed to 'the Company's') board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors."[34]

Rules Backfire

Some blame skyrocketing executive pay in part on the unintended consequences of government efforts to curb

Foreigners Resent U.S. CEOs' High Pay

But defenders say they earn it

Simmering resentment over the gap between American and European CEO pay burst into the open at this year's World Economic Forum in Davos, Switzerland. Skyrocketing CEO pay is a "completely sick" trend that amounts to "theft," said Swiss activist Thomas Minder.

"Managers are employees, too. They are not entrepreneurs," Minder continued, to hearty applause.[1]

American CEOs receive more than their counterparts in other nations, according to Towers Perrin, a U.S. human-resources consulting firm. The typical U.S. chief executive received about $2.2 million in total compensation in 2005, far outstripping his counterparts in other nations. (*See graph, p. 37.*)[2]

"In the United Kingdom, in Canada, everyone involved in the [executive compensation] process is definitely trying to stop the importation of U.S.-style pay practices," says Patrick McGurn, executive vice president of Institutional Shareholder Services, a Rockville, Md., firm that advises institutional investors on corporate-governance issues. "They look at the United States with a certain degree of dread" because of the escalation of pay, the complexity of packages and the layering of compensation methods.

But Bjorn Johansson, chairman of a corporate headhunting firm in Switzerland, warned that Swiss companies cannot just ignore the trend. "There are very few people who are capable" of leading large corporations, he said. "We can't say to them in Switzerland, 'We do things different.'"[3]

McGurn notes that shareholder advocates have tried to import progressive pay practices common in some other countries, such as giving stockholders an advisory vote on executive compensation.

Theories abound as to why U.S. CEOs make so much more than their global counterparts. Many believe U.S. executives exert excessive power over boards and compensation committees and take advantage of weaknesses in corporate governance to maximize their pay.

But Randall Thomas, a law professor at Vanderbilt University who studies executive compensation, offers a long list of other reasons for the pay gap between U.S. and foreign CEOs.

The quest for the corner office is much less competitive overseas than in the United States, where a "winner take all" culture condones bigger rewards for those who come out on top, he says.

American CEOs also tend to have more opportunities to find other lucrative jobs, Thomas notes. Venture capital for entrepreneurs flows more freely in the United States than overseas, he says, and foreign financial markets are less cohesive and are burdened by more regulation.

American CEOs have more power and more decision-making responsibility than foreign CEOs, Thomas also says. Most *Fortune* 500 CEOs chair their companies' boards, which is uncommon in foreign countries. And in some countries, notably Germany, board authority is shared between a management tier and a supervisory tier made up of banks, creditors and labor.

Moreover, in many foreign countries, particularly in continental Europe, a single shareholder can control 60 percent of a corporation, reducing the CEO's power, Thomas says.

When a single shareholder controls a company, Thomas says, there is little need for incentive pay to keep management on the straight and narrow. "In most of continental Europe," he says, "option pay is unnecessary because [companies] already have somebody who's monitoring management."

American CEOs also have more of their pay at risk in the form of company stock and options, a risk for which they expect to be compensated, Thomas notes.

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[1] William L. Watts, "CEO Pay Under the Microscope at Davos," *MarketWatch*, Jan. 25, 2007.

[2] Towers Perrin, "2005-2006 Worldwide Total Remuneration." The figures represent typical pay at industrial companies with roughly $500 million in worldwide annual sales.

[3] *Ibid.*

the growth in pay. When the SEC strengthened its disclosure on compensation in 1992, consultants and corporate executives suddenly had more information on what other companies were paying than they had before. Rather than keeping pay at bay, the new disclosure rules gave CEOs and their compensation advisers new ammunition with which to negotiate even higher pay deals.

Likewise, a 1993 law capped the amount of compensation corporations could deduct on their taxes for each of their five highest-paid executives at $1 million unless it was performance-based. Proponents argued that the law would close the gap between executives and those farther down the corporate ladder.

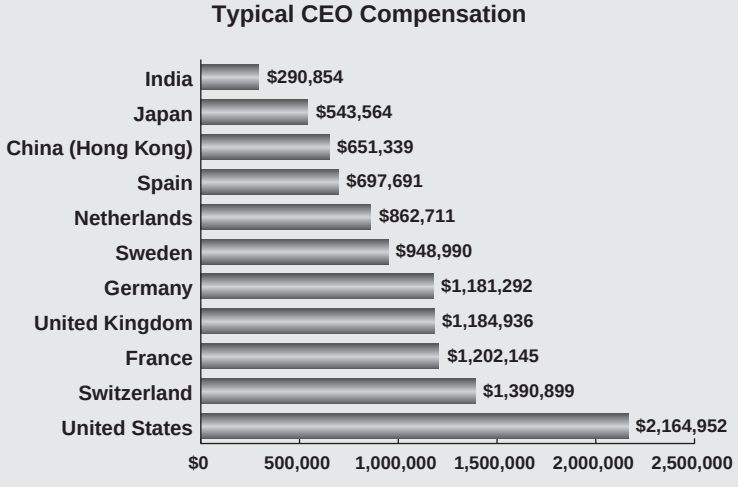
But the law backfired. Rather than curbing compensation growth, it helped propel it forward. For one thing, a $1 million salary suddenly became a floor — rather than a ceiling — for many executives who were making less than that. And because stock options were viewed as performance-based, option grants exploded and their value soared on the winds of the bull market of the 1990s. Some of the biggest option recipients were executives at technology start-up companies that paid lavishly in shares.

"One lesson we've learned, I hope, is that every previous compensation-reform effort has had consequences that in some respects make the whole thing worse than the status quo was before," says Jeffrey Gordon, a Columbia University Law School professor who studies corporate-pay issues.

Ironically, pension funds and other investor groups had pushed for greater stock-option use in the early 1990s, believing options would make executives more accountable for the quality of their management. But that idea also boomeranged. "The institutional shareholder didn't realize how much was being given away and how quickly," says Swinford of Pearl Meyer.

U.S. Leads in CEO Pay

American CEOs of big companies receive an average of nearly $2.2 million in annual compensation, or nearly $1 million more than chief executives in Switzerland, the second-most-generous country.



Note: Compensation includes salary, annual bonus, benefits and perquisites, restricted stock, profits on the exercise of stock options and any other long-term incentive payout.

Source: "Managing Global Pay and Benefits," Towers Perrin, 2005-2006

While many factors help explain soaring executive pay, other factors explain why this perennially controversial issue is taking on new urgency now.

Media coverage of enormous severance deals like Nardelli's and annual rankings in the business press of the most highly rewarded corporate elite help fuel the flames. The growing militancy of pension funds and other institutional shareholders also has fanned the fires. Computer power has made it easier for scholars to track and analyze compensation data, and the Internet has helped groups disseminate information about pay, as the AFL-CIO does on its Executive PayWatch Web site.[35]

Accounting scandals at Enron, Tyco International, WorldCom and other companies focused public and government attention on corporate governance, as did the Public Company Accounting Reform and Investor Protection Act of 2002 — known as the Sarbanes-Oxley Act, which cracked down on corporate-governance and financial abuses.[36]

But one of the biggest catalysts for renewed interest in corporate compensation is the "politics of pay" — the contrast between lavish rewards for top managers and the everyday financial struggles of middle-class and poor Americans. "The problem of excessive pay goes beyond being just a shareholder issue," says Anderson of the Institute for Policy Studies. "The broader society is affected when we have so much economic power in the hands of so few."

The level and structure of corporate pay deals can give executives an incentive to boost short-term profits and shareholder returns so the value of their bonuses and stock options goes up, which can have "negative effects" on the broader community, she says, such as deciding to "slash workers, do layoffs and not invest in research and development to create a more environmentally [protective] company."

As a senior policy adviser in the Clinton administration, Paul Weinstein, now chief operating officer of the Progressive Policy Institute, helped to shape the law that capped the deductibility of CEO pay at $1 million but allowed an exemption for performance-based pay, including stock options. Weinstein now says it was a mistake to allow the loophole for performance-based compensation, which helped lead to the stock-option deluge in the 1990s. "Government shouldn't be creating incentives for excessive CEO pay," he says.

Like many others these days, Weinstein is concerned about the gap between rich and poor and what can be done to raise the incomes of middle-income Americans. That concern appears central to the policy agenda of the new Democratic Congress. With middle-class bread-and-butter economic issues such as minimum wage and health-care coverage on the table, and the Bush administration's tax cuts and war expenditures under assault, Washington is talking about linking executive pay and populist causes.

"In the Bush economy it pays to be a CEO," declares a report on executive compensation by the Democratic staff of the House Financial Services Committee. But, "life is not as easy for the rest of America's workers."[37]

CURRENT SITUATION

Backdating Exposed

In the immediate future, no compensation issue looms larger than the unfolding scandal about backdated stock options, which has elicited outrage in Congress and generated heavy news coverage by *The Wall Street Journal*, among others.[38]

Backdating happens when a company retroactively sets the grant date of a stock option to a day when the firm's stock price was at or near a low point. The practice not only increases the chances that an executive will reap a profit when it comes time to exercise the option but also provides accounting and tax benefits for companies.

Option backdating and other forms of option timing are not necessarily illegal but must be disclosed to shareholders and accurately reflected in corporate financial statements and taxes. Option manipulation can be very difficult to detect.

As many as 200 companies are suspected of having practiced backdating, but Erik Lie, the University of Iowa finance professor who helped expose the practice, says he thinks perhaps 2,000 have engaged in backdating. (*See sidebar, p. 40.*) Lie told a Senate hearing last September that, in a survey of nearly 40,000 option grants at almost 8,000 companies between 1996 and 2005, at least 29 percent of firms that granted options to their top executives manipulated one or more of the grants in some way.[39]

Last September, Sen. Charles E. Grassley, R-Iowa, then chairman of the Finance Committee, called backdating "disgusting and repulsive," adding: "It is behavior that ignores the concept of an 'honest day's work for an honest day's pay' and replaces it with a phrase that we hear all too often today, 'I'm going to get mine.' Even worse in this situation, most of the perpetrators had already gotten 'theirs' in the form of six- and seven-figure compensation packages of which most working Americans can only dream."[40]

The Sarbanes-Oxley Act of 2002 made option manipulation more difficult to hide than in the past by requiring companies to disclose option grants to the SEC within two business days rather than up to 45 days after the end of a fiscal year, as was previously allowed. Even so, "It still is possible for companies to inappropriately time option grants around the release of corporate news," noted Institutional Shareholder Services.[41]

Even if few or no companies are still engaged in backdating, the scandal is likely to have a long shelf life. Federal prosecutors, the SEC, the press and shareholder advocates have been aggressively pursuing companies suspected of option manipulation.

For instance, federal prosecutors were investigating technology giant Apple's past options dealings early this year, but company officials say an internal investigation cleared CEO Steve Jobs of any wrongdoing.

The backdating scandal is focusing national attention on the role of corporate directors. One study found that directors who serve on interlocking boards — that is, directors of one company serve on the boards of other companies — have played a significant role in spreading the backdating strategy from one corporation to another.[42]

Another study focused on directors who themselves received favorably timed options. Harvard's Bebchuk and two research colleagues found that between 1996 and 2005 about 9 percent of 29,000 stock-option grants to outside directors at roughly 6,000 public companies were "lucky" — meaning the "grant events" fell on days when a stock price equaled a monthly low.[43]

Institutional Shareholder Services (ISS) warned that the option-timing controversy could have a negative impact on big pension funds and other institutional shareholders. "[I]nvestors can expect to experience significant stock losses as more companies disclose investigations into their option-grant practices and restate financial results," said the firm.

According to ISS, the stock price of UnitedHealth, for instance, dipped nearly 30 percent after disclosure of regulatory probes into the board's award of options to CEO William McGuire and other employees. In October McGuire was forced to resign and give up part of his $1.1 billion in options as a result of a massive revamping of the insurance company's governance.[44] UnitedHealth was plagued by "inadequate" internal controls related to its option-grant practices and other problems, concluded a law firm hired to investigate its stock-option practices.

"An appropriate tone at the top, adequate controls and discipline over the option-granting process and management transparency with the board and its committees on executive compensation matters are basic and critical to the integrity of option grants," concluded the report, which UnitedHealth posted on its Web site. "[T]here here were various failings in these areas."[45]

Courts, Regulators Alerted

It remains unclear how forcefully shareholders, federal criminal authorities and Congress ultimately will respond to the backdating scandal. Stockholders, for example, could sue companies alleged to have backdated options. In the Apple case, for example, a big New York pension system was lead plaintiff in a shareholder lawsuit accusing the company of illegal backdating.[46]

Pension funds "are completely beside themselves and outraged over the self-dealing that has gone on," said Darren Robbins, a partner in a law firm hired last year by several funds. The goal is "to recover the monies that were diverted from the corporate till."[47]

AP Photo/Manuel Balce Ceneta

Securities and Exchange Commission (SEC) Chairman Christopher Cox presides over a meeting on executive compensation on July 26, 2006. Beginning this spring the SEC will require companies to give investors an unprecedented, plain-English look at how much executives are paid. Even so, critics accused the SEC of retreating on the new disclosure rules under pressure from big business.

Iowa Professor Helps Uncover Backdating Scandal

New law helps to prevent the practice

Erik Lie, an associate professor at the University of Iowa's Tippie College of Business, wondered what happens to stock prices around the time that companies grant options to their executives.

After examining nearly 6,000 option grants made from 1992 through 2002, he found that "quite consistently" stock prices would drop "right before the grant date, and then [pick] up dramatically" — sometimes as much as 20 percent — right afterwards.[1] Lie concluded the only explanation for the phenomenon was that companies were backdating the option grants to a day when their stock price was at or near a low point, drastically increasing the potential for big profits on the options.

Courtesy Erik Lie

Erik Lie helped shine a spotlight on questionable options practices at scores of U.S. companies.

Lie's study — while not the first — helped shine a nationwide spotlight on questionable options practices occurring at scores of companies before U.S. securities laws were reformed by the Sarbanes-Oxley Act in 2002.[2]

Previously, companies had been allowed to notify the SEC about option grants weeks or more after the grants were actually made, allowing option dates to be manipulated. Sarbanes-Oxley narrowed the filing window to two business days — a change that allowed Lie and colleague Randall Heron, a business professor at Indiana University, to test their backdating theory in a second study.

Lie and Heron examined more than 3,700 option grants made after 2002 and found a much weaker stock-price pattern after the two-day reporting requirement became law. For options filed with the SEC within a day of the grant, the pattern disappeared completely, they found.[3]

"In theory, stock options can be used to motivate executives and other employees to create value for shareholders," Lie told a U.S. Senate committee last year. "However, they have also been used to conceal true compensation expenses, cheat on corporate taxes and siphon money away from shareholders to option recipients."[4] Lie says the way to eliminate backdating is to require companies to file grants electronically with the SEC on the same day the grants are given, as occurs in Lie's native Norway.

"They haven't had any problems" in Norway with backdating, Lie says. "There, if you get a grant one day, you have to file information with the authorities before the market opens the next day."

Lie says if he'd been an investor in companies that illegally backdated their stock options, "I would be pretty mad just to see these executives are taking my money, and I'm not aware of it," he says. "And as an investor I would want my business to be run in an ethical, socially responsible way."

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[1] Erik Lie, "On the Timing of CEO Stock Option Awards," *Management Science 51*, May 2005. See www.biz.uiowa.edu/faculty/elie/backdating.htm for background on Lie's work.

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[3] Randall A. Heron and Erik Lie, "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants," *Journal of Financial Economics 83*, 2007.

[4] Lie, *op. cit.*

AT ISSUE

Is CEO pay in the United States out of control?

YES

Brandon J. Rees
Assistant Director, Office of Investment, AFL-CIO

From testimony before Panel on Executive Compensation, House Financial Services Committee, May 25, 2006

CEOs are being paid too much relative to their individual contribution to their companies. No CEO is so talented that his or her compensation should be unlimited. Secondly, executive compensation is poorly disclosed to shareholders. Many forms of CEO pay such as pensions and perks are underreported, and CEO pay-for-performance targets are hidden from shareholders. Thirdly, today's executive compensation packages are creating improper incentives for executives. For example, stock options can create a strong incentive to manipulate company stock prices through creative and even fraudulent accounting.

By any measure, today's CEO pay levels are too high. A reasonable and fair compensation system for executives and workers is fundamental to the creation of long-term corporate value. However, the past two decades have seen an unprecedented growth in compensation only for top executives and a dramatic increase in the ratio between the compensation of executives and their employees....

Executive compensation abuse takes dollars out of the pockets of shareholders, including the retirement savings of America's working families. Union members participate in pension plans with over $5 trillion in assets. Union-sponsored pension plans hold approximately $400 billion in assets, and runaway executive pay has diminished returns for working families' pension funds....

More than any other executive compensation issue, shareholders are concerned about pay-for-performance. Year after year, shareholders learn of record CEO compensation packages that have little connection to executives' individual performance. ...To public shareholders, the executive compensation system appears entirely subjective and subject to influence by corporate insiders....Many CEOs have negotiated retirement benefits that promise a lifetime of income far exceeding what they would be entitled to under the retirement plans of their rank-and-file workers....

Executives have received these extraordinary retirement benefits at the same time workers are being asked to bear increased risk for their retirement security.... [I]ncreasingly, companies are terminating their employees' pension plans and transferring the risk of saving for retirement onto their employees. Many of these same companies have turned their executive-pension plans into CEO wealth-creation devices. As a result, many companies have a two-tier retirement system: one for the CEO and one for everybody else....

NO

Thomas J. Lehner
Director of Public Policy, Business Roundtable

From testimony before Panel on Executive Compensation, House Financial Services Committee, May 25, 2006

There are over 15,000 publicly traded companies in the United States — and if one believed even a few of the stories written you would think all CEOs make tens, if not hundreds, of millions of dollars each and every year. This is not the case, and we believe this type of sensationalism is damaging to the debate, our corporations and our shareholders....

[M]any...claim that CEO pay exceeds company performance. In fact, the data does not support this. Research using the Mercer 350 database shows that...from 1995-2005, median total compensation for CEOs has increased 9.6 percent, while the market cap has increased 8.8 percent, and total shareholder return has increased 12.7 percent....These numbers show a direct correlation between levels of pay, market increase and shareholder return....

We have identified two flaws that contribute to the erroneous figures that inflame this debate. First, many of the statistics cited are averages, not medians. [T]hese are misleading because of extreme instances of the pay scale [that skew] the average for all. The second involves how stock options are counted. When options are exercised, they often represent a decade worth of accumulated stock [but] in the current debate they are characterized as a single, annual amount of compensation.

Furthermore, when counting options we should use the amount when granted, and not the realized gains when exercised. We should also point out that some of the pension payments highlighted in the media represent 30 years or more of service to the company, and deferred compensation payments also represent amounts CEOs have earned over a lengthy period....

[L]egislative proposals...calling for shareholder approval of compensation plans [are] unwise and ultimately unworkable. If we adopted a system where small groups of activist shareholders used the process to politicize corporate decision-making, the consequences could very well be destabilizing....

Despite the rhetoric from critics of the current system, we know of no instance where a board is willing to pay a CEO more than they are worth or more than the market price bears....

[W]e are sensitive to extreme cases about CEO compensation reported in the media, and we continue to develop and promote best practices for our members to follow.

Independent boards and shareholders will deal with extreme cases, and we should not ruin our free-market system because of a few rogues.

Courtesy JetBlue

JetBlue CEO David Neeleman turned down a $75,000 bonus in 2006 after the firm had a bad year. He and the firm's next two top executives receive relatively low base salaries of $200,000. He has received no new stock options since the company went public.

Federal prosecutions also are a possibility, suggested Grassley, now the ranking minority member of the Finance Committee. "Outside the corporate suite, Americans don't get to pick and choose their dream stock price," he said. "The market dictates the price. If the tax laws are inadequate, I want to beef them up. . . . I expect the Justice Department to fully enforce the law."[48]

Lately, the federal government has been proceeding against alleged backdating violators. In February, the SEC announced a $6.3 million settlement with the CEO of a technology company and charged the former general counsel of another.

But some critics complain that enforcement actions have been moving too slowly. What's more, SEC commissioners reportedly have disagreed over penalties for those who backdated options, though SEC Chairman Christopher Cox said no such split exists.[49]

However the scandal eventually plays out, its ramifications are likely to be long-lasting. "It's over, it's not going to happen again, but it [reflects] concern over the stewardship of corporate officers and directors," says Elson of the Weinberg Center for Corporate Governance at the University of Delaware. "It's more fuel to the fire for reform."

New Laws?

The backdating scandal is expected to focus new attention on managerial and board leadership issues and could fuel reform efforts in Congress aimed at curbing pay and empowering shareholders to have more of a say in compensation decisions.

Rep. Frank's idea of letting shareholders have an advisory vote on the compensation of top executives is one potential approach. Frank said he hoped to get a bill passed by mid-year giving shareholders a bigger say on executive compensation and a vote on a provision allowing companies to recover compensation from executives in certain situations.[50]

But Frank's proposal is likely to continue to run into stiff resistance from business groups. "When you're comparing the corporate decision-making process and shareholder votes, it really is apples and oranges when you try to apply a democratic model," Lehner of the Business Roundtable said. In light of the SEC's new disclosure rules, he said, Congress should be careful about making more changes too quickly. "We need to give the SEC changes time to work."[51]

As Congress wrestles with legislation to raise the minimum wage, the Senate proposal to cap tax-deferred income in executive compensation plans is also hitting stiff winds. The provision would raise an estimated $806 million in revenue over 10 years that could be used to help offset the cost to small business stemming from a hike in the minimum wage. But groups such as the Securities Industry and Financial Markets Association have called it a "harmful revenue raiser" that has not been adequately evaluated.[52]

Fallout from the options scandal could also trigger renewed calls to leave Sarbanes-Oxley untouched. Before the scandal broke, several trade groups had proposed softening certain Sarbanes-Oxley provisions, claiming they unduly burden businesses, especially small ones.

But as *The Washington Post* editorialized earlier this year: "[S]ome business lobbyists are aiming to roll back Sarbanes-Oxley, and Treasury Secretary Henry M. Paulson Jr. has made comments that could signal the administration's sympathy for that agenda. The stench from Apple shows the danger of a return to the old system."[53]

Outside of Congress, some want to see companies hold more vibrant shareholder elections for board members by reimbursing shareholders, under certain circumstances, for the expense of putting up their own minority slate of directors.

As things stand right now, "if you put up your own slate, you pay out of your own pocket," says Elson. "One proposal is that if managers can pay to get their viewpoint across, then in certain limited circumstances shareholders should have access to the same" money.

OUTLOOK

Growing Pressure

Eye-popping compensation figures are not likely to end anytime soon, but compensation experts say the pendulum is beginning to swing back from the extremes of recent years.

Corporate boards are becoming more vigilant about their pay practices, according to several experts, hastened by the post-Enron focus on governance failures and the recent option-backdating scandal.

"Boards are more demanding, hiring their own compensation consultation," says Scott of Northwestern University. "Things are happening that are changing the situation very dramatically."

Compensation committees recognize "that they are obligated to ask harder questions, be more persistent about those questions and not accept half-baked answers," says Swinford of Pearl Meyer.

Much of the pressure on boards is coming from institutional shareholders, and that pressure is likely to grow.

In February the insurer Aflac voluntarily became the first big U.S. company to give shareholders a nonbinding vote on pay. The company's board agreed that as of 2009 it will give shareholders an advisory vote on the compensation of the company's top five executives.[54] "Our shareholders, as owners of the company, have the right to know how executive compensation works," Aflac's chairman and CEO, Dan Amos, said in a statement. The board set 2009 as the effective date because that will be the first year that compensation tables in Aflac's proxy statement will contain three years of data reflecting the SEC's new disclosure rules.[55]

Shareholders in other companies are pushing to allow similar advisory votes. Timothy Smith, senior vice president at Walden Asset Management, one of the architects of the "say on pay" resolution presented to dozens of big companies this year, calls the quest for advisory votes "one of the top corporate governance issues in the proxy season this spring."

The institutional investors backing "say on pay" manage more than $1 trillion in assets, Smith says, and include the $235 billion California Public Employees' Retirement System, the nation's biggest public pension fund. "Suddenly you have a huge jump in the number of investors involved in this proactive effort, in the range of investors who have filed resolutions and in the number who have not filed yet but think it's a worthy idea," Smith says.

What's more, a dozen companies have said the resolution is a good idea but need time to study how to implement it, Smith says. "Our view is that in three years this will be a norm and that many companies will put this into effect."

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For More Information

AFL-CIO, 815 16th St., N.W., Washington, DC 20006; (202) 637-5000; www.aflcio.org. Labor organization that maintains the Executive PayWatch Web site, at www.aflcio.org/corporatewatch/paywatch/index.cfm.

American Federation of State, County and Municipal Employees, 1625 L St., N.W., Washington, DC 20036; (202) 429-1000; www.afscme.org. Union that advocates on pension and shareholder issues.

Business Roundtable, 1717 Rhode Island Ave., N.W., Suite 800, Washington, DC 20036; (202) 872-1260; www.businessroundtable.org. Association of CEOs of major corporations.

Committee on Capital Markets Regulation, 1557 Massachusetts Ave., LILC 339, Cambridge, Mass., 02138; (617) 384-5364; www.capmktsreg.org. Bipartisan group that researches regulation of capital markets and shareholder rights.

The Corporate Library, 45 Exchange St., Suite 201, Portland, ME 04101; (877) 479-7500; www.thecorporatelibrary.com. Information source on corporate governance and executive and director compensation.

Institutional Shareholder Services, 2099 Gaither Road, Suite 501, Rockville, MD 20850-4045; (301) 556-0500; www.issproxy.com. Proxy and corporate-governance adviser.

Towers Perrin, One Stamford Plaza, 263 Tresser Blvd., Stamford, CT 06901; (203) 326-5400; www.towersperrin.com. Human-resources management consultant that tracks global executive pay.

Walden Asset Management, One Beacon St., Boston, MA 02108; (617) 726-7250; www.waldenassetmgmt.com. Advocates giving institutional shareholders an advisory vote on executive pay.

WorldatWork, 14040 N. Northsight Blvd., Scottsdale, AZ 85260; (480) 483-8352; www.worldatwork.org. Association for human-resource specialists.