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BODY:

NOTHING in business excites so much interest in the wider world as the pay of top executives. And this is never more true than when, as now, a few prominent cases prompt indignant headlines and rouse normally somnolent shareholders to action. The phenomenon is global. Last month Richard Grasso, chairman of the New York Stock Exchange, quickly went from folk hero, for the way he got the exchange running again after the terrorist attacks of September 11th, to the incarnation of corporate greed when it was revealed that he would be awarded \$140m in accumulated benefits this year. Mr Grasso tried to stem the tide of outrage by agreeing to forgo another \$48m due to him, but that appeased no one, and he was forced into an ignominious resignation.

A few days later it was the turn of Josef Ackermann, the Swiss boss of Germany's Deutsche Bank. He was charged with "breach of trust" and will stand trial in Dusseldorf early next year. His alleged crime was committed in early 2000 when he was on the supervisory board and the compensation committee of Mannesmann. The German mobile-phone company yielded to a bid from Britain's Vodafone, a takeover that it had initially contested. After the deal was agreed, a group of Mannesmann executives was paid bonuses of euro57m (\$53m).

The current trial in America of Dennis Kozlowski, the former boss of Tyco, on charges of plundering the public company that employed him of hundreds of millions of dollars has rekindled in the public's mind the idea that extraordinarily high levels of executive pay are tangled up with corporate shenanigans and illegal activity. But that is not necessarily the case. There has been no suggestion that Mr Grasso broke the law, nor that Mr Ackermann, who is indeed accused of breaking a law, benefited personally from the bonuses that were handed out to Mannesmann's executives. Independence on board

Few bosses these days need to resort to skulduggery to receive **fat** cheques. For the most part, their employers are persuaded to sign legally binding contracts which hand them large sums of money with few questions asked. They are a bit like medieval knights granted great tracts of land by grateful monarchs. It was always too much to expect them

to say, "Thank you, milud, but the little cottage by the main gate will do me nicely." Or, indeed, at some later date to suggest: "Since I just lost that battle, here's half my land back."

Media mentions of "**fat cats**" and pay have been rising sharply--up by 60% in the first nine months of this year on the same period in 2002. Executive pay has taken over as the top concern of corporate governance from last year's biggest worry, the independence of auditors. Governments and regulators are becoming increasingly interested in the issue. Under pressure from institutional investors, America's Securities and Exchange Commission (SEC) this week proposed rules that will make it easier for shareholders to nominate candidates to a company's board. Investors hope this will lead to the greater independence of directors who, in the end, decide how much their company's chief executive officer (CEO) should be paid.

In June, the British government issued a document inviting comments on how to control one aspect of CEO remuneration--the granting of large severance payments when bosses' contracts are terminated, regardless of how their company has performed. "Rewards for failure for a small minority", says Patricia Hewitt, Britain's secretary of state for trade and industry, "damage the image and reputation of the whole of British business." The government has received more than 100 responses to its paper and hopes to produce proposals on the issue within two months.

By and large, governments are reluctant to intervene in the private matter of employment contracts. A British parliamentary inquiry into the subject of paying bosses large amounts even when they fail reported last month that it would prefer the government to give industry's own initiatives on the subject time to work rather than to impose new laws. But trade unions and many shareholders are eager for governments to take action. In Britain, the Trades Union Congress, the unions' national body, wants to reduce the notice given to dismissed senior executives, which can often be as long as two years. "An upper limit of six months should be a legal requirement," it says, to bring the treatment of executives more in line with the three months that is normal for other British employees. The AFL-CIO, which represents most unions in America, is pushing for legislation to curb executive-only pensions that give a chosen few guaranteed above-market rates of return. Soft landings, hard questions

So-called "golden parachutes", large pay-offs even when top executives fail, have become a main focus this year in the debate over executive pay. The Corporate Library, a shareholder watchdog in America, reckons that the average departing CEO in that country receives a severance package worth \$16.5m. In May this year, shareholders at the annual general meeting of GlaxoSmithKline (GSK), the world's largest pharmaceuticals company, revolted against the severance pay promised to its boss, Jean-Pierre Garnier, if he were forced to leave the company prematurely. Since one of the more likely reasons for such a departure would be poor performance, shareholders deemed the \$35.7m farewell gift to be excessive. Under new rules allowing shareholders to vote each year on British firms' executive-compensation plans, GSK's owners gave Mr Garnier's golden parachute the thumbs down.

The vote sent a jolt through corporate Britain, and was hailed as a landmark in corporate governance. Yet it did not actually change Mr Garnier's compensation package. The vote is only advisory. Sir Christopher Hogg, the chairman of GSK, points out that the company (aided by Deloitte & Touche) was already undertaking a review of its remuneration policy before the vote took place. That review is still going on and Sir Christopher says that whatever the outcome, "we will be seeking shareholders' endorsement...at the AGM in 2004." He has written to the Association of British Insurers to say that "the board has registered shareholders' particular sensitivity to payments on termination, whether contractual or ex-gratia."

British union leaders want shareholders' votes on executive pay to be made binding. And they want shareholders to register more concern about the issue. Despite all the fuss over Mr Garnier, GSK remains the only company in Britain this year whose remuneration report failed to meet with its shareholders' approval.

In France, the tide of sentiment against rewards for failure helped persuade Pierre Bilger, a former chief executive of Alstom, to hand back in August the euro4.1m severance package granted to him in March when he stepped down from the troubled French engineering group. He did not, he said, "want to be cause for scandal among the 100,000 Alstom employees whom I had the honour to direct for 12 years"--until, that is, the company had to be rescued by the French government. Mr Bilger's example has not yet been followed by his compatriot Jean-Marie Messier, the former boss of Vivendi Universal. He is still fighting to retain the euro20.5m severance package due to him after he was sacked.

Yet golden parachutes and severance pay are only one part of executive compensation. They have been the main focus in recent months. But that is only because the previous mechanism delivering big payouts--namely, share options--came under such hostile scrutiny. Chief executives are selected for their cleverness and determination, and they have directed these qualities at boosting their own pay. The more the public spotlight is thrown on one aspect of bosses' remuneration, it seems, the more it rises elsewhere.

The amounts awarded through share options in recent years dwarf those paid out by golden parachutes or by any other mechanism. Even in 2001, after the stockmarket bubble had burst, the value of stock options granted to the CEOs of S&P 500 companies, America's largest, rose by 43.6% in a year when the total returns from those companies fell by almost 12%.

The immense and random windfalls that stock options can bring has aroused the anger of shareholders and the general public alike. Last year, for example, Jeffrey Barbakow, the chief executive of Tenet Healthcare, a hospital-management business in California, received \$111m from exercising his stock options in a year when the company's share price fell by nearly 60%. After a group of shareholders led by a Florida doctor threatened to remove him, Mr Barbakow resigned last May.

Share options give rise to a phenomenon known as "pump and dump", whereby top executives do everything they can to pump up their company's share price in the short term (including, in notorious cases such as WorldCom, fiddling the company's accounts) so that they can dump their options and maximise their personal gain.

They also, in effect, dilute shareholders' equity with nary a by-your-leave. According to the Investor Responsibility Research Centre in America, the average percentage of companies' shares that was promised as share options reached a record 15.7% in 2002. In some significant cases, it exceeded 25%. It has been a fundamental tenet of shareholder capitalism for decades that there should be no dilution of equity without the prior approval of the company's existing shareholders. Share options drove a coach and horses through that principle.

Once the options trend slowed, bosses reverted to cash to swell their remuneration. In 2002, the median cash bonus of S&P 500 CEOs rose by 8.8% after falling the previous year, according to figures prepared for CalPERS, the largest public pension fund in America. The value of CEOs' stock-option grants in 2002 fell by 18.6%, having risen by 43.6% the year before.

A number of companies are now rewarding their top executives with stock rather than stock options. Trevor Fetter, Mr Barbakow's successor at Tenet Healthcare, was granted two shares in the company for every one that he purchased, up to a limit of 200,000. Many such awards of shares are in the form of "restricted stock", which the executive is not allowed to sell for a specific period. This retains the link between reward and the company's share price, but removes most of the opportunities to pump and dump.

Another method of showering bosses with rewards which surfaced in 2002 has been pension packages. These first hit the headlines with Jack Welch's divorce settlement. The estranged wife of the former boss of General Electric pointed out to the divorce courts that Mr Welch's retirement package did not just include a generous pension, but also entitled him to the use of GE's corporate jets, help with his \$80,000-a-month Manhattan apartment, and a regular supply of fresh flowers.

Then the bosses of American Airlines, struggling from set-backs in the air-travel business following September 11th, were revealed to have placed \$41m in a pension fund for themselves that was fully protected should the company go into Chapter-11 bankruptcy. This self-appointed perk remained hidden until after negotiations with the airline's unions aimed at securing wage concessions of up to \$2 billion had ended a few months later.

Loans granted and then forgiven are another popular way of enriching CEOs. Charles Conaway, the chief executive of Kmart, an American discount retailer, left the company in March 2002 after just 21 months in the job and two months after the company had filed for Chapter-11 bankruptcy. A company loan of \$5m, granted as part of Mr Conaway's pay package, was "forgiven" upon his departure.

Robert Nardelli, one of two candidates who failed to win the top job at General Electric

on Mr Welch's retirement, left to head Home Depot, a retailer with revenues less than half those of GE. Mr Nardelli's compensation in 2002 (of around \$20m) included \$2.5m for the forgiveness (to be spread over four years) of a \$10m loan granted to him on his appointment. His contract also forgives him any interest on the loan and any tax due, and it includes a golden parachute of at least \$20m. Not bad for an also-ran.

The spotlight rarely falls on the basic salaries of top executives because these do not tend to rise at such a dramatic rate. In 2002, the median base salary of the CEOs of the S&P 500 companies was \$925,000. The median total compensation for that year, on the other hand, was \$3.65m.

It has become almost fashionable these days for bosses to forgo their basic pay. Eli Lilly's boss Sidney Taurel took a salary of only \$1 in 2002. John Chambers of Cisco Systems did likewise, and Larry Ellison, boss of Oracle, took a dollar less. Nevertheless, in 2001 Mr Ellison had been the highest paid executive in America thanks to \$706m garnered from stock options he exercised that year. Scratch and scratch alike

How do CEOs manage to get themselves these handsome contracts? Warren Buffett, the chairman of Berkshire Hathaway and one of America's shrewdest commentators on corporate governance, says in his most recent letter to his shareholders that "the answer lies not in inadequate laws...but rather in what I'd call 'boardroom atmosphere'."

The "you scratch my back, I'll scratch yours" atmosphere of company boardrooms has been recognised for decades. As Mr Buffett describes it, "when the compensation committee--armed as always with support from a high-paid consultant--reports on a mega-grant of options to the CEO, it would be like belching at the dinner table for a director to suggest that the committee reconsider."

Last week, the Wall Street Journal reported that Mr Grasso had tried to persuade a NYSE market-maker to commit more money to the market in the shares of AIG, America's biggest insurance company. Mr Grasso had received complaints about the market-maker from Hank Greenberg, the chairman of AIG. Mr Greenberg happened to sit on the NYSE compensation committee responsible for Mr Grasso's employment contract.

The back-scratching is made more effective because it is exercised within a relatively small circle. Fifteen years ago a book called "Les 200" caused a stir in France by tracing the connections between the 200 individuals who, in effect, ran French big business. In America, where the population and the economy are so much bigger, this network is much larger. Research by The Corporate Library, however, suggests that even in America today a small number of individuals link with each other across the boards of the country's biggest companies. And they compare notes.

In a report published in September, The Corporate Library claims that the best-connected board in America is that of J.P. Morgan Chase (see table). One of the bank's directors, William Gray, president of the United Negro College Fund and the first black American to chair the House of Representatives' budget committee, has the most S&P 500 company

directorships of anybody (eight). Apart from J.P. Morgan, he is on the board of Dell, Pfizer, Rockwell Automation, Viacom, EDS, Prudential Insurance and Visteon. These eight firms have an annual turnover of \$186 billion.

A boss's remuneration is largely determined at the time of his appointment, which follows a fairly standard procedure. At Motorola, whose CEO Christopher Galvin resigned on September 17th, a search committee was appointed immediately after the resignation was announced. Under the chairmanship of John Pepper, a director who was once the boss of Procter & Gamble, it includes Larry Fuller, a former boss of Amoco, and Douglas Warner. Mr Fuller is a director of J.P. Morgan Chase and a member of America's best-connected board. Mr Warner is a former chairman of the board of J.P. Morgan Chase who now sits on the compensation committee of General Electric.

Selection process engineering

One of the first things that the Motorola search committee did was to follow the standard procedure of selecting a recruitment consultant to help them--in their case, the well-established firm of Spencer Stuart. To determine what a new CEO's salary should be, consultants make use of benchmarks. For Tenet Healthcare's new boss, for example, the comparison was with "compensation levels and opportunities made available to executives at the company's peer companies".

This has the effect of continually ratcheting up bosses' pay. No selection committee wants to award their new choice less than the industry average. That will, they feel, not attract the best man to the job, and it will also suggest that their company has settled for someone less than average. Since the tenure of top bosses is getting shorter and shorter, this ratcheting effect is accelerating, especially in Europe where, according to a recent report from consultants at Booz Allen Hamilton, the turnover of top CEOs has almost tripled since 1995.

Warren Buffett said recently, "It would be a travesty if the bloated pay of recent years became a baseline for future compensation. Compensation committees should go back to the drawing board." But it is not easy to see who will be brave enough to fight the benchmarking trend. One feature of the recent scandals over executive pay may help: the finger is now being pointed more directly at those who agreed to extravagant contracts in the first place. Carl McCall, a former UN ambassador, and Jurgen Schrempp, the boss of DaimlerChrysler, resigned from the board of the NYSE shortly after Richard Grasso left because of the brouhaha surrounding his pay. And Josef Ackermann is going to court for no other reason than that he nodded through handsome golden parachutes for some Mannesmann executives.

If members of compensation committees were more regularly held to account for the contracts which they approve, it seems likely that fewer of those contracts would be offensive to employees, shareholders and the general public.

GRAPHIC: Why are company bosses being paid such large sums of money?

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