<u>Pay Me Now *And* Pay Me Later</u>

<u>September 29, 2003</u> **<u>David D. Black</u>**

Have you ever wondered what it would be like to be at the top of a large American corporation? Imagine the crushing responsibility of directing and coordinating the work of tens of thousands of employees toward making a commercial success, i.e. profits for the shareholders of the corporation. There you would be, at the apex of a human pyramid, with no place to turn for guidance about the hundreds of decisions that come to your desk: issues of market uncertainties, capital investments, personnel policies and problems, public relations, and on and on. You would probably be working 12-hour days, 6 days a week, maybe taking 3 weeks of vacation - putting in some 3,530 hours a year, 80% more than a lower level employee. Surely you would want to be compensated for such efforts and responsibilities.

Chances are, you would. Last year in 2002 the median CEO of 350 large, publicly held corporations was paid[1] salary and bonus of $1,802,053. If you add in capital gains realized on stock options, plus other long term compensation, the median CEO got $3,022,505. That's $857 for each of the 3,530 hours. It does not include perquisites like cars, country club dues, company contributions to retirement plans, premiums for split-dollar insurance, sports and theatre tickets, etc.

Those are just median figures. When you look at specific cases, your temptation to take on one of these lonely CEO jobs increases. Before you wade into that kind of data you must stop and recall that Federal rules since 1993 attempt to limit CEO salaries to $1,000,000, but they put no limits on incentive bonuses. The Feds thus encourage pay based on performance, like generating profits for the shareholders.

A job most any Literary Club member would embrace would be running the Reader's Digest. Last year Tom Ryder took a salary of a mere $750,000. But he doubled that with a bonus of $725,000, bringing his year to year increase to 99%. His shareholders, however, didn't do as well: their total return, dividends plus stock price increase was -34% for 2002, dragging down a -7% for the past 5 years.

Comparable shareholder returns, -4% for '02 and -7.5% for the past 5 years, were achieved by Carly Fiorina, the lady CEO of Hewlett Packard. She got the Federally approved $1,000,000 salary, plus a $2,930,600 bonus. That is a 293% increase for Carly for a year in which the corporate profits dropped 321%.

You have to admire Mike Eisner of Disney. He has been getting big bucks for years despite shaky profit performance of -0.5% per year over the past 5 years. Last year he modestly took a $1,000,000 salary, but he also pocketed a $5,000,000 bonus. His shareholders got a -18% total return for '02 and -10% for the past 5 years. You have to wonder what the board's compensation committee is thinking, if, in fact, they are.

---

[1] Compensation figures are from a study done by Mercer Human Resources Consulting for the Wall St. Journal, 4/14/03 edition. Other company data obtained from Value Line reports.

One insight into the thinking processes of compensation committees[2] is the 3 outside directors of John Hancock Financial Services. CEO David D'Allessandro got a $1,000,000 salary and a $1,100,000 bonus. But wait, there's more, as they say in the commercials. Other incentive compensation came to $19,560,200, consisting of $11.69 million in stock, $7.86 million of incentive pay, and $100,000 more for good measure. The company did not do as well: the stock fell 32%, earnings dropped 15%, and over the last 5 years total shareholder returns were -21 %. That disparity got noticed, and members of the compensation committee got questioned about it. They reasoned, if we may use that word, that D'Allessandro's pay was well deserved, that his 2002 pay reflected work done in previous years, and that he might be lured away by a competitor. His counterparts at MetLife and Prudential were paid $8.4 million and $8.2 million respectively - less than half. The compensation committee chairman's closing argument was, "I think the way we approached this was right... We had an outside advisor tell us what the market was. And we had data telling us how well the company had performed. We came out with what we thought was the right number...It was done honestly and we were trying to do the right thing."

A kind of teeter-totter balance, i.e. one end up and the other down, was achieved by the Cendant Corp. [Ramada, Days Inn, and Howard Johnson motels; Century 21 and Coldwell Banker realtors; Avis rent-a-car]. Henry Silverman's salary and bonus went up 41 % and the shareholders total return went down 47%. Over the past 5 years the shareholders lost 21 % per year. But Henry was rewarded with a $3,196,000 salary, plus an incentive bonus [can you believe the terminology?] of $7,891,800. That is a total of $11,087,800, or $3,143 per CEO hour. One wonders how the 85,000 other employees made out last year.

However, there are bigger money mountains to climb for Henry Silverman. Consider Bear Sterns, the investment banking house. Jim Cayne enhanced his $200,000 salary with a $19,440,000 bonus. Granted, profits have been increasing steadily, and the shareholders have enjoyed a 12.5% total return for both last year and the past 5 years. But is anybody really worth $5,567 an hour, even if he works 12 hours every 6 days and takes only a 3-week vacation?

The pay a CEO gets now is just one facet of compensation. Consider the employment contracts[3] of these lonely CEO's.

As we know, Henry Silverman of Cendant, was paid over $11 million in cash last year. His contract guarantees him 1 % of the company's profit before taxes, with a ceiling related to the diluted earnings per share. On top of that is an insurance policy that would pay his heirs $100,000,000. It is not real clear what benefit that policy has for the company or the shareholders, who paid the premium cost of $2.6 million. On top of that is post-retirement office space and secretary, access to the company airplane, car and driver, reimbursement for business expenses. On top of that the Directors would balk at firing Henry, for reasons other than fraud or felony convictions: his termination payment would be $140,000,000 in cash according to the contract.

[2] New York Times of 5/17/03
[3] New York Times of 6/28/03

Back to our friend Mike Eisner of the Disney world of large and creative imaginations. If he were fired or quit under certain circumstances, he would get post-termination annual bonuses of $6,000,000 for the remainder of his 9-year contract plus an additional 2 years [through 2008].

Putting aside the post-retirement deals of [1] Louis Gerstner of IBM [consulting fee of an estimated $1,020 an hour, cars, access to IBM's airplane, an office, an apartment, club fees, all for 10 years], and [2] Geoff Bible of Philip Morris [office and secretary, car, reasonable use of the company airplane, a phone calling card, two cell phones, and two home fax machines], consider Jack Welch[4] of GE. He got expenses for autos and electronics, a Manhattan apartment and all food and wine therein and laundry and toiletries and newspapers, dining bills at the Jean Georges restaurant, floor-level seats at New York Knicks games, and courtside seats at the US Open tennis matches.

You may have noticed that none of the CEO's named here is accused of anything nefarious or criminal. No mention has been made of Enron's Kenneth Lay who took a $67,400,000 salary in 2001 plus a $70 million loan, or sales-tax avoiding Dennis Kozlowski of Tyco who got $36,050,000 in '01. No, the examples given are not in trouble with the law; and the figures are revealed in proxy statements, and sometimes a divorce suit.

Let's get back to the compensation committees of corporate boards. You'll recall that the chairman of the John Hancock committee made the feckless observations that they hired a consultant, came out with what they thought was the right number and tried to do the right thing. It is difficult to get hard data on how compensation committees work, but those comments seem to be representative and descriptive. A study by Prof. Charles O'Reilly of Stanford Business School concludes that [1] there is no competitive labor market for CEO's, and [2] psychology and social dynamics have a dramatic effect on the decisions.

O'Reilly describes three factors which significantly influence compensation committee decisions. First, boards of directors are composed primarily of other CEO's. So there is peer group comparison: "Clyde ought to get about what I get". Secondly, most board members are nominated by the CEO being evaluated. He knows them, perhaps from contact on other boards. They like the prestige and maybe the pay of the directorship, so there is a tendency to feel grateful, even obligated, to the CEO. Thirdly, the perceived social status of the CEO comes into play, i.e. whether he went to an elite university, the clubs he belongs to, his friends and social associations. All of this smells like "an old boy network", and that leads naturally to the congenial approach of, "You scratch my back, and I'll scratch yours." Clearly, it is not a classic, competitive job market.

The New York Times did a study late last year[5] of the boards of 2000 of the country's largest corporations. They focused on a 4th factor influencing executive pay: they found that 20% of the compensation committees had members who had "business ties, or other relationships, with the CEO or the company, that could compromise their

---

[4] Wall St. Journal of 9/9/02 and NY Times of 7/4/03
[5] Reported in the NYT of 12/18/02

independence". For instance, 3 of the 8 people who set the pay of GE's Jack Welch had done business with GE through their own companies.

In 70 of the 2000 companies the chairman of the compensation committee had business ties to the company: Bank of America, Kraft Foods, MBNA Bank, Comcast, and MGM Mirage, for instance.

Some might contemplate these compensation levels and say, "So what? It may look like a lot of money, but it is a tiny fraction of the operating profit of the company." That may be; but a 1999 study by Towers Perin found that American CEO's pay was 475 times the pay of the average factory worker, whereas CEO salary in foreign countries was about 12 times Joe Lunchbucket's pay. Sooner or later, that disparity is going to lead to angry, maybe nasty, revolt, or to competitive disadvantage in a world economy.

So how would you break up the Good Ole Boy fraternity? As a small shareholder, you can vote against proposals that touch on executive pay, if they appear in the proxy statement - which doesn't happen often. You could sue - take on the board and the company lawyers and the compensation consultant - if you could find the money. However, the courts have generally viewed executive pay as a matter best left to business judgment. And as a practical matter individual stockholders are likely to be outmatched.

Both the New York Stock Exchange and the NASDAQ are drafting new listing proposals. They each define director independence differently, and they may provide exceptions under certain circumstances, such as companies with a dominant shareholder.

Perhaps the best chance for reform could be initiated by institutional investors who own big blocks of stock: pension funds, endowment funds, mutual funds. To date they have not become angry or aggressive enough to step up to the plate and take a swing at the problem.

Maybe the best approach for the average citizen is "If you can't beat 'em, join 'em." Those of us who aspire to the kinds of hourly compensation rates mentioned above would like to know, "How do these contracts get written?" One place to inquire is at the firm of Joseph Bachelder in New York. He has negotiated contracts for the CEO's of Allied Signal, Eastman Kodak and Lucent Technologies. He charges $975 an hour[6]. In 1989 when Henry Kravis badly needed a turnaround CEO for RJR Nabisco Holdings, Bachelder got Louis Gerstner a sign-on package valued at $3 million and the right to buy RJR stock at prices as low as a penny a share. Gerstner, no dummy, hired Bachelder again in 1993 to negotiate a contract with IBM. Apparently Bachelder likes to exploit the vulnerability of troubled corporations which badly need a turnaround artist; but he also is able to negotiate juicy severance packages when he argues that a fired executive is being made a scapegoat for problems that blindsided everyone, including the board.

So let's all send our resumes [according to current practice they don't have to be 100% factual] to the Fortune 500 companies, with a copy for Joe the lawyer plus a retainer of a few thousand clams.

I hear there is a juicy opening at the New York Stock Exchange!

[2115 words @ 150 wpm = 14 min.]

---

[6] Wall St. Journal 6/25/03