Paying For Failure

Forbes
On The Cover/Top Stories
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May 19, 2008

What does it cost to attract first-class talent to a chief executive job? A lot. What does it cost to hire a clunker? Almost as much.

You need look no further than Gary Forsee to see why the absurdities of executive compensation rankle shareholders so much. In 2003 Forsee negotiated a pay package to join Sprint as its chief executive officer that promised to leave him rich--whether he succeeded or failed at turning around the troubled long-distance phone company.

Sprint first paid him $6.5 million in cash and stock just to leave BellSouth, where he was the number two executive. Sprint also bought Forsee's house in Atlanta before he moved to Kansas City. Once on the job Forsee was paid between $1.5 million and $5 million a year. His only real claim to fame while running Sprint was engineering the disastrous Nextel merger and watching its stock price tumble from $25 two years ago to $7.40.

At the end of 2007 he was fired "without cause." But he had negotiated well. Sprint gave him $40 million, including a $1.5 million salary through 2009, $5 million in bonuses, stock options and restricted shares worth $23 million and an $84,000-a-month pension for life. This package was structured under his contract as if he were still running the company and had met all his goals. Oh, Sprint also paid for "outplacement services" that landed him the presidency of the University of Missouri (where his annual salary and bonus amount to $500,000).

Nowadays directors, in the guise of rewarding performance, blithely bestow vast fortunes on bosses who destroy shareholder value, as well as on those who create it. Somewhere along the way just becoming a chief executive, rather than a good one, became tantamount to winning the lottery.

In 2007 chief executives overall took a 15% pay cut, rightly so, as the return on the S&P 500 fell nearly two-thirds to 5.5%. Average salaries came in at $1.1 million and total pay at $12.8 million. But, as is evident in our annual performance-versus-pay survey (which weighs shareholder returns against pay over six years), plenty of bosses rake in large sums for mediocre work. Marriott International Chief Executive J. Willard Marriott, for example, ranks among the most overpaid bosses of the past six years. His 2007 pay jumped 22%, to $44 million, as investors suffered a 28% stock price drop.

Black & Decker's Nolan Archibald, another bottom dweller, raked in 269% more, a total of $34 million, as his firm's stock fell 13%. Was this just a statistical fluke related to one bad year in the stock market? Or was it the fact that we count options when they are cashed in rather than when they are awarded? No, it wasn't. There we compare pay over six years with performance both over six years and over the full period that a boss has been in office. In the composite scorecard

Marriott is 18th from the bottom (out of 175 executives) in cost effectiveness. Archibald is 31st from the bottom. (Forsee wasn't around long enough at Sprint to be ranked.)

At Eli Lilly, salary increases, bonuses and long-term performance awards are all based mainly on earnings per share. In other words bosses are paid three times for hitting one target. Bull's-eyes aren't too tough either, since they require only average results among Lilly's peers. If they come in lower, the brass doesn't forgo bonuses--it just earns "below-target payouts." Sidney Taurel, chief executive through March, and now chairman, earned $9.5 million in 2007. Lilly's stock rose 3%, slightly lagging the S&P 500. Over the long term he doesn't look terrific, either. Because he's no longer chief exec, he's not on this year's performance-to-pay ranking; last year he was ninth from the bottom on a list of 189.

"It's like a fourth-grade soccer league where everyone gets a trophy. You can't call it pay-for-performance," says Nell Minow of the Corporate Library, a governance handicapper.

Big business has gone to considerable lengths to protect the status quo. Following Enron, when reform was the rage, executives grumbled about the Sarbanes-Oxley Act's high cost. But they scaled the ramparts when the SEC proposed shareholder "proxy access," meaning the right to nominate independent director candidates who might threaten the pay orgy. They lobbied the White House and got the initiative killed. A chastened SEC responded by revamping pay disclosure rules two years ago. Gaming them has proven a cinch. All told, executive compensation has risen from 40 times that of the average worker in 1980 to 433 times now. The top-paid executives at the country's public companies now collect pay equal to 10% of corporate profit, according to a 2005 study by Lucian Bebchuk of Harvard Business School and Yaniv Grinstein of Cornell University.

Corporate boards are devilishly clever at concocting ways to reward chiefs whether they make shareholders richer or poorer. Some of them:

The Golden Handshake

Last year Robert Nardelli walked away from a mediocre tenure at Home Depot with $210 million. It was too late for the compensation scolds to complain; the board's real sin was committed years before in luring Nardelli to the company from General Electric. His contract said he'd get 90% of his pay regardless of performance, plus an enormous retirement package when he left.

Citigroup has done something similar with new Chief Executive Vikram Pandit. To recruit him the troubled bank paid him $241 million, including $165 million for Pandit's stake in hedge fund firm Old Lane Partners (a quarter of whose value Citi has already written down); a sign-on stock grant, performance-based options reportedly worth $48 million and $250,000 in salary. Pandit may prove to be a management genius. But so far he is still feeling the aftershocks of his predecessor's mistakes. Since his arrival the stock has fallen a further 25%.

Cherry-Picked Peers

One way boards try to deflect criticism is to argue that everyone's doing it. So they compare their chief's pay to the pay at similar companies. But companies cheat by packing the comparison group with "aspirational peers"--firms that are larger, more successful and pay more.

Ford Motor's "peer" group includes Altria, IBM and Procter & Gamble. Those companies have similar revenues, but--in measures that better reflect shareholder value, such as profits and market cap--moneylosing Ford is a laggard. What about General Motors? Ford includes it, too, but it's a circular exercise, since gm bases its pay on many of the same peers as Ford--Altria, IBM and P&G included. On FORBES' performance-to-pay ranking GM Chief Richard Wagoner comes in at position 160 out of 175.

With Ford's pay scale on steroids, directors then set at ankle height the performance bar its bosses must clear to hit the jackpot. Their "profit" goal in 2007 was to lose only $4.9 billion, excluding special items. It hit that goal, losing $3.9 billion. For beating the bogey, Chief Executive Alan Mulally got $12 million, including a $7 million bonus. Ford's shares fell 10% last year. Can he rescue this firm? If--and when--he does, shareholders won't mind a $12 million cost.

Consultant Collusion

Compensation consultants are hired by boards to advise them on how much to pay executives. But their real value appears to be providing cover for lavish pay. In 2006 Countrywide Financial hired a consulting firm that had the temerity to suggest that boss Angelo Mozilo was overpaid at $103 million. It was a conspiracy, Mozilo shot back, in which boards are "under enormous pressure from the left-wing antibusiness press and the envious leaders of unions." He countered by hiring Towers Perrin's John England, whose numbers were more to his liking. Mozilo's board relented, paying him a $10 million bonus just for staying on. Mozilo and his fellow directors soon began selling shares, even as the firm went $1.5 billion into debt to fund buybacks. It lost $19.7 billion in market value last year.

Changing the Rules

When executives don't perform well enough to earn incentive pay, boards sometimes just change the rules. Investors in home builder Toll Brothers have taken it on the chin, with the stock off 28% from the beginning of 2007. Chief Executive Robert Toll, who has made $152 million the past five years, received no bonus last year and saw his pay tumble to $9 million.

His board thought it too much to expect Toll to scrape by for another year without a bonus. So instead of basing it on the firm's financial performance alone, this spring it added an "individualized performance component" so Toll will be enriched by a bonus, even if his shareholders suffer.

Kerry Killinger, chief executive of beleaguered mortgage lender Washington Mutual, received no 2007 bonus amid huge losses and a 70% stock price drop. That cut his pay to a mere $4.9

million. His board decided in March to exclude the financial damage from WaMu's subprime lending from the operating profit figure used to calculate his bonus. Directors backed off in April after shareholders forced former finance committee head Mary Pugh to resign.

Toothless Clawbacks

When a company stumbles, shareholders feel the pain through stock-price declines. But the executives most responsible for the problems are almost never required by boards to give back incentive-based pay--even when earned via questionable means. "A lot of clawbacks are poorly written, and as currently structured don't relate to writedowns," says Broc Romanek, who runs a Web site on corporate governance (www.thecorporatecounsel.net).

Merrill Lynch's former boss, Stanley O'Neal, shows how the absence of clawbacks can encourage executives to take wacky risks. After O'Neal took over as Merrill's boss in 2002, he dramatically hiked its risk profile, pushing deeply into exotic mortgage markets.

O'Neal received $87 million in pay during the five years through 2006, when this strategy appeared to be paying off. Since then Merrill Lynch has suffered $30.5 billion in mortgage writedowns. The employment contract included no clawbacks to recoup pay when the earnings on which bonuses were built had to be, in effect, retracted. Merrill's directors, moreover, allowed O'Neal to resign, rather than be fired, which forced investors to kick in another $136 million for his deferred compensation and stock options.

Perks

An SEC perks rule that went into effect a year ago tightened disclosure of the extras executives receive, but it's full of holes. Goodies need not be itemized, for example, if deemed to be worth less than $10,000 a year.

Even more valuable freebies often go unreported, especially when chief executives mix work with pleasure. "A CEO who makes one business phone call while on a golf trip on the company jet will say that the trip was a business expense," said David Yermack, a professor of finance at New York University.

Some extras are just too big to hide. Bank of America Chief Executive Kenneth Lewis received $127,643 for use of corporate aircraft, $16,740 for tax prep and $16,333 for home security last year. He also received a free apartment, although the bank won't say how much it's worth. It doesn't have to. It can claim there is no "aggregate incremental cost," since the bank owned the apartment before Lewis arrived.

Buyout Bonanza

Coming to work with a new shingle on the building might not sound like a reason for a fat payday. Yet 37% of companies have change-in-control provisions with so-called single triggers. Under them, a buyout triggers a sudden windfall for the bosses.

After drug distributor Caremark merged with CVS last year, Chief Executive E. Mac Crawford stayed on at the combined firm as chairman. That didn't stop him from collecting a $26.4 million "cash severance payment" in addition to $30 million from stock options and other benefits. The buyout was also designed to protect Crawford and other Caremark bosses "to the fullest extent permitted by law" from accusations that they had previously backdated stock options grants.

Gross Gross-Ups

This monster, which involves shareholders' paying executives' taxes, evolved from a 1984 congressional bid to penalize "excessive" golden parachutes by slapping on an excise tax when they exceed three times average annual wages.

Instead of discouraging fluffy golden parachutes, the law legitimized them at just below the level where the excise tax kicks in, says RiskMetrics. If the golden parachutes exceed that level, many firms, including Chevron and Deere & Co., offer "excise-tax gross-ups" and pay the levies for their executives. All told, such policies are in place at 77% of companies with golden parachutes, up from 10% in 1987, says Towers Perrin. Among the top 50 New York Stock Exchange companies, 36 pay all of chief executives' excise taxes on parachutes. Alcoa last year estimated the present value of excise tax gross-ups for its chief financial officer at $2.7 million in the event of a buyout. When his predecessor Joseph Muscari retired a year earlier and was given a watch, the company paid $1,102 in taxes on its value.

Golden Kiss-Off

How does it benefit shareholders to pay a departing chief executive, who is already world-class rich, tens of millions of dollars more as he heads out the door?

That's what ExxonMobil did in January 2006 when Lee Raymond retired without an employment contract but was granted a lump-sum retirement benefit of $98.4 million, based on a multiple of his salary and bonus.

At least Lee went out on a high note. The same can't be said for Charles Prince at Citigroup. Under him, Citi dived headfirst into the mortgage debacle and shunted massive liabilities off its balance sheet. So far it has written off $41 billion as a result and been forced to raise capital from abroad, diluting existing shareholders. Even so, Citi's board decided shareholders should pay Prince a $10.4 million bonus, for which they'd previously had no obligation, on top of $28 million in unvested stock options and $1.5 million in annual retirement perks.

Prince's pay was "entirely proper and fair," based on his years of service and agreement not to compete with or recruit from Citi, the firm said in a written statement.

Proper and fair? Or would it be more accurate to say, "entirely business as usual in the compensation game"?