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PAGE ONE*Money Rules***Behind Soaring Executive Pay,
Decades of Failed Restraints****Instead of Dampening Rewards, Disclosure, Taxes, Options Helped Push Them Higher****Return of Golden Parachutes****By JOANN S. LUBLIN and SCOTT THURM***October 12, 2006; Page A1**(See Corrections & Amplifications item [below](#).)*


In 1993, activist investor Ralph Whitworth shuttered United Shareholders Association, a group that was trying to tackle the contentious issue of executive pay. It looked as if his work was done.

Federal securities regulators had just forced companies to reveal details about pay and perks for top officials, in some cases for the first time. The changes would "make boards think twice" before approving compensation plans that couldn't be justified, Mr. Whitworth recalls thinking. Around the same time, Congress attacked executive pay for the second time in a decade by removing tax breaks on compensation above one million dollars.

Since then, the average pay for chief executives of large companies has quadrupled, according to Kevin Murphy, a professor at the University of Southern California's Marshall School of Business. The average last year was \$10.5 million, a figure that includes salary, bonus and the value of stock and stock-option grants.

There are many reasons why Mr. Whitworth was mistaken in his prediction, including the bull market of the 1990s, cozy corporate boards and CEOs striving to keep pace with highly paid athletes and entertainers. What's often overlooked is the role of all the efforts - by Mr. Whitworth and many others -- to limit CEO compensation. For more than two decades, critics tried to slow skyrocketing pay

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through regulations, legislation and shareholder pressure. Few of their tactics worked. Many backfired.



As it turns out, disclosure requirements can push pay higher by revealing to CEOs what their peers receive. Limiting one type of compensation often encourages new types of pay, such as stock options, which were pushed as a solution only to become tainted by scandal. Now that shareholders are quicker to push out poorly performing chiefs, CEOs are seeking more financial guarantees. And if companies turn to outsiders, they often have to pay extra.

Curbing executive compensation is "like moving Jell-O," says Kayla Gillan, the former general counsel of the California Public Employees Retirement System, or Calpers, the nation's largest public pension fund. When it's limited in one area, "it squirts out in another."

Mr. Whitworth disputes the idea that advocacy like his helped make things worse. "To say there's a causal relationship between reform efforts and high executive pay is not logical," the veteran shareholder activist says. Instead, he says he and his peers erred in not focusing on company compensation committees and their lack of accountability to investors. As a result, he says, "CEOs still get whatever they can."

In recent years, CEOs have raced ahead of other Americans, including their own lieutenants. Mr. Murphy calculates that average CEO pay was 369 times as much as the average earned by a worker last year, compared with 131 times in 1993 and 36 times in 1976. Meanwhile, the

average U.S. paycheck has barely kept ahead of inflation in recent years.

Carola Frydman, a finance professor at the Massachusetts Institute of Technology's Sloan School of Management, says the pay gap between CEOs and other executives at the same company has doubled since the 1960s.

Charles Munger, vice chairman of Warren Buffett's **Berkshire Hathaway Inc.**, and a longtime business partner of the famed investor, describes executive compensation as "wretched excess." In an interview, Mr. Munger says he hears complaints even from "Republicans who grumble on the country-club porch" about the resulting political turmoil over the pay question. They're "mad at corporate America," he says.

The Securities and Exchange Commission recently set forth another set of rules governing the expanded disclosure of top executive pay and benefits. For the first time, it required that companies reveal top executives' "total compensation." Investors, too, are intensifying efforts to limit pay. They're embarrassing some highly paid CEOs, trying to change corporate bylaws and seeking to replace directors who bless exorbitant packages.

There are already doubts as to whether these moves will be any more effective than prior efforts. According to a survey by the

University of Southern California and executive-search firm Heidrick & Struggles International Inc., 64% of directors say they expect CEO cash compensation to continue to rise; 58% say they expect stock compensation to continue to rise.

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Many CEOs say they're paid what they're worth. The Business Roundtable, a group of big-company CEOs, says compensation has roughly kept pace with stock-market returns for the past decade. Using different methodology than that employed by Mr. Murphy, the group says the typical CEO makes 179 times as much as a typical U.S. worker.

"I made a lot of money. I became wealthy," says Harvey Golub, CEO of **American Express** Co. from 1993 to 2000. "My shareholders became even wealthier."

During Mr. Golub's tenure, American Express's shares rose more than sixfold and its market capitalization climbed to \$65 billion from \$10 billion. "How much of that \$55 billion should I get?" he asks.

Mr. Golub was paid roughly \$57 million in salary, bonus and restricted stock over eight years. He also exercised options to buy shares valued at \$92 million. When he stepped down as CEO, he held options valued at \$114.5 million and received an additional 990,000 options. Because he soon after retired as chairman, investors don't know how much Mr. Golub made from exercising those options. He declines to divulge the figure. Mr. Golub is a director of Dow Jones & Co., publisher of The Wall Street Journal.

In his 1936 State of the Union address, President Franklin D. Roosevelt railed against "entrenched greed" at American corporations. At the time, the average compensation for the top executive of a big company was about \$95,000, according to MIT's Ms. Frydman, equivalent to \$1.4 million in today's dollars.

Reflecting the more egalitarian societal values, as well as punitively high marginal tax rates, executive pay barely budged in the prosperous post-World War II decades. In 1970, Ms. Frydman says, average CEO pay was no more, adjusted for inflation, than it was in 1940.

Then, in the late 1970s, the culture of pay started to change. After a decadelong bear market soured executives on stock and stock options, they began to seek out other forms of compensation, aided by a budding industry of pay consultants. Among the most inventive CEOs was the late Steven J. Ross, chief of Warner Communications Inc. and later Time Warner Inc.

The son of an oil-burner salesman, Mr. Ross built a media empire from a chain of funeral parlors and parking lots. He weathered a federal investigation, fought with partners and investors and fended off takeover attempts from Rupert Murdoch, among others.

In 1981, Mr. Ross took home more than \$22 million, including gains on stock options, making him the first executive to crack \$10 million in annual compensation, according to Mr. Murphy.

In addition to a salary and a bonus pegged to Warner's profits, Mr. Ross received a dizzying array of other types of compensation, including stock, stock options and multiple forms of deferred compensation. Between 1973 and 1989, he took home \$275 million, according to Graef Crystal, a former compensation consultant who is now a columnist and critic of executive pay.

The 1980s witnessed a flourishing of different types of compensation, following President Reagan's deep cuts in the top rates of income tax. Some of the techniques were seemingly unrelated to performance, such as "signing bonuses" for new CEOs and "guaranteed bonuses." In 1981, Occidental Petroleum Corp. CEO Armand Hammer was promised a bonus of at least \$240,000.

Golden Parachutes

Another new technique was the "golden parachute," a sizable sum promised to executives if their company was taken over. Without such assurances, boards worried that executives might oppose a deal that was good for shareholders out of concern for their own futures.

In 1983, Bendix Corp. CEO William J. Agee received \$3.9 million over five years after his aerospace, auto-parts and machine-tools concern was acquired by Allied Corp., an industrial conglomerate. It was one of the decade's first bruising takeover battles, sparked by Mr. Agee when he tried to buy aerospace and defense firm Martin Marietta Corp. The size of his parachute, as well as the circumstances in which it was paid, created a furor.

The following year, Congress slapped a special tax on golden parachutes. "The Bill Agee Bill," as some at the time dubbed it, taxed awards valued at more than three times an executive's average compensation over the previous five years.

Rather than curbing pay, the law had the opposite effect. Despite a few well-publicized examples, golden parachutes were rare before Congress intervened. In a survey of companies named in either the Fortune 1000 list or the S&P 500 index, a mere 8% gave at least one executive a golden parachute before the law was passed. By taxing parachutes at a certain level, Congress in effect blessed their existence. It also gave the technique a publicity boost.

Baxter International Inc. adopted golden parachutes for its CEO and 22 other officers for the first time in 1985, promising executives twice their annual salary and bonus. A Baxter spokeswoman says the parachutes came at a "tumultuous" time of mergers in the industry.

By 1991, more than half of the top companies in the survey provided parachutes to certain executives, according to Executive Compensation Reports, a newsletter.

The parachute law also spawned a new form of compensation: payments to cover the new taxes. By 2004, 77% of 1,000 public concerns tracked by consulting firm Towers Perrin offered such tax compensation, known as a "gross up," compared with 10% in 1987.

James F. Reda, a New York pay consultant who began working in the field in the late 1980s, recalls: "It was an easy argument to sell to boards, that it's just money going to the government, so why penalize these people?"

Critics of executive pay say boards, stocked as they often are with CEOs and retired CEOs, rarely need to be sold on pay packages. Mr. Buffett, well known for his dislike of ostentatious compensation, joined the compensation committee of Salomon Inc. after taking a stake in the investment bank in the late 1980s. In 1990, when Salomon's profit declined, Mr. Buffett voted against bonuses for top executives, a rare event inside U.S. boardrooms. Mr. Buffett was outvoted and hasn't been asked to serve on a compensation committee since.

Compensation panels are "tail-wagging puppy dogs meekly following recommendations by consultants," Mr. Buffett wrote in his 2002 letter to Berkshire shareholders. For an outside director to oppose these recommendations "would be like belching at the dinner table."

In spring 1990, Richard Koppes, then general counsel of Calpers, convened a meeting of corporate lawyers and activist investors at Morton's Steakhouse in Washington, D.C. Ira Millstein, a New York attorney and longtime adviser to the boards of **General Motors Corp.** and **Walt Disney Co.**, urged investors to focus on executive pay. "You shareholders can do something about it," he said.

To better align CEO pay with shareholder returns, activists started urging a wider use of stock options. Options give the holder the right, but not the obligation, to buy shares at a specified price. They become valuable only when a company's share price increases.

Calpers began publishing a "target list" of overpaid, underperforming CEOs. Its initial top target was Rand Araskog, chief executive of conglomerate **ITT Corp.** Mr. Araskog, the son of Swedish immigrants, graduated from West Point. After fending off corporate raiders, he spent a decade dismantling ITT, a sprawling conglomerate whose businesses stretched from telephones to timber. In 1990, Mr. Araskog's compensation rose 82%, to \$7.3 million, the same year ITT shares fell 18%.

In September 1991, Mr. Araskog met Mr. Whitworth, the investor activist, at the offices of his group, United Shareholders. "I'm tired of being the poster boy for executive compensation," Mr. Whitworth recalls Mr. Araskog saying. "What would you do?"

On a yellow legal pad, Mr. Whitworth sketched a plan that paid a modest cash compensation and plenty of options. Mr. Araskog "tore it off and took it with him," Mr. Whitworth says. Two days later, the chairman of ITT's compensation committee chairman called Mr. Whitworth and declared, "Rand is going to take you up on your offer." Mr. Araskog says he doesn't dispute Mr. Whitworth's recollection.

As a result, ITT gave Mr. Araskog options for the first time -- 170,000 with an initial value of \$3.5 million. The board also revamped its long-term performance plan and moderated Mr. Araskog's salary increases. The CEO received a 6% raise in 1992, down from a 17% raise the year before. Mr. Araskog says ITT embraced options partly because making money under the old performance plan was "next to impossible."

With subsequent grants, Mr. Araskog held options valued at \$17.8 million by the end of 1995 when ITT broke itself up and sold off the pieces. He retired in 1998 and received \$15 million in severance.

Other top CEOs took up the concept. In 1990, **H.J. Heinz** Co. CEO Anthony J.F. O'Reilly received options to acquire four million shares. The following year, Leon Hirsch, chief of medical-products company U.S. Surgical Corp. received options for 2.75 million shares valued at \$170 million, more than 100 times his annual salary and bonus.

At the time, "we never saw an [option] plan we didn't like," Mr. Whitworth recalls. "People would say, 'How much is too much?' We said, 'The sky's the limit as long as it's tied to stock options,' which we equated to performance."

Shareholders expected option grants would displace other types of compensation. More often, they were doled out as an extra. As chairman and CEO of **Chase Manhattan** Corp., Walter V. Shipley received a \$750,000 salary and options for 90,000 shares in 1993. Four years later, he was granted options for 240,000 shares, with an estimated value of \$3.8 million. Mr. Shipley's salary rose, too, to \$950,000.

The huge option grants began to trigger enormous paydays. In 1992, Disney CEO Michael Eisner exercised options valued at nearly \$127 million. The former studio head reshaped and revived Disney in the 1980s and Disney's share price had risen tenfold.

Amid the economic downturn and corporate restructurings of the early 1990s, complaints about such awards found receptive audiences. In 1992, Democratic presidential candidate Bill Clinton made executive pay a campaign issue. Washington responded.

The SEC said it would require more disclosure about compensation, particularly stock options and executive perks. The following year, after Mr. Clinton was elected, Congress decided companies could no longer take tax deductions on executive compensation of more than \$1 million, unless it was related to performance.

Neither approach slowed the upward march of executive compensation. In fact, the disclosure rules allowed CEOs to see what others were getting, encouraging a competitive spiral. The tax law, meanwhile, drove up the compensation of CEOs who were making less than \$1 million. Executives considered the cap a "minimum wage for CEOs," says Mr. Koppes, the former Calpers official.

SEC Chairman Christopher Cox recently said the 1993 law belongs in "the Museum of Unintended Consequences," because it encouraged the growth of "less transparent forms" of pay, such as pensions and deferred compensation.

Ignoring the Caps

Some companies felt free to ignore the caps altogether, especially as they wooed outsiders, a tactic increasingly used by boards to fix succession problems. In the 1970s, says the University of Southern California's Mr. Murphy, companies picked outside CEOs about 15% of the time. By the 1990s, that had risen to 27%. Last year, executive-search firm Spencer Stuart says outsiders won 40% of the

CEO vacancies at S&P 500 firms.

Eastman Kodak Co. in 1993 wooed George Fisher, the successful chairman and CEO of **Motorola** Inc. Kodak offered a \$2 million salary, more than double what he was earning at Motorola. Kodak didn't seem bothered by having to sacrifice tax deductions on half the \$2 million. Mr. Fisher says, "I don't remember that was ever part of the discussion."

Mr. Fisher says the \$2 million figure originated with his attorney, Joseph Bachelder, who had negotiated a similar deal for Louis V. Gerstner at **International Business Machines** Corp. Kodak also gave Mr. Fisher a \$5 million signing bonus, a \$1 million guaranteed bonus in both 1994 and 1995, 20,000 restricted shares and more than one million stock options.

"Going outside can be frightful," says Alfred DeCrane Jr., former CEO of Texaco Corp., who has served as a director on four compensation committees. "You can negotiate, but if you want to close the deal, you have to close it."

Defenders of CEO pay say these contracts demonstrate the market value of a successful executive. "There is an incredible shortage of qualified people to manage and lead big companies today," says Kenneth Langone, a veteran Wall Street figure. Mr. Langone is a defender of two executives caught up in pay controversies: Former New York Stock Exchange Chairman Richard Grasso and **Home Depot** Inc. CEO Robert Nardelli. Mr. Langone chaired the NYSE's compensation committee and is a director and a co-founder of Home Depot.

Mr. Bachelder, who has been negotiating CEO contracts for 26 years, points to another factor: big paydays for athletes, entertainers and money managers. "It's the Michael Jordan principle," Mr. Bachelder says. "If he can get \$30 million, I have to get it."

Throughout this time, options remained a favorite pay tool for an important reason -- they were effectively free. Options granted at or above the market price of a stock did not have to be recorded as a company expense in financial results.

Accounting regulators proposed changing this rule in 1993 but backed off following opposition from Congress and Silicon Valley. Then-SEC Chairman Arthur Levitt later wrote in his memoir that failing to support the accounting change was his "biggest mistake" as chairman.

A few directors tried to buck the option fad to little effect. In the early 1990s, shareholder activist Robert Monks persuaded fellow directors of **Tyco International** Ltd. to pay CEO L. Dennis Kozlowski with restricted stock -- which requires a holder to wait several years before it can be sold -- rather than options. At Mr. Monks's urging, they also decided to deny Mr. Kozlowski a bonus if Tyco's cash flow and earnings didn't grow by at least 15%.

During a 1993 board meeting at a Tyco factory in Michigan, Mr. Monks says, he called for independent board members to meet privately and discuss even tougher ties between pay and performance. Mr. Kozlowski and his predecessor, John Fort, another board member, refused to leave the room, Mr. Monks says. The following year, Mr. Monks was not renominated for the board.

In 1997, Mr. Kozlowski received 3.3 million options after Tyco acquired security firm ADT Ltd. He later swapped some restricted stock for more options. Between 1998 and 2001, Mr. Kozlowski reaped more than \$400 million in salary, stock grants and gains from options, according to securities filings. Mr. Kozlowski and his former finance chief were convicted last year of looting more than \$150 million from Tyco. Both are serving prison sentences of as much as 25 years, and have appealed their convictions.

Asked for comment, a Tyco spokeswoman would say only that "prior management is no longer in place."

In the bull market of the late 1990s, these awards led to staggering paydays. In general, criticism of such deals was relatively muted as smaller investors also benefited from rising stock prices.

That changed in 2001 when Enron Corp. collapsed in an accounting scandal. Others corporate debacles followed: WorldCom Inc., Adelphia Corp., Tyco. In each case, top executives massaged the books to prop up the share prices that accounted for most of their worth.

In response, the Sarbanes-Oxley Act, passed in 2002, required more timely disclosure of executive-pay deals and required CEOs to return compensation based on financial results that were later restated. The disclosure requirement squelched another pervasive, but little-known, practice of the 1990s, a side effect of the options craze: the "backdating" of stock options. The long-hidden practice burst into public view this year, and now more than 100 companies are under scrutiny for manipulating the timing of option grants to generate even bigger gains for executives.

By 2003, the average option grant fell nearly by half to \$3.3 million, according to the University of Southern California's Mr. Murphy. As a result, average CEO compensation actually declined, to \$8.7 million in 2003, from \$12.8 million in 2000.

The following year, accounting rulemakers finally required stock-option grants to be treated as an expense. Corporate boards responded by distributing fewer options.

In lieu of options, boards distributed more restricted stock. Some questioned whether this was progress; unlike options, restricted stock retains its value even if share prices decline. Other boards pledged to tie pay more closely to performance.

Big awards are now popping up when executives leave their companies, regardless of performance. As of the end of last year, then-**Pfizer** Inc. CEO Henry McKinnell accumulated \$83 million in pension benefits, according to company filings. He was ousted as CEO in July. During his five-year tenure, Pfizer stock declined nearly 37%. Mr. McKinnell is set to remain Pfizer chairman until his retirement in February.

His pension benefits "were awarded on the basis of many years of service to the company, including years in which the company significantly outperformed the market and its peers," says Dana Mead, head of the Pfizer board's compensation committee, in a written statement.

Golden parachutes are back, too. James Kilts, CEO of Gillette Co., received about \$164.5 million in severance and other benefits after the razor maker was acquired by consumer-products giant **Procter & Gamble** Co. last year. **North Fork Bancorp** CEO John Kanas received \$185 million for selling his Melville, N.Y.-based bank to a rival.

"By the time the payments are disclosed, the CEO is gone," notes Sarah Teslik, a longtime corporate-governance watchdog. "The worst that happens is a day's trashing in the press."

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Corrections & Amplifications:

Restricted stock retains some of its value when share prices decline. This article about executive pay incorrectly implies that restricted stock retains all of its value in such instances.

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