Law and Finance
Professor Lucian Bebchuk

Harvard Law School
Fall 2004

Package #4

<u>Session Topic: Executive Compensation: Crystal's Perspective</u>

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NOTE: This session will take place on Monday, September 27th.

New CEO Pay-Outsourcing Study Is Out of Bounds: Graef Crystal

(Commentary. Graef Crystal is a Bloomberg News columnist. The opinions expressed are his own.)

Sept. 1 (Bloomberg) -- The more a chief executive officer outsources jobs, the higher will be his compensation.

That's the conclusion of a study entitled ``Executive Excess 2004.'' And my conclusion after examining the study's findings and doing my own analysis is that this study shouldn't be taken with several grains of salt. It should be taken with an entire box of salt.

The study was conducted jointly by the Washington-based Institute for Policy Studies -- which describes itself as a progressive think-tank -- and the Boston-based United for a Fair Economy, which calls itself an ``independent, nonpartisan organization'' that ``raises awareness that concentrated wealth and power undermine the economy.''

Its key finding: Average CEO compensation at the 50 U.S. companies that outsourced the most service jobs increased 46 percent in 2003 from the year earlier, compared with a 9 percent increase for CEOs at 365 companies overall, as compiled by Business Week magazine.

Outsourcing has been a hot political topic in this U.S. presidential race, so the study received wide media dissemination when it was released yesterday, and it appeared in major newspapers across the country.

The study's main problem is that its weak statistical underpinnings undercut its contention that the 50 major outsourcers ``appear to be channeling their outsourcing profits not into U.S. jobs, but rather into the pockets of chief executives.''

Union Research

Another problem I have with the study is that an affiliate of a major union – the Communications Workers of America -- compiled the database of the 50 largest outsourcers. Let's face it, unions have an ax to grind, and they are in a patent conflict- of-interest situation with this study.

To get a better handle on the study's central claim that there was a positive correlation between a CEO's pay and the amount of outsourcing his company did, I developed my own control group, also comprising 50 companies.

Since the study's 50 outsourcers had net sales ranging from about $185 billion to $350 million, I drew from Bloomberg data every U.S. company with net sales in the same range. There were 1,890 such companies. To whittle the list down to 50, I used a stratified random sampling technique. (Pay data for my analysis were obtained from Aon Consulting's eComp database.)

Defining Pay

A major weakness of the study was its dependence on the definition of total pay as favored by Business Week, which includes the actual gains from exercising stock options, rather than the estimated present value of stock options granted in a particular year.

Since hardly any executive ever waits until the very end of an option's term to exercise his shares (a term which is almost always 10 years in duration), the decision as to whether to harvest option profits in any given year is fundamentally idiosyncratic.

One CEO decides to take, say, $25 million of a much larger amount of gains in a given year, while a second one, who has the same harvestable gains, takes none. Obviously, that first CEO is going to have a big increase in his year-over-year pay, as the study defines pay, while the second CEO will look like a saint.

Kenneth Lewis

Case in point: Kenneth Lewis, the CEO of Bank of America Corp. In the study, he was listed as one of the 15 outsourcers with the highest raises in pay between 2002 and 2003. His company was also cited as having exported 1,100 jobs to India in 2003 as part of a total reduction in its workforce of 5,000 jobs. The study also says that the company will ``cut an additional 12,500 U.S. jobs in the next two years.''

Bank of America spokesman Bob Stickler acknowledged in an interview that the company had indeed sent about 1,100 jobs to India last year. He said that the number of full-time equivalent positions -- 133,000 at the end of 2003 -- was the same as at the end of 2002. He also told me that the planned future reduction of 12,500 jobs has nothing to do with outsourcing, but rather with last March's acquisition of FleetBoston Financial Corp.

In 2003, Lewis exercised options seven times for $20.3 million in gains. The exercises occurred between May 2003 and November 2003. But all the option shares he exercised had an expiration date of July 1, 2005. Thus, Lewis could have waited, and if he had, his total pay for 2003, instead of being reported by the study as having risen 108 percent, would actually have been shown to decline by 3 percent

Defining Total Pay

To correct for this problem, I defined total pay to include the estimated present value of stock-option grants made in 2003 and 2002 and to exclude any gains received from exercising options in those same two years.

With pay analyzed in this alternate way and after controlling for variations in company size, I found there to be no statistical differences to the increases in total pay between 2002 and 2003 among the outsourcers compared with the control group companies.

The median change in CEO total pay was 9 percent for the outsourcers and 5.8 percent for the control group. And the probability of that small difference occurring by chance was a ludicrously high 32 percent.

The study's contention that the 50 outsourcers appear to be putting their outsourcing profits into CEOs' pockets is even more questionable, given that further analysis showed absolutely no significant differences between the total returns among the outsourcers for the year ended last Dec. 31 and the control group companies.

Grunts Bear Brunt

The probability of a chance result here is a staggering 76 percent. So though outsourcing would appear to lower costs and increase profitability, that extra dollop of profitability has definitely not been translated into higher short-term total returns for shareholders.

I do agree with another of the study's findings, that there's a yawning gulf between the pay of CEOs and their workers, which I think borders on the obscene. The study uses the low ratio of pay for a military general compared with the pay of an enlisted man to underscore its point. The business world does resemble the military in one big way: It's the grunts who bear the brunt.

--Editors: Ahearn, Todd.

Redstone Rewards His Two No. 2s -- and Himself: Graef Crystal

(Commentary. Graef Crystal is a Bloomberg News columnist. The opinions expressed are his own.)

Aug. 18 (Bloomberg) -- You've got to hand it to Sumner Redstone, the chief executive officer of Viacom Inc. He's a real egalitarian.

He gave his two top subordinates -- co-presidents and co-chief operating officers Thomas Freston and Leslie Moonves – the same grossly excessive compensation packages. And in the spirit of egalitarianism, then topped off his own pay tank.

Had he done nothing with his compensation, Redstone would have been earning less than Moonves and Freston. That, of course, couldn't be allowed.

What's even crazier about all this is that Redstone has an 11.4 percent stake in Viacom, as of the April 15 filing date of the proxy statement for the third-largest U.S. media company. Owning lots of shares is supposed to cause the CEO to identify more closely with his shareholders than with his bank.

Of course, an 11.4 percent ownership stake doesn't, on its face, offer unlimited control of the company. But wait, there are two classes of common stock -- A and B -- with 12 times more B shares than A shares. None of the B shares are offered a vote. Redstone owns 71 percent of the A shares, the only voting shares, thereby giving him 71 percent voting control.

Redstone seems to be suffering from a case of ``Paleyitis.'' For many years, I was the compensation consultant to the legendary William Paley, the founder of CBS. Paley simply couldn't stomach the idea of having anyone succeed him. Under his long reign, a whole host of No. 2s bit the dust. Finally, when Paley was already in his mid-80s, Larry Tisch, himself up in years, administered the coup de grace.

The Numbers

And here we find Redstone, now 81, doing pretty much the same thing. He fired Frank Biondi. He may have pushed Mel Karmazin out. And now he has set up a competition between Freston and Moonves. Each has been named co-chief operating officer with the chance to succeed Redstone if he retires on or before Dec. 31, 2007.

Redstone gave each a pay package that rarely exists in the real world for a single COO, and doesn't exist for two co-COOs.

Check these numbers out. Remember, you have to double them to get the combined pay of Freston and Moonves:

-- A salary of $3 million, notwithstanding that anything over $1 million isn't deductible on Viacom's tax return.

-- Deferred compensation of an additional $2 million, annualized. So far, we have $5 million a year of risk-free pay, not dependent at all on performance.

-- A ``target'' bonus of twice the sum of base salary and deferred compensation, or $10 million a year. That's the level of bonus that will be paid simply for expected performance. For really good performance, the bonus could be even larger.

-- From 2005 through 2008, the chance to earn additional bonus in the form of free shares of stock -- 115,000 shares of B stock each year based on the same performance criteria that govern the cash bonus. Using the $33.70 closing price last Friday, the annual grant now would be worth $3.8 million a year.

-- An option covering 1.5 million shares of B stock and carrying a strike price of $35.51 a share. A little more than one year into the option's term, the grant is currently under water.

Karmazin's Pay

It's illuminating to compare the pay package of either Freston or Moonves with Karmazin. In salary, deferred compensation, target bonus and free shares, Karmazin, in his employment agreement executed in March 2003, had been promised $10.6 million a year. Moonves and Freston each earn $18.8 million a year, and they aren't quite splitting Karmazin's old job. Karmazin had everyone reporting to him, including staff officers. Moonves and Freston have only operating heads reporting to them.

As to Redstone's pay, a new employment agreement executed July 1 and replacing the one of March 2003, raises his annual salary to $3.5 million from $1 million. His deferred compensation went down, though, to $2 million a year from $3.4 million a year. But he also receives those free share grants starting next year. So his salary, deferred compensation, target bonus and free shares total $20.3 million. That's 83 percent more pay.

Pay vs Performance

A pay increase of that magnitude -- especially pay that's pretty spongy and not subject to a lot of risk -- is hard enough to swallow in the best of circumstances. It's impossible to digest when you consider Viacom's recent performance.

In the year ended June 30, 2004, the day before the new contracts for Redstone, Freston and Moonves were signed, total return for the B stock was negative 17.7 percent while the return on the S&P 500 Index was 19.1 percent.

Looking longer term, Viacom's stock price appreciation between May 4, 2000, the day it acquired CBS Inc., and last Friday ranked it only in the 16th percentile of the companies comprising the S&P 500 Index, meaning that 84 percent of CEOs in those companies outperformed Redstone.

Redstone has the right to do whatever he wants with his own billions, like paying Freston and Moonves a good part of their compensation out of his own pocket. That's not instinctive behavior on the part of a CEO, I'll grant you, but it isn't unheard of either.

He doesn't have the right to open up his shareholders' collective wallet and pay grossly excessive compensation to himself and his two top subordinates.

He would do well to ponder the words of his fellow graduate of Harvard Law School, Joseph Welch, who said to Sen. Joseph McCarthy 50 years ago: ``You have done enough. Have you no sense of decency, sir, at long last?''

Compensation Committee

According to company spokesman Carl Folta, the members of Viacom's board compensation committee as of July 1, when the new employment agreements for Redstone, Freston and Moonves were executed, were:

-- Robert Walter, chairman and CEO, Cardinal Health Inc.

-- Jan Leschly, CEO, Care Capital LLC and former CEO of SmithKline Beecham

PLC.
-- Frederic Salerno, former vice chairman and chief financial officer of Verizon Communications Inc.
-- William Schwartz, counsel to Cadwalader, Wickersham & Taft.

--Editors: Ahearn, Todd, Siler.

Jeffries Takes Abercrombie & Fitch on Pay Ride: Graef Crystal

(Commentary. Graef Crystal is a Bloomberg News columnist. The opinions expressed are his own.)

Aug. 4 (Bloomberg) -- Michael Jeffries, the chief executive officer of Abercrombie & Fitch Co., is batting .333 -- a terrific performance, if only he were a Major League baseball player.

Sure, as Jeffries acknowledged in February right after the end of his New Albany, Ohio-based retailer's 2003 fiscal year, it was ``a tough year in terms of same-store sales.'' At the same time, his longer-term total return performance is terrible. On the pay rankings, though, he bats them right out of the park.

To get a handle on his pay standing, I compared him with CEOs of 12 other U.S. specialty retailers, all with net sales in the $1 billion to $2.4 billion range. Abercrombie's net sales for the year ended last Jan. 31 were $1.7 billion.

Over the past three fiscal years:

-- Jeffries's $1.1 million average annual salary level put him in the 100th percentile, meaning none of those other CEOs made more.

-- His $2.3 million average annual combination of salary and bonus also put him in the 100th percentile.

-- And for the hat trick, his $22.9 million average annual total pay positioned him -- well, you know where.

(Total pay includes base salary, annual bonus, the estimated present value of stock option grants measured at the time of grant using the Black-Scholes model, the value of free share awards measured on the date of award, payouts under other forms of long-term incentive compensation, and miscellaneous compensation. Data for the analyses in this article were obtained from Aon Consulting's eComp database.)

Erratic Performance

As for performance: Houston, we have a problem. For the one-, two-, three-, four- and five-year time windows, all ended Dec. 31, 2003, Abercrombie's total return ranked it at the 25th, 17th, 42nd, 25th and zero percentiles, respectively, compared with the other retail CEOs.

Notice that erratic series of percentile rankings. And then consider this series of Jeffries's stock option strike prices (each of which equaled the market price of the stock on the date of grant) stretching between 1999 and 2003: $37.69, $44.00, $20.81, $15.56, $30.18, $29.47. $25, $26.60 and $26.98.

Do you see any pattern there? I sure don't.

Perhaps this randomness of Jeffries's performance explains why between Jan. 30, the end of Abercrombie's 2003 fiscal year, and last Friday, total return was a fabulous 43.4 percent, at a time when the return on the Standard & Poor's 500 Index was negative 1.8 percent.

That's fine, but looking at the past volatility of Abercrombie's total return, I begin to hum that famous song from ``My Fair Lady,'' ``Just you wait, 'enry 'iggins, just you wait.''

Same Findings

I also compared Jeffries's pay with the three-year average annual pay earned by 91 CEOs working in a variety of U.S. industries, not just retailing, and all with 2003 net sales in the $1 billion to $2.4 billion range. The findings were essentially the same. Jeffries ranked:

-- 96th percentile for base salary.
-- 88th percentile for base salary and annual bonus combined.
-- 99th percentile for total pay.

Abercrombie's performance against this larger, more heterogeneous group was also down in the basement. The percentile ranks for the five time windows of total return noted above were, respectively, 19th, 14th, 37th, 23rd and third.

The primary reason why Jeffries's pay is so high is a new employment agreement he signed on Jan. 30, 2003. His board gave him a free share grant worth $27.9 million at the time of its award. That was in addition to an option grant made 11 months earlier covering 2 million shares. I estimate the present value of that grant to be $30.5 million.

`Stay Bonus'

In fairness to Jeffries, the huge free share grant was conditioned on no further such grants until at least the Dec. 31, 2008, expiration of his contract.

On the other hand, his three-year average annual total pay of $22.9 million doesn't include another little goodie, a so- called ``stay bonus,'' which gives him $12 million more if he remains with Abercrombie until his contract expires. He also gets this bonus if he's discharged for other than strict legal cause, quits for good reason, dies, is disabled or there is a change of control.

So, Jeffries's board gives him a million free shares as an incentive to remain with the company, with none of the shares vesting until the very last day of his contract's term. Now that's a powerful incentive to remain with the company. And to make sure he really stays until Dec. 31, 2008, the board promises him another $12 million.

Let Him Go

Well, you can't be too cautious when you're trying to keep someone of Jeffries's caliber (based on his performance, I would say 0.22 caliber).

Considering his performance during those one-year to five- year time windows, I think a better strategy would have been to pay Jeffries a lot of money to go away. Let another company give him a ``stay'' -- as in bonus.

* * *

Since there are just two members of Abercrombie's board compensation committee, their approval of Jeffries's huge pay package was, by definition, unanimous. They are:

-- John Kessler, owner of John W. Kessler Co., a real-estate development concern, and former chairman of Marsh & McLennan Real Estate Advisors Inc.

-- Archie Griffin, president and CEO of Ohio State University Alumni Association and the former associate director of athletics at that university, where he was a football running back and the only two-time winner of the Heisman Trophy, in 1974 and 1975.

--Editors: Ahearn, Todd.

SEC's Negligence on Proxy Rules Helped Belnick: Graef Crystal

(Commentary. Graef Crystal is a columnist for Bloomberg News. The opinions expressed are his own.)

July 21 (Bloomberg) -- Mark Belnick isn't out of the woods yet.

Tyco International Ltd.'s former executive vice president and chief corporate counsel, who has been acquitted of criminal charges, is facing civil lawsuits by Tyco and the U.S. Securities and Exchange Commission. Tyco is seeking to force Belnick to disgorge a lot of his past compensation. The SEC alleges proxy violations.

Whether Belnick loses the SEC case, the commission itself is guilty of negligence in its proxy disclosure rules. It's culpable because of how it allows a company to determine what aspect of an executive's pay is going to be disclosed in the company's proxy statement.

Some background: In 1991, I wrote a book called ``In Search of Excess.'' In one part of that book, I detailed all the game playing that had been going on in proxy disclosure and recommended significant reform by the SEC.

The book came to the attention of Michigan Senator Carl Levin, a Democrat, who called a hearing on the matter in early 1992, at which several others and I testified. Levin issued dire threats to the SEC if it didn't clean up its act.

Then-SEC chairman Richard Breeden took the threats seriously. Even though he was a Republican and Republicans aren't known for their zeal in shining a spotlight on top executive pay, Breeden, to his immense credit, totally overhauled the system. I was an informal consultant to him and to others at the SEC during this period.

Breeden's Change

Breeden did give one thing away, though. When it came to valuing stock options, he modified the original proposal, which required companies to use the Black-Scholes option-pricing model to value option grants and then to disclose the results of those valuations in their proxy statement. Instead, he allowed one of two methods to be used, and the great majority of companies chose the non-Black-Scholes method.

A major issue was how to determine which five executive officers' pay had to be reported in the proxy statement. Because Breeden had blinked on the option valuation issue, it became impossible to calculate a systematic total pay value for each company. In those days, restricted stock plans and long-term incentive plans other than stock option plans were not that big a deal.

Breeden's solution: Add up the salary and annual bonus of every executive officer. Put the chief executive officer at the top of the list, no matter what his pay. Then report the pay of the next four executives on the list.

Let the Games Start

That solution opened up the possibility of significant game- playing by any company that wanted to hide the pay of a highly paid executive officer. All the company had to do was to find a way to re-classify what a normal person would see as either salary or annual bonus to another category of pay.

And that is what Tyco alleges Belnick did. In various SEC filings made after Belnick departed the company in June 2002, the company belatedly noted that his pay in 2000 included:

-- A base salary of $737,500.

-- A bonus of $4 million.

-- Free shares of stock worth $14 million at their grant.

-- Miscellaneous compensation of $494,000.

The Tyco filings allege that had Belnick not conspired to move a lot of his bonus into a non-bonus category, he would assuredly have ended up on the proxy statement.

More Compensation

And had he ended up on the proxy statement, Tyco shareholders would have learned a lot more disturbing things:

-- He was loaned $16.5 million, mainly to buy an apartment in New York City and a home in Park City, Utah, the latter a location that contains no Tyco facilities. $14.5 million of the loan was interest-free.

-- He received guaranteed bonuses for three years after being hired in 1998. The bonuses added up to $3.5 million.

-- He became vested in free shares of stock worth $3.4 million in 1999, $6 million in 2000 and $15.6 million in 2001.

-- In 2002, he was given a ``retention agreement'' that offered him an additional $10.6 million cash bonus if he stayed with the company until at least Oct. 1, 2003, and the same amount if he was fired for other than cause at any time. Moreover, the $10.6 million came equipped with a full tax gross-up feature to assure that the entire amount ended up 100 percent in Belnick's pocket. Had his tax rate been, say, 50 percent (counting federal, New York State and New York City income taxes), the shareholders would have been on the hook for $21.2 million.

Come to think of it, Tyco's shareholders wouldn't have been the only people disturbed by all that disclosure. Belnick's former partners at Paul Weiss Rifkind Wharton & Garrison LLP would have turned absolutely green with envy.

Broom Time

Leaving aside who wins in the SEC vs Belnick, it's clear that the commission needs to get the broom and once again clean out its proxy disclosure stable.

At the least, pay, for purposes of deciding who gets on the proxy statement, should include every dollar element shown in the proxy's Summary Compensation Table. That means that not only salary and bonus would be included, but also the value of free share grants, payouts under long-term incentive plans other than stock options and miscellaneous compensation.

Then, if the Financial Accounting Standards Board finally rules, as expected, that companies will have to charge their earnings for the cost of stock options, the present value of those options should also be included in the SEC's definition of pay.

That way, all of the game playing that now goes on would cease. If such sunlight had hit Belnick's pay, he just might not have received anywhere near what he got.

Delete `Not'

Just 11 days ago, Alan Beller, the SEC's director of corporation finance, addressed the American Society of Corporate Secretaries. Acknowledging that the proxy rules governing executive compensation disclosure are now more than a decade old, he said:

``We are in the process of taking a look at them. We will review the rules and the disclosure we are getting and make some judgments about whether there need to be changes. We may not recommend anything to the Commission, but then again we may.''

Mr. Beller: Remove that word ``not'' and get cranking.

--Editors: Ahearn, Reichl, Siler.

Grasso Manages, Weill Leads Pay Hogs: Graef Crystal

Grasso Manages, Weill Leads Pay Hogs: Graef Crystal (Correct)
(Corrects 17th paragraph to insert dropped word million.Commentary. Graef Crystal is a columnist for Bloomberg News. The opinions expressed are his own.)

July 7 (Bloomberg) -- Baseball's All-Star game is next Tuesday, so it seems appropriate that I name my team from the world of executive compensation. So, here are my All-Star Pay Hogs.

Unlike Major League Baseball, there could be no limit on the number of players (past and present) for this team. Indeed, the problem is culling the pack to a manageable number. Nevertheless, I'll list my nine players, as well as a manager.

First, some ground rules (my team, so my rules).

This is an active team, and doesn't include some Hall of Fame compensation winners who have departed for their field of dreams, such as Armand Hammer of Occidental Petroleum, Steve Ross of Time Warner Inc. and Roberto Goizueta of Coca-Cola.

And, with one exception, not included are those who, for whatever reason, have departed the CEO game. More on them later. Now, on to my team.

Weill No. 1

Leading off is Sandy Weill of Citigroup Inc., who has to be considered at least the runner-up to Ross in the all-time pay hog of the world contest, if not the hands-down winner.

He perfected the so-called reload option, which became the gift that kept on giving. His option gains eventually came within a few million of the $1 billion line. Then he discovered the beauty of cash, with a $29 million bonus for 2003.

He's followed by Ray Irani, Hammer's handpicked successor.

Irani continued in the Hammer tradition and, indeed, even surpassed it. He responded to fierce criticism of his sweetheart pay contract, which, among other things, renewed itself daily for seven more years, by graciously agreeing to terminate it in return for a cash payment of $95 million. He then immediately signed a new pay contract for five more years, thereby double-dipping in base salary, bonus and all sorts of other compensation.

Henry Silverman of Cendant Corp. and Ed Whitacre of SBC Communications Inc. are next.

In the old days, I could never do a survey of CEO pay without finding Silverman's name right up with the biggest hogs of all. Now he has cut his pay package twice to bring it closer to those of other CEOs. He's still got work to do, but the direction is encouraging. At the end of his last fiscal year, he was holding 33.6 million unexercised option shares.

I remember back in the 1970S when I was the consultant to AT&T Corp.'s CEO, John deButts. He earned just $300,000 a year to run the world's largest company. Whitacre pulls down that in less than a week to run only a piece of deButt's former empire.

The Options Players

Making up the rest of my picks is a different category of pay hog, the option kings. Each has specialized in obtaining absolutely humongous option grants and, for the most part, turning them into mountains of cash:

-- Larry Ellison of Oracle Corp. In a single year (2001), he exercised stock options with aggregate gains of $706 million.

-- Sumner Redstone of Viacom Inc. He took a while to build up to pay hog status, perhaps because of his more advanced age. But he got there just fine in the last few years. At the end of his last fiscal year, he was holding options on 11.7 million shares and had received cash compensation that averaged $18.1 million a year over the past three years.

Eisner, Diller, Dell

-- Michael Eisner of Walt Disney Co. In three rounds of grants, he received 72 million option shares and has so far turned them into almost $1 billion of pay. He would have crossed that figure had he not agreed, unlike the other CEOs being named here, to take millions of option shares with strike prices that were substantially above the market prices at the time the grants were made.

-- Barry Diller of Interactive Corp. Although Eisner used to work for him, he ultimately became Diller's role model when it came to garnering huge option grants. After reaping gains of $151 million in 2003, he was still sitting on 41.8 million unexercised options with paper profits of $1.1 billion.

-- Michael Dell of Dell Inc. So far as I can see, he seems to have been in an options race with Ellison. As of the end of his last fiscal year, he was holding 18 million unexercised option shares.

Inactive Players

As to those all-stars who have departed the CEO game, they include Al Dunlap of Sunbeam Corp., Christos Cotsakos of E*Trade Financial Corp., Charles Wang of Computer Associates, Richard Scrushy of Healthsouth Corp., Anthony O'Reilly of H.J. Heinz Co. and Leon Hirsch of United States Surgical Corp.

Hirsch was constantly in the pay trough, until he sold his company to another pay hog, Dennis Kozlowski of Tyco International Ltd. Talk about two people deserving each other.

Larry Coss of Green Tree Financial Corp. belongs to this group. He was given a series of bonuses that read something like the stops on New York's Lexington Avenue subway -- going north. His bonuses, in successive years, were $14 million, $29 million, $65 million and $102 million.

And then there is Linda Wachner of Warnaco Inc. In 1991, I wrote the first of many articles about her: ``At Last, a Seriously Overpaid Woman!'' She was a real trailblazer for her female colleagues. Unfortunately, she took so much money out and so mismanaged her company that it was plunged into bankruptcy.

Manager Grasso

And since every baseball team has a manager, here's my one exception to including a former CEO on this All-Star team: Dick Grasso.

His board thought he deserved to be paid on a par with the Wall Street CEOs. But somehow, he ended up being paid even more. New York Attorney General Eliot Spitzer is trying to get Grasso to disgorge scores of millions of what he believes are his ill-gotten gains.

And there you have it. My All-Star Pay Hog Team.

I long remember what Liberace said to those who criticized him for being a faux concert pianist and generally over the top: ``I'm crying all the way to the bank!"

So, too, are most of the people listed here, at least the ones who are still alive.

--Editors: Ahearn, Siler, Ahearn.

Joe Bachelder Wants to Wake Up Pay Committees: Graef Crystal

(Commentary. Graef Crystal is a Bloomberg News columnist. The opinions expressed are his own.)

June 23 (Bloomberg) -- Joe Bachelder is steamed. The 71-year-old normally mild mannered New York lawyer believes that far too many board compensation committees are asleep at the switch.

That would ordinarily be good news to a lawyer who makes his living negotiating fat contracts for his chief executive officer clients. Bachelder is not your normal lawyer. He is, in my opinion, the dean of the executive compensation bar, and he wants to reform the system even if that makes his job a lot tougher.

Bachelder is a nut for what he calls ``process.'' How, he argues, can anyone ever defend what a CEO earns if the process is off the tracks?

For an analogy of what he means, he uses the buying of co-ops and condos on Fifth Avenue and Park Avenue in New York.

``You and I can readily agree that those apartments are awfully high-priced,'' he said in a recent telephone interview. ``But down deep in our hearts, we know they are worth what people pay for them because the process is fair. You have informed sellers, informed buyers, and -- New York being New York – truly vigorous negotiations.''

`Good Faith'

That's not what you find in some boardrooms, he observes, adding that some directors are in danger of falling below the legal standard of ``good faith.''

He quotes a California court decision which states: ``In common usage, this term is used to describe that state of mind denoting honesty of purpose, freedom from intention to fraud, and generally speaking, means being faithful to one's duty or obligation.''

Put that standard against what happens in not many boardrooms.

``Instead of vigilance and, where necessary, the guts to stand up to management, we sometimes find a clubby atmosphere in which directors who are quite proud to be a member of XYZ Inc.'s board discover that they must not make any waves, or they may find themselves off the board. The result is `lemmings to the sea' behavior.''

More Information Needed

His statement brought to mind the 1970s and Fred Borch, the late chief executive officer of General Electric Co., who sat on the board compensation committee of Mobil Corp. Far from joining the lemmings, he protested certain actions vigorously. One year, he argued that the then CEO shouldn't be given a raise as large as the committee eventually voted, and the next year, when performance headed south, he pushed for a large pay cut but lost. He was then invited by his fellow directors not to stand for re-election.

As Bachelder put it: ``Directors are not paid to be nice. They're paid to do what's right.''

He points to certain directors of the New York Stock Exchange who argued that they weren't given enough time to come to an informed decision about former Big Board Chairman Dick Grasso's compensation.

``What a lamebrain excuse,'' he said. ``A major point of procedure should be that we, the directors, want information that we can understand, that gives us a true picture of how the proposed actions fit in with the actual practices of relevant comparator companies. And until we have it, we're not going to do a damn thing. If we don't have enough time at this meeting, then we'll have a follow-up meeting. And, if necessary, another follow- up meeting, until we have the facts necessary to come to an informed decision.''

Second Opinions on Pay

Bachelder is a strong advocate of requiring a compensation committee to have its own consultant, one who has no ties whatsoever to management and whose firm also has no ties. But, he points out, just because the committee has its consultant and management has another consultant, doesn't mean the situation must inevitably be adversarial.

As he put it: ``I believe that the compensation committee could well decide to get the advice of the management's consultant, but they may have their own consultant review the work of the management's consultant. People routinely seek second opinions when facing medical procedures. And when it comes to corporate governance, second opinions are also useful, because the stakes of credibility are so high.''

Now we turn to the role of executive recruiters in the senior executive pay process. The chairman of the search committee wants to get the problem solved, the search consultants want to be paid, and their pay, not infrequently, is a percentage of the first-year pay of their candidate. More than that -- if their candidate is hired, they can look forward to being given many more searches.

Boards Seek Quality

I posed the following notion to Bachelder: The search consultant should bring, not a single candidate, before the board, but, say, three candidates. And each candidate should be asked beforehand to lay out for the board the sort of pay package that he desires.

Bachelder acknowledged that if each candidate knows there are other sellers out there, then each of them will think long and hard before asking for the moon. As he said: ``It's like Park Avenue and Fifth Avenue. Sure, you think your apartment's worth 3 million, but if the equivalent apartment is being offered by another seller for 2 million, you very likely are going to do some re-thinking.''

If that approach is followed, Bachelder doesn't think the job will always end up going to the low bidder. ``In the end,'' he says, ``boards will go for quality. But if the man or woman they want has asked for too much, the board has the opportunity to go back to that person and tell him, `The job's yours, but your price is too high compared to what others have asked. Do you want to reconsider your pay proposal?'''

Bachelder summed up by declaring that ``compensation is not a process. It's the result of a process. And if the process is flawed, then the result can be flawed, too.''

Though I have serious disagreements with Bachelder over whether CEOs are paid too much, I have great respect for him. He's that rare person who's quite ready to appreciate the other side's argument.

--Editors: Ahearn, Todd.

Diller, Mark Are Top Option Gainers: Graef Crystal

Diller, Mark Are Top Option Gainers: Graef Crystal (Correct)
(Corrects length of hitless streak in 18th paragraph.
Commentary. Graef Crystal is a columnist for Bloomberg News. The opinions expressed are his own.)

May 12 (Bloomberg) -- InterActiveCorp's Barry Diller and Colgate-Palmolive Co.'s Reuben Mark made the most among major- company chief executive officers from exercising stock options last year. Diller collected $151 million, while Mark got $131 million.

I know and greatly admire both of them. Diller, who is 62, delivered a 48 percent stock gain in 2003. Mark, 65, presided over a 2.9 percent decline, including reinvested dividends.

More important, their New York-based companies have been superb long-term performers. On that basis, it's hard to say they didn't deserve what they received.

I first met Diller in the 1970s when he was the head of Paramount, a part of what was then Gulf & Western Industries Inc. While Diller had some stock options in those days, I rather doubt he thought of them as a great wealth builder, given the horrid way in which the parent company was being run.

Things got so bad that Diller decamped in 1984 to become head of 20th Century Fox, then actively managed by Rupert Murdoch. A disclaimer: For several years before I retired from consulting in 1987, I was Diller's pay consultant at Fox. I also was for many years the consultant to Gulf & Western Industries.

Cash, Equity

Diller encountered an owner -- Murdoch -- who was willing to pay a lot of cash but didn't want to part with equity. As a result, Diller got a then unheard-of salary of $3 million a year, a figure that even today would put him in a very exclusive circle. Diller's salary in 2003 at InterActiveCorp was $500,000.

Murdoch also gave Diller a large percentage of Fox's profit in the form of a cash bonus. There was no equity that I recall.

When Diller finally went into business for himself, he made sure to get equity payments in the form of options, which give a holder the right to purchase stock at a specified price over a set period.

Shareholders of Diller's company aren't likely to hurl brickbats at him over his huge option gains in 2003 because of the stock rise last year. The annual average total return for holders of Diller's company and its antecedents from Jan. 18, 1993, to last Friday was 31.7 percent, almost three times as large as the 11.3 percent average gain in the Standard & Poor's 500 Index in the same span.

Outpaced Indexes

Shareholders at Colgate, on the other hand – particularly shareholders who bought their shares in the last few years – may be wondering why Mark deserved $131 million in option profit. Colgate's decline last year followed an 8 percent drop in 2002.

Perceptions are often distorted by more-recent events, and gains from options usually come many years after the grant date. In Mark's case, he literally ran out the 10-year term of his options before exercising them; they were granted in January 1993.

Taking a long-term perspective, Mark has been a truly fine performer. From April 30, 1984, just before he became CEO, to last Friday's close, Colgate's stock appreciation averaged 18.1 percent a year. That exceeded the 11.4 percent annual gain for the S&P 500 Index and 16.2 percent rise at bigger competitor Procter & Gamble Co. (These figures are based on a regression analysis that took into account every daily closing price.)

More than that, Mark delivered a superior return with lower- than-normal risk. Colgate's beta, which measures how much the share price moves counter to or in line with the S&P 500, has been just 0.90 in Mark's tenure.

Shareholder Friendly

I was well aware of Mark when I met him a couple of years ago because he and his board compensation committee's innovative pay consultant, John England of Towers Perrin, crafted extremely shareholder-friendly option grants.

To put Colgate's approach into context, it should be remembered that some 99 percent of all option grants carry a strike, or exercise, price that is equal to the market price at the grant date.

Not so with Colgate's grants. In January 1993, Mark got options on 4 million split-adjusted shares. (His next grant wasn't made until November 1997.) They had trigger prices that were 10 percent to as much as 80 percent above the market price.

In effect, Mark was willing to embrace an idea to which virtually every other CEO has been durably resistant: taking on a lot of pay risk to justify the possibility of a lot of pay reward.

So, to possibly restive shareholders at Colgate, I say: ``Chill out.'' Remember that even the New York Yankees great Derek Jeter went hitless for 32 at-bats earlier this season.

With his superb long-term performance record, I wouldn't want to count Mark out, either.

The following table shows the 15 CEOs who had the largest option-exercise gains in 2003. The list was culled from a study of 583 CEOs at companies with market values of at least $3 billion. Data were obtained from Aon Corp.'s eCOMP database.

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Option Gain

Company	CEO	$millions
IAC/InterActiveCorp	Barry Diller	151.0
Colgate Palmolive Co.	Reuben Mark	131.0
Unitedhealth Group Inc.	William McGuire	84.2
United Technologies Corp.	George David	66.2
NVR Inc.	Dwight Schar	54.9
Oracle Corp.	Lawrence Ellison	40.5
Coach Inc.	Lew Frankfort	42.9
Lehman Brothers Holdings	Richard Fuld	37.5
Cendant Corp.	Henry Silverman	37.2
Forest Laboratories Inc.	Howard Solomon	34.6
Countrywide Financial Corp.	Angelo Mozilo	34.4
Waters Corp.	Douglas Berthiaume	32.2
Chicos FAS Inc.	Marvin Gralnick*	31.8
Kohls Corp.	Lawrence Montgomery	29.2
St Joe Co.	Peter Rummell	27.4

*former chief executive

*T

--Editors: Wayne, Wiegold, Bray.

Kumar, Wang Got One-of-a-Kind Pay Plan: Graef Crystal

Kumar, Wang Got One-of-a-Kind Pay Plan: Graef Crystal (Update1)

(Updates with Kumar's resignation in first and sixth paragraphs. Commentary. Graef Crystal is a Bloomberg News columnist. The opinions expressed are his own.)

April 21 (Bloomberg) -- Now that Computer Associates International Inc. Chief Executive Officer Sanjay Kumar has resigned and the company has had a flurry of firings and guilty pleas in connection with a federal investigation of securities fraud, longtime shareholders can look back and, well, simply just look back.

The year was 1998, and the event was a $1.1 billion payday for the worst-designed corporate incentive plan ever. And calling it designed is an oxymoron; calling it a windfall isn't.

The benefactors were then company President and Chief Operating Officer Kumar; his boss at the time, company founder and longtime Chairman and Chief Executive Officer Charles Wang, who ran the company from its inception in 1976 through August 2000; and Russell Artzt, an executive vice president.

Interestingly, one of the architects of that plan was a person who has been much in the news for having himself received wildly excessive compensation: Dick Grasso. The former head of the New York Stock Exchange was a member of Computer Associates' board compensation committee when the plan was approved.

The Plan

First, an update on the continuing federal investigation.

The 42-year-old Kumar, who became CEO in 2000 and chairman in 2002, stepped down today amid the two-year investigation into the software company. On Monday, the company fired nine employees in its legal and finance departments after former Chief Financial Officer Ira Zar and two other officials pleaded guilty to securities fraud.

Kumar, Wang and Artzt haven't been charged with any wrongdoing.

Now back to March 1995. That's when the new incentive plan was approved by Computer Associates' shareholders, notwithstanding that Institutional Shareholder Services, a well-regarded proxy advisory organization, urged shareholders to reject it. The closing price on the date of approval was a split- adjusted $17.59 a share.

The new plan offered Wang, Kumar, and Artzt the opportunity to earn free shares of stock, provided that one of various future stock price scenarios unfolded. One of those scenarios was that the company's closing price had to exceed $53.33 a share for at least 60 trading days within the preceding one-year period.

May 21, 1998

Following the approval of the new plan, a zone of silence ensued until May 21, 1998, when Computer Associates' stock price exceeded $53.33 for the 42nd consecutive day and for the 60th day in the preceding year.

At that point, the doors of the company's treasury opened wide, and the three participating executives took title to $1.1 billion of Computer Associates stock. Wang's share was $651 million, Kumar's was $326 million, and Artzt received $109 million.

In effect, you had $1.1 billion of payout hanging on 1/16 of a point on a single day.

As bad as the payout was for shareholders, what happened next was even worse. For Computer Associates, it seems, had forgotten to book any of the plan's expenses. As a result, on July 21, 1998, it told its shareholders that it would be taking a single charge to after-tax earnings of $675 million. The next day the company's stock price promptly dropped 31 percent, to $39.50.

The inevitable conclusion is that had the company taken accruals for this immense charge, the stock price would never had hit $53.33 a share on May 21, 1998, and Wang, Kumar and Artzt wouldn't have earned what they did.

Gave Back Free Shares

In a subsequent court decision, Wang, Kumar and Artzt were forced to give back some of their free shares. The givebacks reduced the size of their awards by 22 percent each. And last August, Computer Associates announced that it was paying out 5.7 million shares of stock worth $144 million to settle various civil suits involving accounting issues.

On June 13, 2000, Wang decided to exercise options covering 2.6 million shares of Computer Associates stock. On the same day, he sold 1.1 million shares. The closing price that day was $52.50, a level that was still a bit below the $55.13 close price on May 21, 1998, that triggered the huge award of free shares.

As part of his guilty plea earlier this month, Zar, the former CFO, acknowledged that in January 2000, just six months before Wang made his option exercise, he had approved a decision to move sales from the quarter in which they really occurred to an earlier quarter, presumably to keep the stock price up.

It didn't stay up for long following Wang's June 13 exercise. On July 5, 2000, the stock dropped 42 percent in a single day and closed at $29.44. As former New York Yankees catcher Yogi Berra was fond of saying, this seemed to be a case of deja vu all over again.

A Matter of Luck?

Of course, the possibility exists that Wang and Kumar were just plain lucky -- lucky in that the stock crossed the $53.33 line when it did and lucky when Wang exercised his huge stock option just days before the stock plummeted.

If that's true, I'm ready to give either of them all that I have and let them head out to Vegas and place some bets for me. Plans like the free share one at Computer Associates and the grant and timing of exercise of huge option grants can, at least sometimes, be quite motivating. In some of those times, the expression of that motivation may not be a nice thing to behold.

After all that motivation stretching back to 1998 and even before, Computer Associates' stock price, which closed yesterday at $25.57, was trading at less than half what it was when all the huge payouts began.

--Editors: Ahearn, Henry.

Eliot Spitzer Seeks to Make Grasso a Hat Trick: Graef Crystal

(Commentary. Graef Crystal is a Bloomberg News columnist. The opinions expressed are his own.)

May 25 (Bloomberg) -- I confess I'm not a medic, but to my eye, Eliot Spitzer is suffering from a case of terminal hubris.

Flush with success from beating up on stock analysts and mutual funds, the New York State attorney general is now going for the hat trick. He has sued Dick Grasso, the former chairman of the New York Stock Exchange, to recover what he hopes will be more than $100 million of pay.

He's also suing Kenneth Langone, the New York investment banker and co-founder of Home Depot Inc., who was chair of the NYSE board compensation committee from June 1999 to June 2003. Spitzer figures that Langone should cough up $18 million or so to atone for his alleged transgressions.

Spitzer's suit is based on a New York law regulating not-for- profit corporations -- of which the NYSE is one -- which states that compensation paid to senior executives must be ``reasonable.''

Spitzer's contention that Grasso's accrued pay, which has been variously described as ranging from $140 million to $189 million, was, on its face, unreasonable is beyond dispute. The process that led to Grasso's enormous payday was terribly flawed.

The issue comes down to this: Who is responsible for this mess and who should make restitution to the NYSE?

New York Morality Tale

Spitzer has made Grasso the villain of this New York morality tale. It pits an upstart kid from Queens with no college degree, who worked his way up to the head of one of the world's most prestigious institutions, against the scion of an extremely wealthy Manhattan family who graduated from Princeton University and Harvard Law School. Think of it as David vs. Goliath, but where David, besides wielding a slingshot, is wearing armaments of solid gold.

It's a fundamental American right to get as much compensation as you can, and there's no doubt that Grasso should be offered a chair at the Harvard Business School to share his expertise on how fledgling CEOs can themselves one day win the pay lottery.

As I have argued before, unless someone can prove that Grasso acted in a fraudulent manner, the blame for his excessive compensation isn't on the person who sought that pay. The blame should be on the people who acceded to that pay, namely, the members of the NYSE board compensation committee and the other members of the NYSE board.

`Following Orders'

To be fair to Spitzer, he should be given a nod for causing two players to turn what you might think of as state's evidence. One is Frank Ashen, the former head of human resources of the NYSE, who confessed to various errors and omissions and who is returning $1.3 million to the exchange. The other is William Mischell, a consultant with Mercer Human Resources Inc. His firm is returning some $400,000 of fees it had earlier received for its work involving Grasso.

On the surface, the ``confessions'' of Ashen and Mischell buttress Spitzer's case that there was wrongdoing at the NYSE. But he has failed to tie Grasso himself to that wrongdoing. Among other things, had Grasso been responsible for it, you would have thought that Ashen would have claimed an Adolf Eichmann-like defense (``I was just following orders'').

There's a lot of innuendo in Spitzer's complaint, yet I couldn't find a smoking gun implicating Grasso.

It's also curious that Spitzer has gone after only one of many members of the NYSE board compensation committee, namely, Langone, who is usually described as one of Grasso's buddies.

What About McCall?

Which raises the question: Who's missing from this picture?

The most obvious answer is Carl McCall, the former New York State comptroller and the chairman of the NYSE compensation committee during the last few months of Grasso's reign.

McCall, according to the complaint, was the key actor in obtaining NYSE compensation committee approval and subsequently board approval for Grasso's huge payday.

And, at least for a while, McCall was a vocal defender of what the board did for Grasso. Stating that Grasso was a possible contender for posts in Washington, including that of Treasury secretary, McCall said: ``You have to do what you can to retain good people.''

He also pointed out that under Grasso's leadership, the value of a seat on the NYSE had almost tripled and that the number of listed companies had doubled, to 2800. Finally, he observed: ``It's his money. That's money that accrued over a long period of time.''

So why isn't Spitzer going after McCall as well as Langone? Could it be that fellow Democrat McCall's support would be vital if Spitzer, as is widely believed, runs for governor?

And the Others?

And what about all the other members of the NYSE compensation committee who approved Grasso's pay package, which included the heads of most of the major Wall Street firms? What are they? Dressmakers' dummies? Of all people, they should know at least as much as Donald Trump about the art of the deal. And virtually every day, they hone their negotiating skills against all the greedy mercenaries who work for them.

Yet there's nary a mention of those people. It's easy to go after Langone. He doesn't employ thousands of potential Spitzer voters.

Grasso overreached himself. Somehow, his better angels deserted him when he was negotiating his pay deal. But face it, friends, better angels rarely put in an appearance when senior executives start slopping at the pay trough.

If Grasso has overreached himself, so has Spitzer. If there's justice in America, there's no hat trick in store for him.

--Editors: Ahearn, Henry.

Horton, Toll, KB Home Pay-Performance Inverted: Graef Crystal

(Commentary. Graef Crystal is a columnist for Bloomberg News. The opinions expressed are his own.)

March 10 (Bloomberg) -- If you want some serious evidence of the not-infrequent inversion between pay and performance, where the best performer earns the least and the worst performer earns the most, take a look at three U.S. homebuilders and their chief executives.

The companies are D.R. Horton Inc., Toll Brothers Inc. and KB Home. Their CEOS are, respectively, Donald Tomnitz, Robert Toll and Bruce Karatz, and their companies are, respectively, the fourth, 11th and fifth-largest homebuilders in the U.S.

A review of their performance from Nov. 12, 1998, the earliest date all three of these CEOs were in their positions at the same time, to last Friday's close of trading shows:

-- Horton's cumulative total return was 480 percent. In stock price appreciation alone, the Arlington, Texas-based Horton would have ranked eighth against companies in the Standard & Poor's 500 Index.

-- Toll Brothers' performance is also impressive, though not nearly as good as Horton's. Its cumulative total return was 294 percent, and it would have ranked 20th in stock-price appreciation.

-- The caboose of this three-car train is KB Home, with cumulative total return of 212 percent. The firm ranked 42nd among the S&P 500 group.

In sum, we have three excellently performing companies, some more excellent than others.

Total Pay

Now, what about the total pay for each of these CEOs? Here's the inversion. (Total pay includes base salary, annual bonus, my estimate of the present value at grant of stock options granted during 2003 using the Black-Scholes model, the value at grant of free share grants made during 2003, payouts in 2003 under other forms of long-term incentive compensation and miscellaneous compensation.)

For the year ended Dec. 31, 2003, Tomnitz earned $5.8 million. Pay statistics for 2003 for other U.S. CEOs aren't yet widely available, but looking at the 2002 pay of 302 CEOs running U.S. companies with net sales in the $2.5 billion to $9 billion range (which encompasses the 2003 net sales of the three companies), a pay level of $5.8 million would rank Tomnitz in the 63rd percentile, meaning that his pay would have exceeded all but 37 percent of the companies in the group. (Pay data on the 302 companies were furnished by Equilar Inc., an independent provider of executive compensation information.)

2002 vs 2003

Is it fair to compare the 2003 compensation of the three homebuilders with the 2002 pay of other companies? It may not be as unfair as it first appears to be, because my preliminary analyses of early 2003 pay trends suggest that, on the whole, year-over-year pay for CEOs looks to be fairly flat.

A 63rd percentile pay-rank for a company with Horton's performance suggests strongly that its shareholders are sitting on a much undervalued asset, namely, the company's CEO. That's even more the case, because CEO pay is strongly correlated with company size, and Horton is by far the biggest of the three companies. Its 2003 net sales of $8.7 billion were 3.2 times Toll Brothers' net sales of $2.8 million and 1.5 times KB Home's net sales of $5.9 billion.

Horton was the best performer over the time period reviewed, and No. 1 among the three in 2003, with total return of 152 percent. Tomnitz is the best ``buy'' among the three.

Robert Toll

For a fine 2003 performance with a total return of 80 percent, a bit more than half of Horton's, Robert Toll didn't receive just $5.8 million. His total compensation was $23 million, with $20.3 million of it being his annual bonus.

In an article on March 4, 2003 (``Toll Boosts Robert Toll's Bonus 46 Percent''), I warned that Toll's new bonus plan had the potential to create runaway compensation. His $20.3 million bonus was more than double his already-huge bonus of $9.6 million for the year ended Oct. 31, 2002. Against the 302 similarly sized companies, the Huntingdon Valley, Pennsylvania-based Toll outranked all but 4 percent.

Finally, there is Karatz of Los Angeles-based KB Home. His performance was the lowest of the three in the time period studied. He also had the lowest 2003 total return of 55 percent. Karatz's total pay for 2003 weighed in at $27 million. Against the 302-company group, Karatz came out higher than all but 3 percent of the companies.

So the best performer among the three homebuilders earns the least, while the lowest performer earns the most. And that, friends, passes for pay-for-performance in early 21st century America.

Go figure.

--Editors: Ahearn, Bray, Siler.

Eisner, Semel Are in Out-of-the-Money Options: Graef Crystal

(Commentary. Graef Crystal is a columnist for Bloomberg News. The opinions expressed are his own.)

Jan. 7 (Bloomberg) -- Out-of-the-money option grants, which should be the norm in corporate America, are only a bit less rare than saber-tooth tigers.

An out-of-the-money option is one where the strike price is set higher than the market price on the date the option is granted.

I put on boots, grabbed a stout walking stick and started hiking through 3,593 option grants made in 2000 through 2002 to CEOs running U.S. companies with 2002 net sales of $1 billion or more. I found only 105 grants that were out of the money on their grant dates. And of those, only 46 could be considered seriously out of the money, which I defined as a strike price that was 25 percent or more higher than the market price at grant.

(Data for this study were furnished by Equilar Inc., an independent provider of pay information.)

It's obvious from these findings that CEOs react to an out- of-the-money grant in the same manner they probably did when their mothers tried to force cod liver oil between their tightly sealed lips. After all, an out-of-the-money grant denies a CEO the first portion of stock price appreciation that occurs after the grant is made.

It's that first portion of appreciation that really needs to be taken out of a CEO's pay package.

The Vest's Sleeves

Consider that on Monday, an investor could have purchased a zero-coupon Treasury bond with a 10-year maturity and been guaranteed a compounded annual return of 4.73 percent a year.

Now consider a CEO who receives an option covering 1 million shares on a stock with a market price of $50 a share and no dividend. If that stock appreciates to $79.37 a share by the end of the option's 10-year term, that CEO, assuming that his strike price was the same $50 as the market price on the grant date, would walk away with $29.4 million in option gains.

Yet all that CEO did was to give his shareholders the sleeves out of his vest. A stock price of $79.37 in 10 years represents a 4.73 percent a year return, and that level of return could have been had, risk-free, by investing in a Treasury bond.

Still, there are a few hardy souls out there who have accepted out-of-the-money option grants, and even options that are way out of the money.

Disney's Eisner

Two such CEOs are Michael Eisner of Walt Disney Co. and Terry Semel of Yahoo! Inc.

Eisner, in 1989 and again in 1996, received out-of-the-money option grants, along with at-the-market grants. In 1996, of 24 million option shares granted on a post-split basis, 9 million were out of the money, with 3 million carrying a strike price that was 25 percent above the market price at grant. Another 3 million carried a strike price 50 percent above the market price, and a final 3 million had a strike price that was

100 percent above the market price.

(I was a consultant to Disney's board compensation committee during the negotiations that led to the 1989 and 1996 option grants. Eisner had his own attorney representing him.)

Disney's performance since the Sept. 30, 1996, grant date has been such that all of Eisner's 9 million out-of-the-money options were still out of the money -- to the tune of $84 million -- as of Monday's $24.14 close price. Had those grants carried strike prices equal to the market price at grant, Eisner's options would have been in the money by $27 million.

Yahoo's Semel

As for Yahoo's Semel, on April 16, 2001, at about the time he joined the company, he was given options on 5 million shares, carrying strike prices that ranged from a low of 170 percent above the market price at grant all the way to 426 percent above the market price. One thing you can say for Terry Semel is that he doesn't fool around when it comes to playing fair with his shareholders.

As of Monday's $46.90 closing price, Semel's option with the strike price that was set 170 percent above the market price at grant was in the money by $42 million. His other two options were out of the money by a collective total of $48 million. Had these last-mentioned options carried strike prices equal to the $17.62 a share market price on the grant data back in April 2001, they would collectively have been in the money by $73 million as of Monday's close.

A few other CEOs have accepted out-of-the-money grants in more than a single year. They include Bruce Nelson of Office Depot Inc.; Paul Charron of Liz Claiborne Inc.; and Stuart Miller of Lennar Corp.

Allergan's Pyott

Unhappily, though, quite a few of the CEOs who accepted out- of-the-money grants in earlier years have lost their nerve in more current years. An example here is David Pyott of Allergan Inc. In 2001, he accepted three different option grants carrying strike prices that were 120 percent, 144 percent and 173 percent above the market price on the grant date. But in 2002, he reverted to at-the-market grants.

At the time the 2001 grants were made, the market price was $76.60, and the strike prices were set at $91.92, $110.30 and $132.36. But by April 24, 2002, Allergan's stock price had dropped to $64.79. That decline evidently caused Pyott to go weak in the knees, because he then accepted an option covering 283,377 shares with a strike price equal to that $64.79 market price.

Doing what's right by shareholders shouldn't be left to a handful of CEOs like Eisner and Semel, who know to do the right thing. On the contrary, doing what's right by shareholders should be imposed on all CEOs by their boards of directors. Only then will we begin to avoid lavishing millions on CEOs who end up giving their shareholders the same -- or even a lesser -- rate of return than the shareholders could have received from risk-free Treasury bonds.

Redstone Is No. 1 in U.S. Chiefs' Pay: Graef Crystal

Redstone Is No. 1 in U.S. Chiefs' Pay: Graef Crystal (Correct)
(Corrects 99.7 percent to 95.4 percent and 99.9 percent to 99.7 percent in 12th paragraph. Commentary. Graef Crystal is a Bloomberg News columnist. The opinions expressed are his own.)

June 2 (Bloomberg) -- What's with billionaire chief executive officers? Some, recognizing their vast wealth, pay themselves literally nothing or hardly anything. Others can be seen standing at the front of the line as the doors to their company's treasury swing open.

I examined the share ownership of 457 CEOs running U.S. companies with current market caps of at least $3 billion. Of these, I concentrated on the 26 who had the most actual shares and paper profits in unexercised option shares. In virtually every case, the size of their holdings was $1 billion or more.

Among this group, there are two genuine pay saints: Kinder Morgan Inc.'s Richard Kinder and Pixar's Steve Jobs.

Kinder earned precisely nothing over the three years that ended with 2003, while Jobs earned $53 a year. In his other day job as CEO of Apple Computer Inc., Jobs has been decidedly less saintly, accepting, among other things, a free personal jet and, at one point, the largest stock option grant ever made on a single day.

The evil twins of Morgan and Jobs are Viacom Inc.'s Sumner Redstone ($32.9 million of pay per year) and UnitedHealth Group Inc.' s William McGuire ($27.l million).

(These and all other pay statistics in this column are based on average annual total pay over the three years ended with 2003. Total pay is the sum of all elements of the package, including base salary; annual bonus; the value of free shares of stock, measured at the date of award; the estimated present value of stock options, measured at the date of grant using the Black- Scholes option pricing model; payouts under other long-term incentive plans and miscellaneous compensation. Data for this study were obtained from Aon Consulting's eComp database.)

Three Main Findings

The study produced three principal findings.

First, the dispersion in pay among the 26 billionaires is awesome. Why Redstone, for example, feels the need to be paid far more than a professional working-stiff CEO earns, is best left to a moral theologian. Lord knows, Redstone, who turned 81 just a week ago, could not possibly spend the money he has amassed in the time left to him.

Second, the average billionaire CEO is paid neither higher nor lower than the average non-billionaire CEO. Although the average CEO among the 26 billionaires earned seven percent less than the market rate of pay for a company the same size, that difference proved to be statistically insignificant.

Performance IQ

Third, the notion that having a CEO who owns a ton of stock and who, as Warren Buffett is fond of observing, eats his own cooking will guarantee you a superior return compared with investing your money elsewhere seems unfounded.

For each company in the study, I calculated a weighted- average total return in three time windows: three years, two years and one year, all ended December 31, 2003.

These weighted average returns were then transformed into what I call a performance IQ score. Like intelligence IQ's, the average CEO had a performance IQ of 100. In any perfectly normal distribution (the old bell-shaped curve), 95.4 percent of scores will fall between 80 and 120 (the actual percentage for the performance study was 94.1 percent), while 99.7 percent of the scores will fall between 70 and 130 (the actual performance percentage was 99 percent). The average performance IQ score for the 26 billionaires was 103. This difference was statistically insignificant when compared with the non-billionaires.

Ellison and Bezos

As with pay, there is a wide range of performance, with Larry Ellison's IQ score of 86 putting him in the bottom eight percent of performers, and Jeffrey Bezos beating every billionaire and non- billionaire CEO with a score of 135. The normal probability of achieving such a high score is 20 out of 100,000.

There also wasn't a statistically significant link between the size of a CEO's shareholdings and his performance IQ score. Which brings up the value of insisting that a CEO hold a lot of company stock.

It seems intuitively correct that a person whose net worth is mainly tied up in his company's stock will work harder and smarter than one who holds hardly any shares and who dumps any option shares the moment he exercises them.

That belief has prompted many companies to adopt so-called shareownership guidelines. For example, the CEO is told that within five years, he must own shares worth at least five times his then-current base salary. And unexercised option shares don't count.

Your Own Cooking

Based on this study and other similar studies I have conducted in earlier years, that intuitively correct belief isn't borne out by the stats. Eating your own cooking sometimes delivers you an extremely satisfying repast. In other times, it can cause dyspepsia. Both Bezos and Ellison have, in other time periods, experienced both extremes.

One could, of course, argue that having the CEO load up on company shares, even if doesn't necessarily help matters, at least doesn't hurt, either.

Wrong. Because in companies with share ownership guidelines, there is often an attempt to help the CEO out by giving him more than the usual number of option shares and/or more than the usual number of free shares, such that satisfying the guidelines can be accomplished without breaking a sweat. The cost to shareholders in such cases is quite high.

The table below covers the 26 billionaires from the study. For each CEO, the table shows the average annual total pay from the 2001 through 2003 period; the percent by which that pay is higher or lower than what a company with the same net sales would pay its CEO; and the company's performance IQ score for the three-time windows of performance ended with 2003.

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Average Annual Percent Total Pay Above/'01-'03 (Below) Perf. IQ

Company	CEO	($ mil)	Market	'01-'03
Viacom	Sumner Redstone	$32.9	195	92
UnitedHealth Group	William McGuire	27.1	138	108
EBay	Margaret Whitman	21.3	287	121
Forest Laboratories	Howard Solomon	16.0	174	106
AIG	Maurice Greenberg	14.7	-3	88
Dell Computer	Michael Dell	13.1	4	104
Lennar	Stuart Miller	10.9	33	121
Qualcomm	Irwin Jacobs	10.6	62	94
Polo Ralph Lauren	Ralph Lauren	10.3	80	99
FedEx	Frederick Smith	8.3	-22	103
Clear Channel	Lowry Mays *	7.4	-10	94
Limited Brands	Leslie Wexner	5.5	-33	99
Wm. Wrigley Jr.	William Wrigley	3.9	-36	96
USA Interactive	Barry Diller	3.4	-54	105
Nike	Philip Knight	2.9	-66	102
Golden West	Marion & Herbert Sandler	2.1	-68	107
Mohawk Industries	Jeffrey Lorberbaum	1.6	-78	107
Franklin Resources	Charles Johnson	1.4	-77	105
Paychex	Thomas Golisano	0.9	-80	94
Microsoft	Steven Ballmer	0.8	-93	93
Washington Post	Donald Graham	0.7	-87	100
Berkshire Hathaway	Warren Buffett	0.3	-98	97
Amazon.Com	Jeffrey Bezos	0.1	-99	135
Oracle	Lawrence Ellison	0.0	-99	86
Pixar	Steve Jobs	0.0	-100	111
Kinder Morgan	Richard Kinder	0.0	-100	99
	Low	0.0	-100	86
	Median	3.7	-45	101
	Average	7.5	-7	103
	High	32.9	287	135

* Former CEO

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--Editors: Ahearn, Reichl, Bray.

Milken Brothers and Ellison Taken to Cleaners: Graef Crystal

(Commentary. Graef Crystal is a columnist for Bloomberg News. The opinions expressed are his own.)

Nov. 26 (Bloomberg) -- Corporate-governance activists insist that the best way to curb runaway executive compensation is to elect smart board members who have some significant skin in the game.

Well, no sane person would argue that the two Milken brothers -- Michael and Lowell -- and Oracle Corp.'s Chief Executive Officer Larry Ellison aren't as smart as they come. (Though maybe they'd hold off doing that until they read the rest of this column.)

And nobody would dispute that these three worthies don't have skin in the game. Through their supermajority Class B voting stock, their partnership controls 71.5 percent of Nextera Enterprises Inc., a Cambridge, Massachusetts-based service company, whose only operating unit is Lexecon, an economic and legal consulting firm based mainly in Chicago.

Now that we have introduced our three Goliaths, let's bring on stage our David. He is Daniel Fischel, who became chief executive officer of Nextera last February. Fischel is a former dean of the University of Chicago Law School and still is a full professor at that institution.

When he became CEO, Fischel was given an employment agreement so huge that it has literally led to the decision to dissolve Nextera as an operating enterprise.

Fischel's Base Compensation

Fischel, as of Oct. 1, didn't own one share of Nextera stock. Right off that establishes him as being even smarter than our three Goliaths because since its IPO on May 17, 1999, Nextera's stock has declined by 97 percent. It went public at $10 a share. On Monday, it closed at $0.35.

Next, we have what has been characterized by the company as Fischel's base compensation. Actually, he is being paid in this portion of his compensation package all of his personal billable income, with no deduction whatsoever for overhead costs. What is more, Fischel himself gets to set his own billing rate.

Between 2001 and 2002, his base compensation rose to $1.5 million from $944,000, an increase of 60.5 percent.

What really caught my eye is what has to be one of the most wacko bonus plans ever devised. Under this arrangement, 43 percent of all operating income of Lexecon's Chicago office (before deducting from operating income the actual bonuses generated by the plan) is put into a bonus pool. Unlike most bonus plans, where the first tranche of profits go exclusively to the shareholders before executives are allowed to approach the bonus oasis, this plan contributes 43 cents out of even the first dollar of profits.

Signing Bonus

For 2003, that 43 percent funding rate continues until operating profits reach $18.1 million. Then, of all things, the funding rate increases to 100 percent for the next $400,000 of operating income, before dropping back to 43 percent of all further operating income.

Fischel is entitled to take up to 36 percent of that bonus pool.

Talk about playing tennis with the net down. Here, the net has been entirely removed from the court.

But I'm just getting warmed up. Next we learn that Fischel received a $2 million signing bonus when he became CEO, notwithstanding that he had been with the company for some time.

Then as if all that weren't enough to keep Fischel glued to his employer and infused with utter loyalty, Nextera went on to agree to give him millions more to make sure he wouldn't leave and compete with his former employer:

-- He was handed a further payment of $2.5 million just to get him not to compete for a tiny six-month period, which ended this past July 15.

Selling Lexecon

-- He was paid another $2.5 million to secure his non- competition pledge for the six months slated to end Jan. 15, 2004

-- And he was promised a final $10 million to keep him from competing until Dec. 31, 2008.

Nextera has now decided to sell Lexecon, its only remaining operating unit, to FTI Consulting Inc., an Annapolis, Maryland- based firm with a current market cap of about $930 million.

And why are our three Goliaths doing that? Well, what do you know, it's because they found they didn't have enough cash to pay Fischel his final $10 million non-compete payment. (One other Lexecon employee, Dennis Carlton, will also receive a $10 million non-compete payment from the proceeds of the sale to FTI.)

As Lexecon says in a proxy statement filed on Oct. 24, ``We have no viable alternatives other than the asset sale to enable us to meet these obligations.''

That painful admission is underscored by the fact that, as of this past June 30, the company had only $1.4 million in cash or near cash equivalents.

David Wins

And how does this modern-day tale of David and Goliath end? Our David walks away as a huge winner, and our three Goliaths are out cold on the mat.

Is it possible that the Milken Brothers and Larry Ellison are not really as smart as everyone says they are? It's at least worth considering, given that they signed an employment agreement that appears to have literally destroyed their company.

As for Fischel, one is tempted to criticize him for a vast amount of overreaching. But hey, that's how the system is supposed to work. By Adam Smith's reckoning, Fischel was supposed to maximize his own self-interest, and there's no doubt he's done that. Besides, he has done absolutely nothing that can be considered to be illegal.

Perhaps as he and his colleagues at Lexecon come under new management, he should consider branching out to help executives all over the United States negotiate plush employment agreements.

For Fischel, that's a case of ``Been there, done that.'' Bigtime.

John Bedrosian Finds `Alice' in Court: Graef Crystal

John Bedrosian Finds `Alice' in Court: Graef Crystal (Update1)

(Updates spokesman comment in second paragraph from end.)

(Commentary. Graef Crystal is a columnist for Bloomberg News. The opinions expressed are his own.)

Nov. 12 (Bloomberg) -- John Bedrosian has won the equivalent of the California Lottery, thanks to a $253 million award from three California state appellate judges and their ``Alice-in-Wonderland'' reasoning.

The staggering award to Bedrosian, a co-founder and the No. 3 executive of Tenet Healthcare Corp. when it was called National Medical Enterprises, modifies a lower-court ruling from earlier this year that gave him $7.6 million in a breach-of-contract suit.

Bedrosian was dismissed from National Medical in 1993. He was the one of the last members of top management who either resigned or was fired after alleged fraudulent practices in the company's psychiatric hospitals and after the company's stock tanked in late August 1993.

In his dispute with Tenet, which has continued for 10 years, Bedrosian alleged that the company breached his contract by not offering various stock options and free shares.

The Los Angeles County Superior Court last spring awarded Bedrosian the $7.6 million based on a stock price of $19 per share and not accounting for a subsequent Tenet stock split. And then last Tuesday, along came the 2nd District Court of Appeals with its eye-popping award given at a stock price of $52.50 a share, that included an adjustment for a three-for-two stock split occurring on July 1, 2002.

The Oct. 3 Date

The appellate court assumed Bedrosian would hold all his shares until Oct. 3, 2002, more than nine years after he was fired.

Why Oct. 3, 2002? Well, that was the day when Tenet stock reached its highest price -- $52.50 a share. That wasn't the closing price; it was the stock's intraday high.

The court used the $52.50 price to value all of Bedrosian's options and free shares and came up with an award of $141 million.

In selecting that high price, the court relied upon what has come to be called the New York rule. In its opinion, the California court wrote that the New York rule ``takes the highest value of the shares within a `reasonable' period after conversion or breach.''

How anyone could figure that using a price that occurred more than nine years after someone's firing could be construed as having occurred in a ``reasonable period'' is beyond me.

It's also beyond the thinking of AnnaMary Gannon, a San Francisco-based employment lawyer, who took note of a ``big time gap where there is nothing happening.''

It's hard to believe that Bedrosian's free share awards carried restrictions on resale that extended all the way to Oct. 3, 2002. There would be no business reason to do that, since he had left the company years before.

Assuming that the restrictions would have lapsed earlier, then Bedrosian would have had a taxable event, which likely would have required him to sell off approximately half his shares to meet his tax liability. Yet the court implicitly assumed that Bedrosian would have retained all his shares and never had a taxable event, or at least not one until Oct. 3, 2002.

Applying the Court's Reasoning

The same reasoning informed the court's valuation of stock options. It's conceivable, though not very likely, that Bedrosian's options might not have expired by Oct. 3, 2002. If they had, he would again have had to sell a number of shares to fund the exercise of his options and taxes. (Interestingly, the court erred in the valuation of his options by increasing the number of his option shares by 50 percent to account for the subsequent 3-for-2 split but by failing to decrease his options' strike prices proportionately. Had the court not made this mathematical error, Bedrosian's judgment would have risen to $149 million from $141 million.)

The court also failed to reason that the $52.50 price on Oct. 3, 2002, was artificially inflated due to so-called ``outlier profits.'' When the news of those profits hit the marketplace, the stock plunged to $14 a share on Nov. 11, 2002, just a bit over a month after that high price of $52.50 was recorded.

I have applied the court's reasoning to every Tenet closing price from the end of August 1994, when the first case was being concluded, to Oct. 3, 2002. The median and average settlements wouldn't have been the $141 million decreed by the court, but a much smaller $32 million and $43 million, respectively. The lowest payment would have been a mere $2.8 million.

$111 Million in Interest

Having concluded that Bedrosian was due $141 million, the court then awarded him $111 million in interest payments. California law allows for interest to be levied on an unpaid judgment from a date prior to the entry of the judgment that the court determines until the current date. The annual interest rate is 10 percent. The period in this case would have been just a bit under eight years.

How, having decided that Bedrosian would have kept all his options and free shares for nine years, could the judges then turn around and assume that his judgment wouldn't have been invested in anything, and that it would therefore be eligible for 10 percent annual interest?

That's like allowing an executive with a $100,000 bonus in company stock either to defer it or to let it sit in the company's treasury and draw interest. Then, at the end of the deferral period, give the executive both the appreciation that he would have received had he taken the stock choice and the interest he would have received had he kept his funds in the treasury. What the court did here was to engage in an unequivocal exercise in double-counting.

And the error in the judges' reasoning that granted Bedrosian $141 million was magnified by the interest payment of $111 million. The larger the judgment, the higher the interest rate.

Another way to look at the $253 million judgment is to conclude that it is the equivalent of assuming a Tenet stock price of $88.20 a share without the interest payment. Tenet never got close to that stock price.

Maybe Bedrosian is entitled to some damages. What the California appellate court did, however, was anything but reasonable and nothing short of disgraceful.

Tenet will appeal the judgment -- the equivalent of almost one-third of the company's earnings in 2002 -- to the California Supreme Court. Tenet spokesman Steven Campanini would not say whether the company had insurance to cover the award.

Unless Alice is alive and well there, I have to believe that Bedrosian will get only a small fraction of what he has been awarded.

SBC's Whitacre Mocks Shareholders on Pay, Stock: Graef Crystal

(Commentary. Graef Crystal is a Bloomberg News columnist. The opinions expressed are his own.)

Feb. 19 (Bloomberg) -- Anyone who thinks Ed Whitacre, chief executive of SBC Communications Inc., paid too much for AT&T Wireless Services Inc. should take a look at his compensation.

It will show that Whitacre simply lost sight of the value of a dollar, as he and his board compensation committee have assiduously cast their collective gaze away from any performance statistics.

Cingular Wireless LLC, whose parents are SBC and Atlanta- based BellSouth Corp., announced Tuesday that it had agreed to buy AT&T Wireless for $41 billion. That's $15 a share, or 27 percent more than Redmond, Washington-based AT&T Wireless's closing stock price Friday. San Antonio-based SBC owns 60 percent of Cingular, while BellSouth owns 40 percent. Among other things, the acquisition is not expected to add to SBC's earnings per share until 2007.

At this point in time, it would be the rare SBC shareholder who would give his automatic approval to any decision made by Whitacre.

The Numbers

For proof, take a look at these numbers:

-- For the three years ended Dec. 31, 2003, SBC delivered to its shareholders a cumulative return of negative 39 percent. The comparable figures for major competitors Verizon Communications Inc. and BellSouth were, respectively, negative 22 percent and negative 25 percent. The return during the period of the Standard & Poor's 500 Index was negative 12 percent.

-- For the year ended last Dec. 31, SBC delivered a return of 2 percent. That compares with returns of negative 6 percent, positive 13 percent and positive 29 percent for, respectively, Verizon, BellSouth and the S&P 500 Index.

-- For the year ended last Dec. 31, SBC's revenue decreased 5 percent from the preceding year, while its operating earnings dropped 25 percent. In contrast, net sales for Verizon and BellSouth were little changed. Verizon's operating income rose 12 percent, while that of BellSouth rose 4 percent.

-- Small wonder that the 33 analysts following SBC's stock have weighed in with three ``buys,'' 18 ``holds'' and 12 ``sells.''

Pay Comparisons

Now let's look at some pay comparisons:

-- For the three years ended last Dec. 31, Whitacre's cumulative pay was a stunning $114.5 million. That compares with Verizon Chief Executive Ivan Seidenberg's $76.9 million and BellSouth's Duane Ackerman's $40.6 million. (Total pay includes base salary; annual bonus; my estimate of the present value of stock option grants, measured at the date of grant using the Black-Scholes option pricing model; the value of free shares granted; payouts under other long-term incentive plans; and miscellaneous compensation. Pay data were furnished by Equilar Inc., an independent provider of executive compensation information.)

-- For all that extra money, Whitacre, as already noted, delivered the worst three-year total return of the three companies, as well as the worst net sales and operating earnings performance.

-- On top of that, SBC wasn't even the largest of the three companies. Its cumulative three-year net sales were $130 billion. That compares with $203 billion for Verizon and $69 billion for BellSouth.

2003 Pay

And now we come to 2003's pay for Whitacre. So far, SBC is the only one of the three companies to have released its pay statistics for the year just ended. (SBC's disclosures came in the form of a preliminary proxy statement filed on Feb. 13. If Verizon and BellSouth file their proxy statements in the same months they did in 2003, we can expect pay information on Verizon around the middle of March and on BellSouth around the end of February.)

For his dismal performance in 2003, Whitacre received:

-- Essentially the same salary -- $2.1 million -- as he earned in 2002.

-- A bonus of $5.7 million, up from $4 million in 2002.

-- A payout under another long-term incentive plan of $2.4 million, up from $1.8 million in 2002.

-- A satisfying award of free shares worth $7.2 million, up from nothing in 2002, 2001 and 2000.

-- Three option grants with a total estimated present value of $5.5 million versus much higher figures of $14.1 million in 2002 and $44.9 million in 2001.

-- Miscellaneous compensation worth $2.1 million, up from $716,000 for 2002.

Free Shares

All of that totals $25 million, not a lot higher than Whitacre's $22.7 million in 2002. But think how much he might have earned if he actually did something of value for shareholders.

Note the de-emphasis on stock option grants and the new prominence of free share grants. Whitacre may be greedy but he's smart, too. No point in getting a lot of stock options when your stock seems to be heading nowhere but down. Free shares at least produce some value under that type of scenario.

The only bright light in the San Antonio sky is SBC's decision to move from stock options and free share grants to performance share grants. Under the new plan, 75 percent of the shares will be earned on the basis of meeting return on invested capital goals, and the remainder will be earned based on a comparison of SBC's total return to that of mostly major telephone companies.

The plan, though, is starting this year when Whitacre is already 62. So by the end of the first three-year performance cycle, Whitacre will have reached his normal retirement age of 65.

What he does or doesn't receive under this performance-oriented plan will constitute little more than a minuscule fraction of his abusive total pay over the last several years. Still, it would be refreshing to see him have to do what the common folks do: work for his dough. --Editors: Ahearn, Henry, Reichl.

Higher Executive Pay Doesn't Mean Fewer Jobs: Graef Crystal

(Commentary. Graef Crystal is a columnist for Bloomberg News. The opinions expressed are his own.)

Dec. 10 (Bloomberg) -- There's a common belief out there that the more a chief executive gets paid to maximize shareholder return, the more likely he'll eliminate jobs -- lots of them -- to get the company's stock price higher.

Wrong. Research I have done doesn't support the notion that CEOs make their millions from stock options and free share awards on the backs of their workers.

The research also shows that the longer a CEO has to wait for his compensation rewards, the more he'll concentrate on long- term performance -- as opposed to short-term fixes -- and that helps create more jobs.

My study group consisted of 195 members of the Standard & Poor's 500 Index. All had fiscal years that ended Dec. 31 and all had at least 10 years of employee headcounts and stock-price histories.

I first tried correlating percent changes in total employee headcounts in 2002 versus 2001 against total returns for the one- year period ended Dec. 31, 2002. Despite all the anecdotal evidence about layoffs causing runups in stock prices, I found no correlation whatsoever. From that, I concluded that those stock- price spikes that occur after a layoff are quite transitory.

I then repeated my correlation analysis but changed the window of measurement to five years from one year. That prompted a significant and positive correlation: 9 percent of the changes in employee headcount were related to five-year total returns to shareholders. And that showed the higher the returns, the higher the headcount.

My Conclusion

Finally, I did a third analysis, this one using a 10-year time window for both change in headcount and total return. The relationship became much stronger. Fully 22 percent of the headcount changes could be explained by 10-year total returns.

To be sure, a correlation of only 22 percent is by no means perfect, in that 78 percent of the changes in headcounts have nothing to do with total return. Still, in the world in which I operate, 22 percent counts as a strong relationship; the likelihood of the result having occurred purely by chance is less than 1 in 10,000. Pollsters should do so well.

My conclusion: Giving top executives incentives for total return doesn't work against creating jobs in the U.S. economy and even helps to create jobs if executives are required to earn the bulk of their reward through truly long-term performance.

Long-term Incentives

Yet those findings collide with what are euphemistically called long-term incentives, because they aren't very long term at all.

Consider stock option grants, the most widely employed form of long-term incentives. Using data covering 2,918 option grants made during 2000 through 2002 to CEOs running U.S. companies with 2002 net sales of $1 billion or more, I found that 56 percent of those options become fully vested within three years of grant dates. Increase the period to four years, and the percentage leaps to 85 percent. And 97 percent of all options are fully vested within five years. (Information here was drawn from databases prepared by Equilar Inc., an independent provider of executive pay data.)

For an example of how a long-term incentive can be transformed into a short-term incentive, we have Leonard Schaeffer, the CEO of WellPoint Health Networks Inc. In 2002, he received an option covering 400,000 shares. Although the option contained the usual 10-year term, thereby making it look like a long-term incentive, the fine print showed that one-sixth of the shares became vested in just six months, with further one-sixth portions becoming vested every six months thereafter. Thus, after three years, all 400,000 shares would be up for grabs.

If WellPoint's stock price were to jump sharply early on in the option's 10-year term, Schaeffer could immediately pounce on that stock surge and cart away millions. But what would that have to do with long-term performance? Precisely nothing. Yet it is that very long-term performance that is the most beneficial, not only to long-term shareholders, but also to job creation.

The Right Way

For an example of the right way to do things, there is Steven Reinemund, CEO of PepsiCo Inc. In 2001, he received three different option grants. The first, covering 605,672 shares, provided that no shares could be exercised for three years. The second, covering 750,000, provided that no shares could be exercised for five years. And the third, covering another 750,000 shares, provided that no shares could be exercised for 10 years.

How, you might ask, can you grant an executive an option with a term of 10 years and then tell him he can't exercise any shares for 10 years? At best, he would have just one day to make his exercise, i.e., the last day of the option's term. PepsiCo got around this problem by extending the term of this third option to 15 years.

Now that's the way things should be done. Reinemund isn't going to become wealthy on short-term upticks of PepsiCo's stock price. He is only going to become wealthy if PepsiCo's returns to shareholders are excellent and over a very long period. And, as my study has shown, it takes a very long period for total returns to have a significantly beneficial effect, not merely on shareholders, but on workers, too.

Win-Win

Extending the periods before which options can be exercised to a minimum, say, of five years, and better yet, to perhaps seven or eight years, isn't going to win any popularity contest with CEOs and other senior executives. They want to make their money as soon as they can, the long term be damned.

But changes like this ought to be imposed by boards.

I know Milton Friedman says that businesses should be run only for the benefit of their shareholders, and without regard to the interests of employees or the communities in which the businesses operate. Yet transforming what are now short-term incentives masquerading as long-term incentives into true long- term incentives can a produce a rare result: A win-win for both shareholders and employees.