Center for American Progress

The Great CEO Guarantee

Get Really Well-Paid Regardless of Your Performance

By Kate Sabatini, Research Associate and Christian E. Weller,
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Progressive Ideas for a Strong, Just, and Free America

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Introduction

Calculated self-enrichment by America's cosseted chief executive officers has institutional shareholders up in arms and the Securities Exchange Commission pondering new corporate disclosure rules for CEO pay. The response of corporate chieftains varies.

Some note that their boards of directors and compensation experts agree they are worth an average annual salary of between $2.5 million and $5.4 million (in 2005 dollars) including performance-based stock incentives and other perks of the famed "C Suite." Other executives simply point to their companies' share price as proof they earn every penny of their pay.

On occasion, both of these arguments may boast some basis in fact, but often the great pay guarantees that chief executives in America engineer for themselves are simply blessed by compliant boards and conflicted compensation experts without much real regard for executive performance. This is costly for shareholders, but from a public policy perspective escalating CEO pay packages are a debilitating drag on the American economy.

How costly? Every dollar of CEO compensation, which on average accounts for about 10 percent of aggregate corporate earnings, displaces a dollar that corporations could have invested in other things, such as labor, new plant and equipment, and research and development. Skyrocketing CEO pay can be detrimental to a company's longer-term performance and on our economy's overall competitiveness. And CEO pay that is not linked to real performance can ultimately undermine shareholders' trust in financial markets, where millions of Americans have placed their retirement savings.

Recent investigative reporting by the financial press has exposed the most egregious examples of over-compensated CEOs and the means by which they enriched themselves. Institutional investors and financial analysts also regularly crunch the numbers of individual corporations to see whether CEOs' claims of superior performance are in fact reflected in their companies' stock price. It is, however, striking to see the extent to which CEOs as a group have managed to maintain healthy pay levels even though, in some cases, their companies' stocks have performed poorly.

Our analysis of CEO pay during five years, from 2001 to 2005, shows that many companies increased the pay of their CEOs even when the company's stock price fell short of basic benchmarks, such as the S&P 500 stock price index, or even when the company's stock failed to out-perform staid U.S. Treasury bonds. Performance-based pay is meant to set the company's stock performance apart from the broader market, but if a company's stock fails to beat the S&P 500 then the basic goal of performance-based pay is not met.

Similarly, performance-based pay at the very least should encourage CEOs to lift their companies' shares above the cost of capital. This is most easily defined as the rate of interest on U.S. Treasury bonds, which serve as an anchor for other interest rates on corporate borrowing, such as commercial paper and corporate bond rates. Yet, from 2001 to 2005 many CEOs failed to meet this basic performance goal.

Our analysis of this five-year stock and bond data shows that total compensation for CEOs of well-performing companies tended to be higher than compensation for CEOs of poorly performing companies, yet the differences are small. Consider the following:

- Salaries, which account for 25 percent to 35 percent of a CEO's total compensation, are similar for CEOs of poorly performing companies and well-performing companies. The mean salary of a CEO whose company's stocks underperformed U.S. Treasury bonds during any five-year period ending between 2001 and 2005 was $982,757, compared to $943,445 for CEOs whose stocks performed better than Treasury bonds.

- The bulk of CEOs' compensation comes in forms other than salaries in order to inspire good performance, yet CEOs of companies whose stocks performed poorly still received very high compensation beyond their salaries. CEOs whose companies' stocks failed to do better than Treasury bonds during any five-year period ending between 2001 and 2005 received compensation in addition to their salary to the tune of $2.1 million.

- A substantial share of companies with underperforming stocks still chose to bump up their CEOs' compensation. For example, 16.5 percent of CEOs whose company's stocks did not rise faster than Treasury bond yields during any five-year period ending between 2001 and 2005, still received raises in their total compensation.

Such unjustified growth in CEO pay deserves serious attention. This rising share of corporate resources is diverted away from other uses, such as long-term corporate investment that is critical to the future competitiveness of our economy and job growth throughout the country. Ever-escalating CEO pay also contributes to rising income inequality in America. In the interest of a healthy and more equitable economy, it is time to rethink corporate policies and practices that can result in pay without performance for a substantial share of corporate executives.

Components of CEO Pay: Multifaceted and Mysterious

Fortunate employees at prosperous corporations obtain pay packages that often contain a mix of salary, health and retirement benefits, as well as other benefits. In comparison, CEOs can often secure exceedingly healthy salaries alongside performance-based compensation that is almost guaranteed to exceed their salaries by factors of two or three. Even as many corporations cut back on pension benefits for almost all of their employees, some continue to boost the pension plans of their chief executives.

CEOs also receive a range of other forms of compensation: ancillary perks such as country club memberships, corporate jets, chauffeured cars and, in some instances, something called gross-up payments, or compensation for personal taxes. As if these mostly guaranteed forms of compensation weren't enough, there is growing evidence that the improper back-dating of stock options for CEOs has undermined the very reason for offering such performance-based incentives.

Worse still, many CEOs face little financial risk if they are fired for poor performance. The reason: They negotiated healthy severance packages before agreeing to take the job. Most of these forms of compensation for CEOs are buried in proxy footnotes, or are not disclosed at all in regulatory filings with the SEC, which means their shareholders often cannot grasp the overall size of CEO pay or the extent to which most of it is, in fact, guaranteed. With such a myriad of complex and often difficult to comprehend compensation components, it should come as no surprise when particularly egregious cases of CEO greed become public (See Appendix, page 14)

Recent economic research, however, suggests that such headline-grabbing news stories are not isolated cases of individual CEO greed. Rather, recent research indicates that much of the CEO compensation process is fundamentally flawed. A 2005 study, titled "The Growth in Executive Pay," co-authored by Harvard University professor Lucian Arye Bebchuk and professor Yaniv Grinstein of Cornell University, concludes that CEO pay in recent years increased not necessarily because of improved performance, but because of historic happenstance. The authors found that the rising stock market of the mid- to late-1990s diminished public outrage about CEO pay levels, and that early enthusiasm for "pay-for-performance" goals in the early 1990s gave CEOs the opportunity to persuade boards to increase their overall pay in ways that appeared favorable to outsiders, such as stock options, because they can be defended as performance-based and are not expensed.

Professor Bebchuk and professor Jesse M. Fried of the University of California, Berkeley also detailed in a 2003 study, titled "Executive Compensation is an Agency Problem," that CEOs wield a substantial amount of power over boards and compensation committees, and thus, exercise control over the design of their compensation packages, which may result in adverse incentives in the allocation of corporate resources. In a similar vein, University of Chicago professor Marianne Bertrand and professor Sendhil Mullainathan of Harvard University found that CEOs of poorly governed companies are often rewarded for pure luck. Their study, titled “Do CEOs Set Their Own Pay? The Ones Without Principles Do,” published in 2000, also discovered that CEOs of poorly governed companies have to forfeit less in salaries and benefits to receive the same amount of performance-based compensation as CEOs of well-governed companies.

Indeed, academic research increasingly questions the link between CEO pay and corporate performance. A study released in March 2005, titled “Pay for Corporate Performance or Pay as Social Division: Rethinking the Problem of Top Management Pay in Giant Corporations,” found that the rapid gains in CEO compensation are not justified by corporate value created by management efforts. An earlier study, titled “The Relevance of Firms’ Accounting and Market Performance for CEO Compensation,” published in 2001, similarly found that most corporate performance measures are not a predictor of CEO compensation. Other than bonuses, the study found that CEOs receive other forms of compensation regardless of how their company is doing.

There is, of course, research that points to alternative conclusions. Professors John E. Core and Wayne R. Guay of the University of Pennsylvania and Randall S. Thomas of Vanderbilt University, in a 2005 article, titled “Is U.S. CEO Compensation Broken?,” argue that CEO pay increases were commensurate with the growing risks that CEOs face, the rising size of U.S. companies, and the increasing complexity of running U.S. corporations. In some instances, this may well be true, but one obvious flaw in the analysis is that the authors never establish a causal relationship between CEO incentive pay and stock price changes. It is unclear from their study if CEOs actually were rewarded for their clever management strategies or if they just reaped the windfalls of a booming stock market that was driven by other fads or factors.

Pay for Performance: A Market Analysis

Our study of CEO pay performance compared chief executives' compensation to two key benchmarks, the S&P 500 stock market index and the average rate of interest paid over three years and five years on long-term U.S. Treasury bonds. Our findings raise further questions about the link between CEO pay and performance. In particular, many companies increased pay for their CEOs even though the company's stock prices fell short of these two basic benchmarks.

Why these two particular benchmarks? Performance-based pay is meant to set the company's stock performance apart from the broader market. The S&P 500 index is a broad stock market measure. If a particular company's stock fails to beat the S&P 500, the basic goal of performance-based pay, narrowly defined as stock price performance, is not met. Similarly, performance-based pay is meant to entice CEOs to lift their companies' stock prices at least above the cost of capital. This is most easily defined as the rate of interest on U.S. Treasury bonds, which serve as an anchor for other interest rates on corporate borrowing, such as commercial paper and corporate bond rates.

During the period from 2001 to 2005, the S&P 500 benchmark varied greatly, depending on which years and which time periods were considered, while the Treasury bond benchmark has generally been low and declining for the past few years (Table 1). Yet both benchmarks are exceedingly useful when comparing CEO pay and performance.

Using data for the current members of the S&P 500 and combining them with available data on CEO compensation allows us to compare pay levels and changes in CEO pay with company performance. We first compare the pay levels for CEOs for well-performing and for poorly performing corporations (Table 2).2 From a salary perspective, there is virtually no difference between CEOs of poorly performing and well-performing corporations. CEOs of corporations with stock prices that did not beat Treasury bonds over a period of five years had a median salary of $982,757 (in 2005 dollars). CEOs of corporations with stock prices that performed better than Treasury bonds received $943,445 (in 2005 dollars). The difference in salary between the two sets of corporate chieftains: only 4 percent.

Table 1
Stock market and Treasury bond returns for 3-year and 5-year periods ending between 2001 and 2005

Year ending	Total stock market return		Treasury bond return	
	3-year average	5-year average	3-year average	5-year average
2001	-3.4%	7.4%	2.6%	2.9%
2002	-18.1%	-2.2%	2.0%	2.7%
2003	-6.7%	-3.2%	2.0%	2.3%
2004	0.0%	-5.4%	1.8%	1.9%
2005	10.6%	-1.9%	1.5%	1.8%

Notes: All figures are annual average percent changes, based on real levels, for the respective periods ending in the relevant years. Treasury bond returns refer to long-term, 30-year and 10-year, treasury bonds. Authors' calculations based on Tradetools.com (2006).

As expected, CEOs of poorly performing companies receive less than CEOs of well performing corporations in other compensation forms. Yet the CEOs of poorly performing companies still receive other compensation that was between 50 percent and 100 percent greater than their salary. The median for other compensation for CEOs of well-performing corporations was between \$1.5 million and \$2.1 million, compared to the median salary for CEOs of poorly performing corporations of between \$0.9 million and \$1.0 million. Even though the poor performers received less than CEOs of well-performing corporations, CEOs of corporations with poorly performing stocks still received substantial pay for performance. In general, they still more than doubled their take-home pay.

The upshot: CEOs of corporations that perform poorly on the stock market still typically received multi-million dollar compensation packages. CEOs of corporations where the stock price did worse than Treasury bonds on average for five years received a typical compensation package of more than \$3 million between 2001 and 2005.

Table 2
Total compensation, salary, and other compensation by performance level, 2001 to 2005

Comparison threshold	CEO pay at companies that fail to meet threshold		CEO pay at companies that meet threshold	
	Mean	Median	Mean	Median
	Salary			
3-year stock market average	$920,023	$938,140	$980,671	$965,353
5-year stock market average	$948,619	$964,932	$974,954	$958,449
3-year Treasury bond change	$956,818	$965,965	$965,682	$950,693
5-year Treasury bond change	$982,893	$982,757	$951,952	$943,445
	Other compensation:			
3-year stock market average	$3,247,911	$1,534,574	$4,453,560	$2,463,000
5-year stock market average	$3,437,470	$1,785,488	$4,436,021	$2,457,281
3-year Treasury bond change	$3,317,518	$1,772,340	$4,645,826	$2,555,820
5-year Treasury bond change	$3,800,168	$2,068,425	$4,340,031	$2,408,392
	Total compensation:			
3-year stock market average	$4,167,935	$2,552,835	$5,434,232	$3,514,870
5-year stock market average	$4,386,088	$2,810,897	$5,410,974	$3,542,585
3-year Treasury bond change	$4,274,336	$2,703,365	$5,611,508	$3,601,516
5-year Treasury bond change	$4,783,061	$3,045,083	$5,291,983	$3,404,945

Notes: All figures are in 2005 dollars. Authors' calculations based on S&P (2006), Executive Paywatch (2006), and BLS (2006). Other compensation consists of bonuses, exercised stock options, long-term incentive pay, restricted stock grants, and other compensation.

Still, these compensation levels reflect the disparities in compensation levels for CEOs of poorly and well-performing corporations (Table 3). Typically, CEO pay declined at corporations where stocks performed below both thresholds. For instance, total CEO compensation declined by 7.1 percent at corporations that did not perform better on average than Treasury bonds over any five-year period that ended between 2001 and 2005.

Table 3
Change in total compensation, salary, and other compensation by performance level, 2001 to 2005

Comparison threshold	Change in CEO pay at companies that fail to meet threshold		Change in CEO pay at companies that meet threshold	
	Mean	Median	Mean	Median
	Salary			
3-year stock market average	0.0%	-0.5%	2.6%	1.6%
5-year stock market average	-0.2%	-0.1%	2.3%	0.9%
3-year Treasury bond change	-0.7%	-0.3%	3.6%	1.7%
5-year Treasury bond change	0.0%	0.0%	2.8%	1.1%
	Other compensation:			
3-year stock market average	-11.6%	-4.8%	-0.8%	3.0%
5-year stock market average	-14.0%	-11.5%	0.4%	-0.3%
3-year Treasury bond change	-25.2%	-19.1%	11.9%	12.2%
5-year Treasury bond change	-10.8%	-9.5%	1.6%	2.2%
	Total compensation:			
3-year stock market average	-6.1%	-2.5%	-1.7%	3.4%
5-year stock market average	-10.6%	-8.6%	-1.3%	0.3%
3-year Treasury bond change	-16.8%	-14.1%	7.6%	8.4%
5-year Treasury bond change	-8.4%	-7.1%	-0.6%	1.7%

Notes: All figures are based on levels in 2005 dollars. Authors' calculations based on S&P (2006), Executive Paywatch (2006), and BLS (2006). Other compensation consists of bonuses, exercised stock options, long-term incentive pay, restricted stock grants, and other compensation.

The question, though, is how many corporations raised CEO compensation when their stocks did not beat basic performance benchmarks? It turns out that a substantial share of corporations raised their CEO compensation — even when their stocks performed poorly (Table 4). In 15.1 percent of the cases, corporations increased CEO salaries in inflation-adjusted terms over the same five-year period, while their stocks had a lower rate of return than long-term Treasury bonds.

Not including inflation, CEO salaries grew in close to 31.2 percent of the cases when the stocks of their companies underperformed long-term Treasury bonds during the same five-year period. Interestingly, the share of cases in which other CEO compensation rose in inflation-adjusted terms, when stocks failed to meet basic benchmarks

Table 4
Incidence of CEO pay increases when stocks failed to beat benchmark, 2001 to 2005

Comparison threshold	Incidence of real CEO pay increases when stocks failed to beat benchmark	Incidence of nominal CEO pay increases when stocks failed to beat benchmark
	Salary	
3-year stock market average	16.0%	16.4%
5-year stock market average	14.5%	20.6%
3-year Treasury bond change	21.3%	25.4%
5-year Treasury bond change	15.4%	31.2%
	Other compensation:	
3-year stock market average	15.2%	19.5%
5-year stock market average	10.0%	11.1%
3-year Treasury bond change	14.3%	14.9%
5-year Treasury bond change	15.5%	17.4%
	Total compensation:	
3-year stock market average	15.5%	16.7%
5-year stock market average	10.6%	11.6%
3-year Treasury bond change	14.0%	16.3%
5-year Treasury bond change	16.5%	18.0%

Notes: Authors' calculations based on S&P (2006), Executive Paywatch (2006), and BLS (2006). Other compensation consists of bonuses, exercised stock options, long-term incentive pay, restricted stock grants, and other compensation.

Rising CEO pay misallocates corporate resources and contributes to rising inequality

The disparity between CEO pay and performance detailed in our analysis has profound implications for our overall economy. Money spent on a CEO's compensation cannot be spent on employees, on new plants and equipment, or on research and development. Nor is this a small pot of money. Professors Bebchuk and Grinstein noted in their 2005 study of CEO compensation that from the period of 1993-1995 to the period between 2001 and 2003, aggregate CEO compensation grew from five percent of aggregate corporate earnings to 10 percent of aggregate corporate earnings.

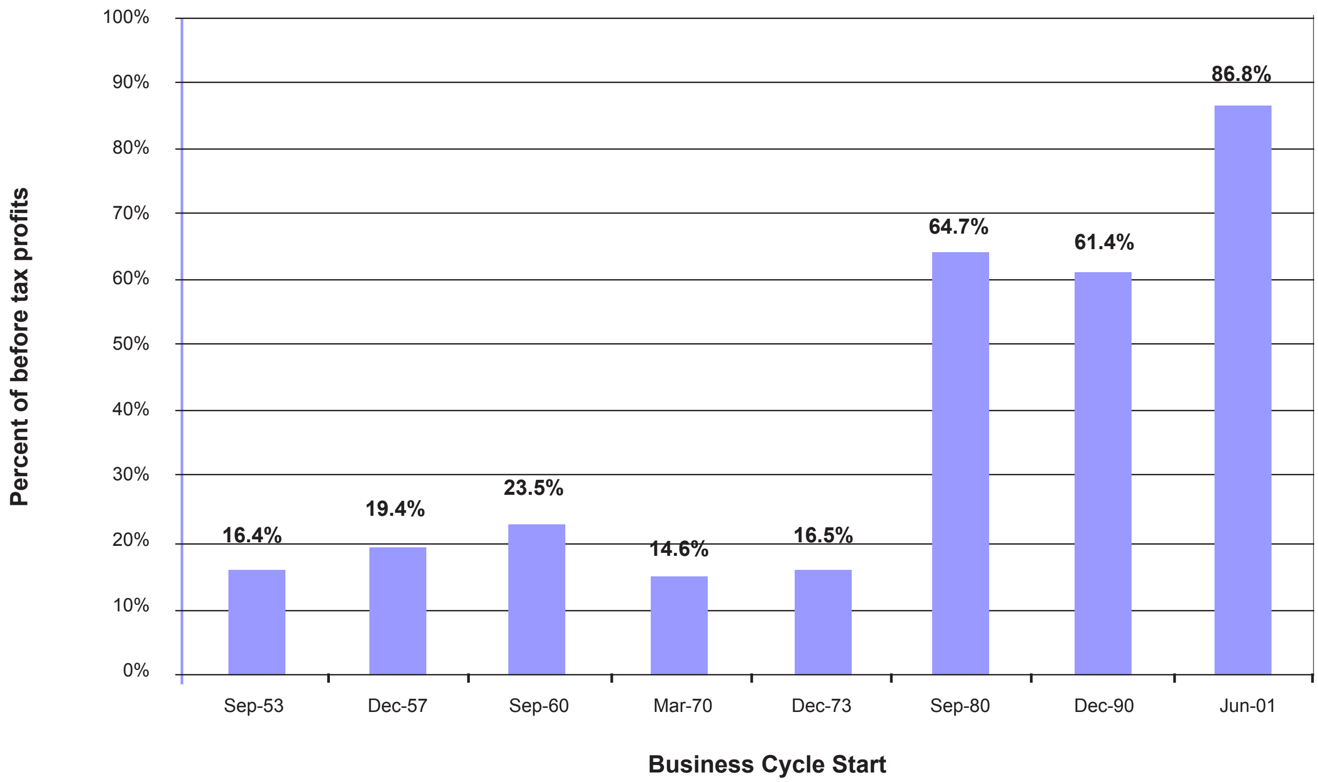
Underlying this rise in total corporate compensation for CEOs is the growing use of stock grants and stock options. When corporations give CEOs stock options, they tend to repurchase their own shares to satisfy the exercised stock options. The alternative would be to issue new shares, which would dilute the share prices.

Furthermore, corporations have increasingly used their cash resources to pay dividends to boost stock prices, thus making it more likely that CEOs can realize the value of their stock options. In the current business cycle, which started after March 2001, corporations spent 86.8 percent relative to their before-tax profits on share repurchases and dividend pay-outs, more than in any prior business cycle (Figure 1).

Because money used to boost CEO compensation is no longer available for corporate investments, the innovative capacity of the U.S. economy could suffer. As the Center for American Progress's Christian E. Weller noted recently in two separate studies, the record high use of cash for share repurchases and dividend payouts happened at a time when corporations were more profitable than at any point in the past 25 years, and at a time when they were investing record low levels in new plants and equipment.

High CEO pay not only affects the allocation of corporate resources, but has also contributed to the rising income inequality in the United States. In 2005, CEO pay among a sample of 350 companies, as reported in The Wall Street Journal, rose to 279 times the average worker's pay, according to a study by John Burton and Christian E. Weller of the Center for American Progress, titled "The Gap Between CEOs and America's Middle Class Widened in 2005."[1] This was almost twice as much as the ratio in 2002, after the stock market crash, and more than 10 times the ratio of CEO-to-worker pay of the 1960s and 1970s.

Figure 1: Net Share Repurchases and Dividened Pay-outs to Before Tax Profits, Business Cycle Averages



Notes: All figures are business cycle averages. Business dates are taken from NBER (2006). Authors' calculations based on BOG (2006).

This mirrors growing and persistent income inequality in America. Case in point: The share of income accruing to the 20 percent of families with the highest income totaled 50.1 percent in 2004, the last year for which data are available from the U.S. Census Bureau. At the same time, the share of income going to those 20 percent of families exactly in the middle of income distribution declined from 17.0 percent to 14.7 percent over the same period.

Chief executives receiving an average of $2.5 million to $5.4 million a year in total compensation are, of course, seeing far higher income gains than the top 20 percent of American families. As our analysis shows, there's very little if any justification for such corporate largesse.

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[1] This calculation refers to a different sample of CEOs than the one used in the analysis later in the paper.

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Appendix

A.1 Illustrative Examples

A.1.1. CEO Severance Packages: Cushioned from the Fall

Shocking severance packages in the hundreds of millions of dollars never fail to make headlines. The recent case of former Exxon Mobil Corporation CEO Lee Raymond's retirement package is no exception. At a record-breaking $400 million — comprised of a lump-sum payment, salary, bonus, restricted stock, long-term incentive payouts, and accrued long-term compensation — the package presented a field day for the press and became a quick target for shareholder outrage.

What is perhaps more disturbing to shareholders is when such excess appears to be lavished on a failing chief getting booted out the door, as was the case when Hewlett-Packard awarded "disgraced" CEO Carly Fiorina a $40 million severance package. In that case, shareholders expressed their anger and disappointment, primarily at Fiorina, paying little or no attention to the board's complicit decision to let her walk away with such a large sum.

Yet, what many fail to realize is that these severance packages are rarely determined when an executive decides to retire or the board forces the issue. Rather, many severance agreements were formulated when the CEO walked in the door, as an added, and considered necessary, incentive to lure executives away from their comfortable situations to often riskier propositions.[2] The boards in this case make the assumption that the incoming CEOs can and should be shielded from possible risk.

It appears that time and experience is teaching shareholders some lessons. Wasting no time on Raymond, shareholders have gone straight for the decision-making body — the board. At Exxon Mobil's recent annual meeting shareholder discontent was clear, with more than 20 percent of them withholding votes for directors on the compensation committee, and a majority of shareholders backing a non-binding resolution requiring majority, as opposed to plurality, votes for directors.

This proposal for a non-binding resolution is not alone. In fact, it's indicative of a growing trend in board election reform. According to Institutional Shareholder Services, 11 out of 13 proposals, some of which are binding, have won majority support, averaging 56.8 percent of votes overall.[3]

[2] Welch, Jack and Suzy: "Paying Big-Time For Failure; Who is really to blame for those fat severance packages given to CEOs who falter?" Business Week, April 10, 2006.
[3] ISS Corporate Governance Web Blog, May 12, 2006, "Majority Vote Trends Continue." Accessed at , http://blog.issproxy.com/2006/05/majority_vote_trends_continues.html.

Looking ahead, additional proposals seeking to give shareholders a say in particularly large severance packages have been gaining some steam, with many rallying around a similar formula. Under proposals supported by shareholders of companies ranging from McDonald's Corporation to Morgan Stanley, any severance package that exceeds 2.99 times the sum of the manager's salary and bonus in benefits and/or cash would require shareholder approval.

A.1.2 Backdating: Pay-For-Fraud?

The granting of stock options is one of the most prominent pay-for-performance tools that compensation committees have at their disposal. Executives are granted the opportunity to buy a certain amount of shares in the company at a set price — known as the "strike price," or exercise price — generally equal to the market price on the day of the grant, and are generally required to wait a few years before they can be exercised. As soon as the share price increases, the executive sees a benefit, thereby directly tying his or her compensation with the market performance of the company.

If an executive is granted options on a day when the share price is particularly low, the profit opportunity is that much greater. If the date of the grant happens to be on the same date as a yearly or quarterly low for the company's stock price, all the better. In recent months, it has become apparent that a large number of executives have been just that lucky… every time.

This fortuitous streak enjoyed by many chief executives has sparked allegations of a practice known as backdating — either changing the date of a grant or retroactively granting options on a date when the stock price was at a particularly low point. The practice significantly reduces the incentive aspect of the options by providing the executive with a built-in profit. The executives can gain more if the share price increases further, but the pressure is off.

While backdating is not illegal per se, it is if it is not approved by the directors and fully disclosed to investors. Companies file shareholder-approved option plans with the SEC, outlining the terms of their option grants. Backdating is legal if a company is willing to admit to its shareholders that it is essentially rigging the system in order to de-incentivize their CEO with options.

UnitedHealth Group, for example, had a unique options plan for a number of years. Until last year, CEO Dr. William W. McGuire chose the dates of his own option grants, with the only requirement that he give "oral notification" to the chairman of the company's compensation committee. A recent analysis by The Wall Street Journal shows that Dr. McGuire consistently chose very wisely — with grants between 1997 and 2001 falling on yearly lows or at the bottom of sharp dips.

The Journal's analysis shows that the probability of someone choosing all of those dates by chance is at most 1 in 200 million. Dr. McGuire has realized $200 million in the past four years and has another $1.8 billion in unrealized gains to look forward to, $1.6 billion of which can be exercised at any time.[4]

UnitedHealth Group is one of about 20 companies that the SEC is said to be investigating. Companies caught backdating may have to restate financial results, pay back taxes and penalties, and potentially incur disclosure and securities fraud violations. Executives found complicit could be charged with wire fraud and other criminal charges.

A.1.3 CEO Pension Benefits: Passing the Top Hat

Many families worry about retirement security, for good reason. In 2004, the last year for which data are available, only 46.3 percent of private-sector employees were covered by an employer-sponsored pension plan[5]. This figure masks the fact that traditional pensions, so-called defined benefit pension plans, have declined from covering 39 percent of the private-sector workforce in 1974 to 21 percent in 2004[6]. At the same time, riskier defined contribution retirement savings plan have become more prevalent.

In stark contrast to these trends, many CEOs continue to enjoy defined benefit pensions, often referred to as Top Hat plans, which can include advantageous features that are not available in employee plans, such as a no-waiting period. In 2005, 69 percent of Fortune 1,000 companies offered a Supplemental Executive Retirement Plan and 91 percent of these companies offered a Nonqualified Deferred Compensation Plan. At many companies, both of the trends outlined above are happening concurrently — at the same time that a company is freezing or terminating a pension plan for regular employees, they are continuing to offer and often growing their executive pension plans.

In a diminishing number of cases where regular employees are fortunate enough to receive a retirement benefit, executives are often given further preferential treatment via these Top Hat plans. In defined contribution plans, the benefits could include guaranteed above-market interest rates, a greater match, or a shorter vesting period. For defined benefit plans, executives could accrue higher percentages of their final pay or could even accrue benefits for years not actually worked.

[4] The Wall Street Journal, "UnitedHealth Cites 'Deficiency' in Options Grants as SEC Steps Up Probes, Insurer Warns Restatement Could Total $286 Million," May 12, 2006.
[5] Purcell, Patrick, 2005, Pension Sponsorship and Participation: Summary of Recent Trends, Congressional Research Service.
[6] Weller, Christian E., 2005, "Middle-Class Turmoil: High Risk Reflects Middle-Class Anxieties," Center for American Progress.

On the extreme end of this retirement excess, Pfizer, Inc. CEO Henry A. McKinnell is currently slated to receive a $6.5 million annual pension, ranking him number one in the CEO pension category. His total pension value is currently estimated at $83 million. And he's not the only Pfizer executive with such pension benefits. All executive pensions, including McKinnell's, account for 12 percent of Pfizer's total $9.1 billion pension obligation.[7]

Unlike employee pension plans, executive pension plans are usually unfunded, which results in a hefty drag on earnings, disproportionate to their size. Pensions for regular employees are either partly or wholly offset by returns from dedicated investments, whereas executive pensions often have no such dedicated funds, so there is nothing to soften the budgetary blow. In the case of Pfizer, the effect of unfunded executive pensions is greater than that from pensions for regular employees.[8]

In addition to sending a poor message to rank-and-file workers and having a large impact on earnings, Top Hat plans also represent yet another form of compensation for executives that is not tied to performance. Many multi-million dollar pensions are essentially guaranteed, regardless of what happens to the company or its share price, and they are easy to hide from investors.

Full disclosure of the dollar amount of CEO pensions is not yet required, and companies can often bury the costs of executive retirement package by lumping them into the costs of pensions or defined contribution plan programs for the company on the whole. This is yet another way for chief executives to beef up their total pay package without making waves in the investor community.

A.1.4 CEO Tax Benefits: Grossly Inefficient

One of the most recent trends in excessive, and somewhat creative, executive compensation is quite accurately referred to as a "gross-up." That's when the corporation pays taxes on behalf of their CEO or former CEO. It's a fitting term for a rather gross trend that appears to be growing — 52 percent of companies disclosed gross-ups to at least one executive in 2005, up from 38 percent in 2000.[9]

[7] Francis, Theo and Schultz, Ellen E., "Hidden Burden: As Workers' Pensions Wither, Those for Executives Flourish," The Wall Street Journal, June 23, 2006.
[8] Ibid
[9] Maremont, Mark: "Duty Calls — Latest Twist in Corporate Pay: Tax-Free Income for Executives — Companies Reimburse Bosses for Levies on Perks, Stock: Scant Details in Filings — a Recruiting Tool, Say Some," The Wall Street Journal, December 22, 2005.

Gross-up payments first took off during the 1980s as a response to the 20 percent excise tax Congress devised to limit excessive severance payments. Unfortunately, rather than curbing the practice, companies' response was simply to shield executives from the tax payments altogether. In recent years, their growth and continued prevalence is likely due to the fact that the payments offer yet another subtle, under-the-radar method for companies to bolster their executives' compensation packages.

Disclosure is certainly required for gross-up payments, but they don't live in the basic compensation tables and can be buried just about anywhere in a company's financial report. They can also be described in just about any way. "An estimated $11,127,981 to offset certain excise taxes under Section 4999 of the Internal Revenue Code so that he would remain in the same after-tax position he would have been in had the excise tax not been imposed"[10] is all that AT&T, Inc. had to say recently about the gross-up for former Chairman David Dorman's $20-million severance payment.

Gross–up payments also can pop up unbeknownst to shareholders as a large, and often hidden cost, of a merger or acquisition. Such was the case when North Fork Bancorp, Inc. was purchased by Capital One Financial Corp. North Fork CEO John Kansas received $135 million from the deal, and lucky for him, Capital One picked up the tax tab at a cost of $44 million.

Beyond the astounding concept that CEOs need not pay taxes, what should also disturb shareholders is that these gross-up payments are grossly inefficient. As soon as the company pays the taxes for the executive, that payment is counted as additional taxable compensation. The company therefore needs to pay taxes on its own tax payments, with the net effect of gross-up payments costing the company more than double the amount of the original tax payment. For example, gross-up payments of $1 million dollars, a modest sum for most CEOs, could run the company anywhere from $700,000 to $900,000.[11]

A.1.5 CEO Compensation: Indecent Disclosure

Much of the discussion surrounding CEO compensation and any related shareholder awareness and activism hinges on two key assumptions. First is that companies disclose all of the information that a shareholder would need to know to assess the compensation of the CEO. Second is that the average shareholder can actually comprehend the information provided.

[10] Gross, Daniel: "Gross-up? Gross Out," Slate Magazine, March 15, 2006.

[11] Maremont, Mark: "Duty Calls — Latest Twist in Corporate Pay: Tax-Free Income for Executives — Companies Reimburse Bosses for Levies on Perks, Stock: Scant Details in Filings — a Recruiting Tool, Say Some," The Wall Street Journal, December 22, 2005.

Neither of these assumptions held for the shareholders of General Electric Company (GE) as they and others discovered in 2004. GE had failed to disclose millions in perks for former CEO Jack Welch, including but not limited to "unlimited travel on corporate jets, chauffeured limos, a leased Mercedes-Benz, a furnished New York apartment worth $11 million, security systems, and even bodyguards for his book tour."[12]

Companies only need to disclose what the SEC requires of them, which often means less than full disclosure of retirement benefits. Those benefits can often account for a third of compensation, including accurate assessments of future obligations on stock options, and a full accounting of the costs of executive perks. SEC compliance also doesn't require that the information companies do provide to shareholders be packaged neatly in one place. Nor does the SEC require that someone with a basic command of English be capable of interpreting the fine print.

In January 2006, The Atlanta Journal-Constitution showed just how complex and cryptic financial disclosures can be. They asked Dennis Beresford, an accounting professor at the University of Georgia, chairman of audit committees at two major companies, and a former chairman of the Financial Accounting Standards Board, to tally the pay for Neville Isdell, CEO of the Coca-Cola Company. After slogging through the documents for about 20 minutes, Beresford came up with around $17 million, but in fact he was off by as much as $14 million. The reason? He missed a footnote.[13]

Perhaps companies expect that someone with greater expertise and better credentials will be reviewing these documents. But not everyone loves the idea of more disclosure. Some argue that increased disclosure of compensation could lead to an even greater race-to-the-top among executives as they seek to leverage each others' pay packages to barter for more. More likely, however, is that greater disclosure will enable shareholder activism and public outrage to become more powerful drivers for change.

Earlier this year, the SEC introduced a host of new disclosure rules — a long awaited update to 14-year-old rules. Similarly, it appears that the SEC is poised to react and impose additional rules in light of the recent stock option backdating probe. Clarification of rules regarding the treatment of stock options would go a long way toward increasing the accuracy of executive compensation disclosures. At present, companies have a variety of accounting and disclosure options often leading to incomplete or inaccurate assessments of future commitments.

[12] Countryman, Andrew: "GE Vows to Make Perks Visible; Welch case draws no fine from SEC," Chicago Tribune, September 24, 2004.
[13] Kempner, Matt: "Figuring execs' pay hard, even for pros," The Altanta Journal-Constitution, January 21, 2006.

While these actions are much appreciated by shareholders and activists alike, the SEC still has work to do. There is still plenty of room to improve disclosure in several areas, including CEO performance targets, retirement benefits, and directors' related party transactions.

A.2 Robustness Tests

To ensure that the results of our analysis of CEO pay and performance against the S&P 500 index and the rate of interest over three and five years on long-term U.S. Treasury bonds are not sensitive to a selection bias, we estimated a few comparable figures from a separate data set. The Wall Street Journal releases CEO pay data for the CEOs of the 350 largest corporations. This sample is less comprehensive than the one we used, although there is obviously a lot of overlap. Based on the published information, we calculated the level of CEO pay relative to five-year company stock performance — the only direct calculation to the figures in the text. A similar calculation was done for both data sets for the levels of CEO pay relative to one-year changes in the total rate of return on the company stock relative to the S&P 500 and long-term Treasury rates.

Table A-1 summarizes the ratios of median and mean CEO compensation for CEOs who beat the benchmarks relative to those who did not. The results show that our sample is not biased toward CEOs who performed well or those who performed poorly. Comparing our sample to the data collected by The Wall Street Journal shows that in the short-run our data generated a larger difference between CEOs of well-performing and those of poorly performing companies

Table A-1
Comparison between S&P 500 data and The Wall Street Journal data, CEO compensation levels relative to one-year and five-year total real stock market performance

	Median		Mean	
	S&P 500	WSH	S&P 500	WSJ
1-year stock market performance	1.27	1.02	1.19	0.96
5-year stock market average	1.26	1.76	1.23	1.94
1-year Treasury bond change	1.44	1.39	1.39	1.17
5-year Treasury bond change	1.12	1.66	1.11	1.77

Notes: Figures are ratios of median and mean CEO pay for respective groups. All calculations are based on real CEO compensation. Authors' calculations are based on S&P 500 data, AFL-CIO, Executive Paywatch, and The Wall Street Journal CEO compensation survey, various years

— over a longer period, the reverse is true.

In addition, we calculated the share of CEOs in each data set who saw a one-year increase in pay even when the total rate of return fell either below the total real rate of return for the S&P 500 or below the real Treasury bond rate. As there is substantial volatility from year to year in both figures, these are less meaningful than the three-year and five-year comparisons done in the body of the text. These comparisons here are only done to show the comparability between the two data sets.

Table A-2 shows that both data sets generate similar shares of underperforming CEOs who received pay increases. The data sets used in the main text shows that 18.3 percent of CEOs whose companies saw their total rate of return fall below the S&P 500 over the course of one year received a pay increase, compared to 17.6 percent of CEOs in The Wall Street Journal sample. Using the real Treasury bond rate, the shares are 20.1 percent and 16.8 percent, respectively. Both data sets generate similar outcomes, thus supporting the notion that our data do not

Table A-2
Comparison between S&P 500 data and The Wall Street Journal data, share of CEOs who received compensation increases with declining stock prices

	S&P 500	WSJ
1-year stock market performance	18.3	17.6
1-year Treasury bond change	20.1	16.8

Notes: Figures are percent. All calculations are based on real CEO compensation. Authors' calculations are based on S&P 500 data, AFL-CIO, Executive Paywatch, and The Wall Street Journal CEO compensation survey, various years.

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