

The New York Times

# SundayBusiness

Sunday, January 15, 2006

GRETCHEN MORGENSEN

## *Gee, Bankruptcy Never Looked So Good*

If executive pay is out of control across America — and who would argue that it isn't? — then the compensation being paid to managers running companies in bankruptcy nowadays can only be described as insanity squared.

First came the outrageous sums sought by executives at Delphi, the troubled auto parts marker, even as they asked company workers and other stakeholders to endure huge cuts. Then, last Thursday, unsecured creditors and executives at the UAL Corporation, parent of United Airlines, agreed to a deal in which 400 executives

stand to share an astonishing 10 million shares, or 8 percent of the total that the company expects to issue upon its emergence from bankruptcy. As in the Delphi case, this share grab — worth an estimated \$115 million — comes after other UAL stakeholders have been asked to make severe sacrifices.

When the UAL deal was announced, it was spun as evidence that the company's managers were exercising restraint. A previous plan, after all, had called for executives to divvy up 10 million shares now and 8.75 million later. Don't ready the poorhouse for these folks, howev-

er. Only in corporate America, circa 2006, can executives agreeing to a 47 percent cut in pay still fare so spectacularly.

Bankruptcy experts say that outsized pay at troubled companies is a new and disturbing trend. "Chapter 11 was traditionally about sharing the pain," said Elizabeth Warren, a professor at Harvard Law School who specializes in bankruptcy, "but now it is more a game of feast and famine — starving the shareholders and creditors while the management team grows fat on big sala-

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ries."

How fat? Annual salaries for the top eight UAL executives, for example, will total \$3.5 million after the company exits bankruptcy, according to court filings. On top of that are target bonuses, at levels equal to 55 percent to 100 percent of salary, depending upon the executive involved.

Glenn F. Tilton, UAL's chief executive, will receive a base salary of \$605,625 and a target bonus equal to that amount, the filings state. This is on top of \$4.5 million he has received in benefits as part of a pension agreement and a \$3 million signing bonus.

Then there are retention payments of \$1.39 million earmarked for seven top executives, excluding Mr. Tilton. UAL will pay club dues of \$16,520 for two executives as well.

Nice.

But it is the plan's stock compensation component that Brian Foley, an executive pay expert in White Plains, finds so remarkable. Not only is it rich, it is immediate. Mr. Tilton,

for example, is in line to receive 822,000 options, valued at around \$9 each, and 545,000 restricted shares, estimated to be worth \$15 each. Awards to other UAL executives are a similar combination of restricted stock and options.

Tasty.

The heavy emphasis on the restricted shares under the plan increases the pay package's value, Mr. Foley said. Because options will generate gains for the executives only if the underlying stock rises, they are not as valuable as restricted shares, which have a clear value from Day 1. For that reason, Mr. Foley said, compensation experts estimate that each restricted share is equal to three stock options.

Therefore, he said, the UAL package of options and restricted stock is equivalent to a stake of around 14 percent of the company's outstanding shares for executives if options alone were used.

Mr. Foley also noted that the 8 percent stake to be received by UAL executives exceeds what was described as "reasonable" by Towers Perrin, the compensation consultant employed by the company, in court filings last fall. Those filings show Towers Perrin concluding that a reasonable stake of new shares to be received by executives ranged from 3.5 percent to 7.5 percent of stock issued.

"I don't know how they got to a potential spend of 8 percent," Mr. Foley said. "And there is nothing in the documents to preclude them from going to shareholders immediately after emergence and saying now we need a new stock plan" that bestows more options and restricted stock on executives.

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## **Sharing the pain at UAL? The managers aren't hurting.**

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According to Jean Medina, a UAL spokeswoman, Towers Perrin noted in another report it filed with the court that "the plan, which has since been reduced, was both reasonable and appropriate for United's situation."

So what's another half a percent among friends?

The vesting period of the pay plan is also remarkably short, Mr. Foley said. According to the court filings, 20 percent of the stock grants will vest after six months, another 20 percent after one year and 20 percent in each of the following three years.

Ms. Medina said in a statement: "We believe, and the official committee of unsecured creditors, which represents our creditors and unions, agreed, that this program was appropriate to enable United to attract and retain top performers. It's in everyone's interests for management to have this component of management compensation tied to the future performance of United's stock price."



Dennis Cook/Associated Press

Glenn F. Tilton runs a company, UAL, that is in bankruptcy. That situation is not evident in a new pay package, compensation experts say.

Ms. Warren of Harvard said a trend of excessive pay for officials at bankrupt companies is a troubling result of the lack of pushback from other stakeholders. "The lawyers and management team are running the show," she said. "Shareholders are out of the picture and creditors are often unsure about the overall financial stability of the company. That is a perfect set of circumstances for the management to extract much higher compensation than they would get if other people were competing for those management jobs."

Mr. Foley agreed. "The basic con-

cern here is that the players don't seem to discipline themselves as much as they should and the external forces aren't executing any braking power," he said. "And the courts don't seem to hold people as accountable as they should."

Mr. Foley said he was also surprised that Towers Perrin apparently advised both management and the board, and wondered if another consultant would have recommended the same pay package to the board. The court overseeing the UAL bankruptcy is expected to rule on the compensation plan on Tuesday. Got your airsickness bag handy? □

The New York Times

# SundayBusiness

Sunday, February 5, 2006

GRETCHEN MORGENSEN

## *Rising Prices Lift All Bonuses*

**E**XXON MOBIL announced record earnings last week: \$36.13 billion for 2005, a 43 percent increase over the previous year. That was the highest annual profit any American company has ever earned. Shareholders of energy companies are surely delighting in the gains that sky-high oil prices bring. But their windfalls pale next to the bonanzas received by the executives running these companies, proving again how imperfect the current state of pay-for-performance can be.

Linking executive compensation to a company's results was supposed to align managements' interests with those of shareholders and to bring fairness to pay practices. But when a company does well mostly because of a rising commodity price rather than managerial genius, pay-for-performance becomes an unfunny joke.

Analysts estimate that every \$1 increase in the per-barrel price of oil translates into a 1.5 percent increase in Exxon Mobil's earnings. Because a significant portion of executive pay at Exxon Mobil is related to earnings growth (as is the case at many companies), rising oil prices mean bigger paychecks.

"It's such a sharp and vivid example of windfalls at work," said Lucian A. Bebchuk, professor of law, economics and finance at Harvard, "because obviously the rise had to do with the Iraq war and the Chinese demand, but certainly did not have to do with the managers' own performance."

"If you took the top five or nine major oil companies and looked at their returns and chose the one that performed the worst," he added, "you could still find that their executives probably made very large gains from their options even though they performed as badly as one could do."

With proxy season not yet in full swing, it is too early to tell just how fat oil-company executives' paychecks were in 2005. But all signs point to bloat.

In 2004, when Exxon Mobil's earnings rose at less than half of last year's rate, Lee R. Raymond, its chief executive at the time, received \$7.5 million in

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salary and bonus, \$28 million worth of restricted stock awards and \$2.16 million in long-term incentive pay. Mr. Raymond retired from Exxon Mobil in December.

Regulatory filings show that Exxon Mobil's compensation committee typically establishes a bonus pool that is shared by about 1,300 top employees. The pool's size is determined by the annual performance of the company.

The 2004 pool had a ceiling of \$184 million and was a result of the company's record-setting financial results — an 18 percent increase in net income over 2003 — as well as "record levels of operating performance in all segments of our business; strengthening of our worldwide competitive position; and progress toward long-range strategic goals, which include objectives in the areas of safety, health and environment," according to the proxy.

That \$184 million pool was 10 percent larger than in the previous year. Exxon Mobil's top five executives received almost 7 percent of it, or \$12.85 million in total.

Proxies indicate that Exxon Mobil has raised its bonus pool ceiling in recent years at roughly half the rate of its earnings growth for each period. So if the past is prologue, Exxon Mobil's bonus pool ceiling may have risen by at least 20 percent in 2005, putting it at \$220 million.

If the top five executives get their typical share of this pie — say, around 6.5 percent — that translates into \$14.3 million in bonuses alone. Salaries, restricted stock grants and other goodies would be additional.

Executives receiving bonuses at Exxon Mobil can get cash payments and something called an earnings bonus unit, which does not pay out until the company's earnings have reached a specified level. Cumulative earnings of \$3.25 a share were required for each unit granted in 2004 to pay out, for example, up from \$3 in 2003. It is not clear what hurdle Exxon Mobil's earnings had to clear last year to pay out on the units, but the company made \$5.35 a share, so it is highly likely that bonus units paid out.

Professor Bebchuk, co-author with Jesse M. Fried of "Pay Without Performance" (Harvard University Press, 2004), suggests that executives should not be paid based on their company's absolute performance but rather in comparison to others in the industry. Pay formulas, Mr. Bebchuk argues, should take into account any rising tides that are industrywide and unrelated to man-

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**With oil prices  
up, energy  
executives can  
sit back and  
watch their  
pay grow.**

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agement prowess. Alas, existing plans "do nothing to neutralize this general industry movement," he said.

Did Exxon Mobil's compensation committee adjust the terms of its executive pay packages to reflect the role that rising oil prices played in the company's extraordinary earnings last year? William R. Howell, chairman emeritus of J.C. Penney and chairman of Exxon Mobil's compensation committee, did not return a phone call seeking comment. Russ Roberts, a company spokesman, could not be reached.

Executives at **XTO Energy** Inc., a natural gas producer in Fort Worth, are also looking at a banner year. The company has turned in a stellar performance recently — earnings more than doubled in the first three quarters of 2005 from the same period a year earlier — and its shareholders have prospered. Shares of XTO closed last week at \$46.45, giving it a market capitalization of almost \$17 billion.

Proxy materials disclosing last year's pay at XTO have not been filed. But in November, the company said Bob R. Simpson, its chief executive and co-founder, would receive \$17 million in bonuses as well as a new salary of \$1.2 million, up from \$1 million. The company did not disclose what Mr. Simpson received in options or restricted shares.

Using previous years as a guide, those grants may be substantial. In 2004, Mr. Simpson received restricted stock awards worth \$24.3 million and four million options exercisable at just under \$25 each. His bonuses totaled \$15.5 million in 2004 in recognition of "the performance in negotiating during the first two quarters of 2004 the exceptional acquisitions of approximately \$1.3 billion in producing properties," the filings said.

Officials at XTO did not return phone calls seeking comment. But XTO's filings say its executive pay is justified by the company's top performance.

Still, tying executives' bonuses to acquisitions is not in shareholders' interests, Professor Bebchuk said. Managers already have incentives to make their companies larger, he explained: bigger companies usu-

ally mean larger pay and perquisites for those at the top. And if their acquisitions truly create value, executives holding a significant amount of the company's stock will profit from higher share prices.

"From the point of view of the shareholder, an acquisition is beneficial only if the shares go up," Professor Bebchuk said. "If executives already have incentives that reward them for increasing the stock price, having an extra increase for doing an acquisition can have the perverse effect of encouraging an acquisition that may not be value-increasing."

**O**f course, if the overall market for an industry declines, managers stand to lose when their pay is tied to their company's earnings or stock price. But the risks of this are far outweighed by potential rewards, Professor Bebchuk said.

For starters, the stock market tends to rise over time, producing positive returns more often than negative. And even if up and down moves are equally likely, Professor Bebchuk argued, executives with stock options are more likely to win. As he noted in his book: "At worst, negative shocks would make the managers' options worthless. On the other hand, positive shocks can boost the value of options by an unlimited amount."

Shareholders who are enjoying their gains on energy stocks might think it chintzy to complain about executive pay. But compensation committees who pay managers because an exogenous event or trend propels their results into the stratosphere are breaching their duty to shareholders. Pay should be adjusted to account for right-place-right-time windfalls — especially since executive pay never seems to decline, even in rocky times.

It has long been a stock market axiom that a rising tide lifts all boats. But today's sea, alas, has become two-tiered. While a rising tide does lift shareowners' boats, those of the me-first managers float far higher. □



Chip Somodevilla/Getty Images

Lee R. Raymond was Exxon Mobil's chief executive in 2005, the year of soaring oil prices and record earnings. Now, how big will his bonus be?

The New York Times

# SundayBusiness

Sunday, July 9, 2006

GRETCHEN MORGENSEN

## *Is ‘Total Pay’ That Tough To Grasp?*

THE Business Roundtable published an 11-year analysis of pay practices at 350 of the nation's largest companies last week, aiming, it said, to set the record straight on executive compensation. Care to guess what this lobbying organization representing 160 chief executives of top United States companies concluded? That pay dispensed to those in the corner office is entirely justified by growth in the shareholder returns at the companies they run.

Using the roundtable's figures, chief executives' compensation — up only 9.6 percent annually from 1995 to 2005 — has not even kept pace with total stockholder returns of 9.9 percent at the companies the executives stewarded during the same period.

"We wanted to try and promulgate a consistent set of facts because a lot of what we have seen in the media on executive pay we felt was misleading," said Thomas J. Lehner, the roundtable's director of public policy, in an interview last week.

It sure is a relief that we can cross off greedy executives from our list of what's ailing America.

But wait. A closer look at the roundtable's data shows that it omitted a tidy pile of pay from its calculation. The study's figure for "total" executive compensation is anything but that.

Brian Foley, an expert in executive compensation who runs his own independent firm in White Plains, examined the roundtable analysis. "It really is disingenuous," he said.

For starters, the total pay figures exclude dividends paid to executives on their restricted stockholdings — not an inconsequential figure, in many cases.

The total shareholder return to which the roundtable compares executive pay does, however, include dividends. Apples and oranges.

The roundtable study also excludes what executives have made by cashing in stock options and restricted stock over the 11 years — enormous numbers, in many cases. Instead, the study counts only the value of the options and restricted stock received by the 350 executives on the dates the

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awards were made. Hide and seek.

If the stocks underlying these options fell after they were granted, of course, the executives would not have received any value from them. But because the study covers 1995 through 2005, it's a fair guess that executives at these companies exercised boatloads of options and banked huge gains. Ditto for restricted shares.

That the roundtable doesn't consider options and restricted shares to be real money is reminiscent of Silicon Valley executives arguing that options shouldn't be accounted for as an employee cost because their precise value was hard to calculate. Cute, but not credible.

Pension benefits, deferred compensation and money received in severance packages — serious lucre all — are also missing from the roundtable's calculation. Finally, the study's total pay figure includes only the targeted value of all other performance-based cash or stock awards granted executives, in addition to the options and restricted stock already considered. These values, of course, can be much lower than what companies actually dispense. Shell game.

"I can understand why somebody might want to go with that pay-and-performance statistic because the way you control the debate is to control the statistic," Mr. Foley said. "But at a minimum don't you have to go side-by-side with actual numbers? The typical C.E.O., like the typical American worker — when you ask him how much money he earns, he is going to focus on what is either banked or bankable, not on some projection."

Frederic W. Cook, the founding director of a compensation consulting firm based in New York, who is considered to be an authority on executive pay, produced the roundtable's study. He used numbers provided by Mercer Human Resource Consulting, a unit of **Marsh & McLennan**.



Susan Stava for The New York Times

Brian Foley, an expert in executive compensation, was critical of a Business Roundtable analysis of pay practices at big companies.

Asked why he excluded dividends on restricted shares from his analysis, Mr. Cook conceded that it did make for an apples-and-oranges comparison. But they were excluded, he said, because not all companies pay them, and because those that do, don't disclose them. He offered a similar rationale about his exclusion of pension, severance and deferred compensation amounts from his analysis: such figures are not found in proxies, he said, so he couldn't include them.

As for using a target instead of an actual value on performance-based awards, Mr. Cook said: "We certainly weren't trying to make the number higher or lower because if the typical plan is three years, the target has a little bit of stretch in it, like a bonus: sometimes it earns more and sometimes less."

Why exclude the mountains of cash generated by executives' stock option exercises over the 11 years? "It's flawed to look at realized gains because they most often represent years of grants," Mr. Cook said. "We

felt the critics of executive comp were falling into the trap of using the big gain numbers, which could represent grants earned over multiple years."

But given that the analysis is over 11 years, it seems odd to exclude gains for this reason. Wouldn't amounts earned in big years even out with those earned in smaller ones?

Given all these omissions, how can Mr. Cook contend that total C.E.O. pay has lagged behind shareholder returns? "I felt it was a fair correlation, based upon the S.E.C. requirements as they now exist," he said.

This is not the first time that Mr. Cook has trotted out these numbers as evidence that executive pay today is both fair and fitting. They were also the basis for his testimony last May before a House Financial Services Committee hearing on executive compensation. "The media has been flooded with a multitude of distorted, misleading and oftentimes erroneous statistics to portray U.S. C.E.O.'s

and board governance in a negative light," Mr. Cook said in his testimony. The roundtable recycled those exact, thunderous words in its study last week.

Roundtable members have quite a dog in this executive compensation hunt, of course. The organization's chairman is Hank McKinnell, the chief executive of **Pfizer**, who will receive an \$83 million pension benefit from his company even though its shareholders have suffered losses since he took the helm.

Another knight of the roundtable is Robert L. Nardelli, the \$245 million man atop **Home Depot**, a company whose stock has declined during his term as chief executive. Mr. Nardelli, who ran his company's annual meeting this year like a prison camp commandant, is also chairman of one of the roundtable's task forces: the Partnership for Disaster Response.

Mr. Lehner, who declined to say how much the roundtable paid Mr. Cook for his analysis, said the study was started three or four months ago. That was right around the time that Mr. McKinnell became the target of shareholder outrage over the munificent pay he has received as Pfizer's performance declined.

Despite its claims of setting the record straight on executive compensation, the roundtable's analysis does exactly what it has accused pay critics of doing: picking and choosing numbers to bolster their views. That's fine. Even expected. But will it be the last word?

Not a chance. □

The New York Times

# SundayBusiness

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GRETCHEN MORGENSEN

## *Options Fiesta, And Investors Paid the Bill*

**B**UYING high and selling low is nobody's idea of a get-rich-quick scheme. But that is precisely what companies do — with their shareholders' money — when they bestow stock options on executives and employees and then buy back shares to offset the grants.

When companies then backdate those option grants to secure a lower price for the lucky people getting the options, they have essentially used stockholder money to buy high and sell *even lower* than their filings had previously disclosed.

Much of the recent discussion about backdating has centered on its inequity and its basic cheesiness. Outside shareholders, after all, do not get to change the terms of their stock purchases to manufacture the lowest possible price. Do-overs that sweet seem to be only in the purview of insiders.

But backdating is not a victimless crime. There is already a cost associated with unaltered options grants and for many technology company shareholders it has been high. Backdating only adds to the price tag.

Now that accounting rule makers have required companies to deduct options' costs from revenue, as they do for other employee expenses, options' effects on corporate income statements have become clearer. But you can also weigh option costs another way — by analyzing how much money companies must spend to buy back shares that the granting of options creates. Amounts spent on these buybacks keep share counts from ballooning too high, but also reduce a company's net worth (or what investors — the company's real owners — like to refer to as shareholders' equity).

Companies don't like it when their option programs are described in these stark terms. A tough analysis of the Altera Corporation's high-cost buybacks was behind its retaliation last July against Tad LaFountain, a technology stock analyst then at

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**Sell shares low  
and buy them  
back high.  
Does this  
make sense?**

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Wells Fargo Securities. Altera, a semiconductor maker, stopped talking to Mr. LaFountain because he rated the company's stock a sell.

A primary reason for his pessimism was his view that Altera's stock buybacks were a poor use of shareholder money. And a great deal of money it was. Altera's most recent annual report stated that between 1996 and the end of 2005, it had repurchased 86.6 million shares at a cost of \$1.8 billion. That averages out to \$20.78 a share. The stock closed Friday at \$17.34.

**A**t the same time that Altera was buying back its shares in the open market, it was selling shares to its employees — through option grants — for far less. Last year, for example, Altera paid \$18.58 on average to buy back 20 million shares. When employees exercised options in 2005, Altera received only roughly half that amount — \$9.32 a share on average. In other words, Altera and its shareholders swallowed a 50 percent hit on shares the company purchased to maintain its lush options program — while Altera employees and executives who sold stock after exercising options pocketed that lucrative difference.

The figures are similar in earlier years. In 2004, the company paid \$21.36 on average to repurchase stock while receiving \$7.01 a share, on average, from employees exercising options. And in 2003, Altera paid \$19.17 a share in buybacks versus the \$6.23 on average that it received.

Some \$155 million in shareholder money has gone down this particular drain at Altera over the last three years. That translates to about 22 percent of the company's net income during that period. That's real money and Altera's shareholders are all the poorer for it.

Mr. LaFountain, who is no longer

an analyst, offers a simple explanation for why this occurred at Altera and other companies. "The whole reason for this vehicle," he said in an interview last week, "is it is a way of channeling excessive amounts of shareholder wealth to the insiders."

An Altera spokeswoman declined to comment. Regulators are scrutinizing its options grants for possible backdating; the company has said it will have to restate 10 years of financial figures as a result.

The stock option arithmetic at other companies is similarly eye-opening. Since 2003, for example, **Affiliated Computer Services**, an information technology company in Dallas, has purchased 22 million shares at an average price of \$50.27 each. In fiscal 2004, the company's shareholders paid \$49.57 a share to cover buybacks. Yet the shareholders received just \$16.46 a share from employees exercising their options in 2004. Last year, the company paid \$50.95 on average to buy back shares; it received an average of \$19.24 a share from employees exercising options. Over all, Affiliated's shareholders paid almost \$130 million to buy high and sell low — the equivalent of 13.5 percent of the company's net income.

And shareholders at **Broadcom**, a semiconductor company in Irvine, Calif., last year paid on average \$42.12 a share, presplit, to buy back 3.6 million of its shares. They received just \$21.09 a share on average from option exercises. Buying high and selling low cost Broadcom's shareholders \$77 million in 2005. Broadcom has also said it will have to restate its financial results; depending on how much backdating accompanied its options grants, the cost to shareholders will rise.

There's something wrong with the idea of using shareholders' money to turn corporate insiders into multi-millionaires. Wasn't it supposed to be the other way around? □

The New York Times

# SundayBusiness

Sunday, August 20, 2006

GRETCHEN MORGENSEN

## *Belated Apologies in Proxy Land*

LET us now praise a mutual fund company that actually voted in its customers' interests when casting annual proxy votes this spring. And let us now rebuke the corporate executives who didn't bother responding to letters from the fund company's chairman detailing its views.

August is the month when mutual fund organizations file their proxy votes with the Securities and Exchange Commission. These votes reveal whether fund organizations are putting their own interests ahead of their clients' by supporting company practices that are

shareholder-unfriendly.

Not all fund companies have filed their votes yet. One group that has is Putnam Funds, the big fund company that is a unit of **Marsh & McLennan**. Putnam's independent trustees, headed by John A. Hill, have analyzed their funds' votes at 1,150 annual meetings held by United States companies this year. They opposed directors in 16 percent of elections and voted against 64 percent of proposals by these companies to adopt or amend stock option or restricted stock plans for company executives or directors.

Putnam's board, in other words, did the right thing for its shareholders. And it did so regardless of whether the votes jeopardized other money management services, like 401(k) administration, that Putnam provided to the companies whose plans or directors they opposed.

"The trustees are dedicated to promoting strong corporate governance practices and responsible corporate action at companies in which the Putnam Funds invest," Mr. Hill said. "I don't think institutions and funds have been aggressive enough on this. I think the culture

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is changing and we are a part of the change."

Putnam has seen its share of problems and questionable practices in the past, including improper trading by some of its own fund managers. Taking a pro-shareholder approach, Mr. Hill is earning back investor trust.

The policy and nominating committee of the Putnam Funds' board devoted a good deal of time to developing its governance criteria and applying them to proxy votes, Mr. Hill said. Putnam's focus has been on director independence, executive compensation, and shareholder proposals that have been approved by a majority of owners but have still not been put into effect by companies.

On compensation, Putnam's trustees study each company in which its funds own shares; if a proposed stock option or restricted share plan would add more than 1.67 percent to a company's existing shareholder base, they vote against it.

This benchmark is far lower than that of other major fund companies. Proxy voting guidelines at **Fidelity**, for example, state that it will vote against stock plans that would dilute existing shareholders' stakes by more than 10 percent at big companies and by more than 15 percent at smaller ones.

"People in corporations think ours is an overly tight restriction," Mr. Hill said, "but we continue to think it makes sense."

This year, Putnam's board also began writing letters to companies, explaining why it viewed their compensation policies as inappropriate. Representing the board, Mr. Hill wrote to



Kate Cosby for The New York Times

**John A. Hill of Putnam; he wrote letters and kept awaiting answers.**

the chief executives of **Countrywide Financial**, the big lending concern; **Herley Industries**, a military contractor that was indicted earlier this year by the Justice Department, accused of overcharging the government; **Home Depot**, the home improvement retailer; **Jones Apparel**, a clothing maker; and **Pfizer**, the nation's largest drug company.

Mr. Hill sent the letters in May, June and July, after voting. He said the board wanted the executives to understand the fund company's stance and to engage them in dia-

logue. "I thought we would hear from all of them," he said.

Dream on. Until last Thursday, Mr. Hill had yet to receive a single response. Not one of the five hired hands at the companies wrote back to an entity that represents thousands of their hard-working, hoping-to-retire-someday owners.

It has become clear in recent years that many companies care little about their shareholders. But disdain? That's a new one.

So what happened on Thursday? This reporter began asking all five companies why their chief executives had not responded to Mr. Hill's letters. Immediately, Mr. Hill's phone began ringing off the hook.

An investor-relations official at Home Depot called Mr. Hill's assistant to say that she was not aware that a response to the letter was expected. But at 8:18 a.m. Friday, Robert L. Nardelli, Home Depot's chief executive, called Mr. Hill to apologize for not responding to his letter and for having to learn from a reporter that he had not responded.

Another Home Depot spokesman said that company officials met with Putnam portfolio managers in June and discussed corporate governance. The funds did not voice concern over Mr. Nardelli's failure to respond to Mr. Hill's letter, the spokesman said.

And at Pfizer, officials said a response to Mr. Hill was drawn up, reviewed by Pfizer management and approved by the board. It was "prepared for mailing and we believed the letter had been sent," a spokesman said on Friday. The company also said it apologized to Putnam and has "now sent the letter."

A Jones Apparel spokeswoman

said the company had no record of having received a letter from Putnam. Now that it has been brought to the company's attention, she said, it plans to answer it.

Officials at Countrywide and Herley did not return phone calls.

Shareholders are accustomed to getting the silent treatment from United States companies, said Colin S. Melvin, director of corporate governance for the **Hermes Group**, which manages Britain's largest pension and has \$100 billion in assets. His organization votes proxies at 3,500 companies worldwide. "In all cases where we oppose resolutions proposed by company management we contact the company to let them know what we're doing," he said.

Companies based in Britain "will invariably answer letters we send to them and seek out our opinions ahead of time," he added. And in the United States? "We do from time to time hear back," he said, "but they are generally less responsive."

**M**R. MELVIN said that United States laws and practices made it more difficult for shareholders to work with companies to improve governance. First, shareholder proposals that win a majority of support at British companies must be put into effect; such proposals in the United States can be — and are — routinely ignored by management. And directors can actually lose elections in Britain, which they cannot do here.

"Globally, the U.S. is probably one of the most difficult environments to work in," Mr. Melvin said.

But companies care about their shareholders, we are told. Ours is the ownership society, after all.

Sure. And the customer always comes first. And your call is important to us. □

# The New York Times

# SundayBusiness

Sunday, October 8, 2006

GRETCHEN MORGENSEN

FAIR GAME

## *Fidelity, Staunch Defender of the Status Quo*

**O**VERSEEING more than \$1 trillion in investor assets, **Fidelity Management and Research** has the crucial job of casting hundreds of thousands of votes on its clients' behalf at annual shareholder meetings each year. Those votes — more than 350,000 in the most recent 12 months — give the nation's largest mutual fund company great power over corporate executives and directors.

How Fidelity uses that clout, which derives from other people's money, is a question that can only be answered each fall, after Fidelity files its proxy votes with

regulators and posts them on its Web site.

It is not easy to plow through those votes. But it is an important exercise for any client who wants to know whether Fidelity is using his or her investment stake to simply maintain the status quo in the boardroom — or instead is advancing shareholder issues like executive and director accountability and executive pay.

Alas, data for the 12 months ended June 30 show that Fidelity likes things just the way they are: cozy, with no apple carts tipped. Fidelity sided with corporate management and directors in 92.5 percent of its votes

and supported 99 percent of the directors whom management nominated. On shareholder proposals intended to give investors more say in board elections or to limit executive or director pay, Fidelity repeatedly voted "no."

"Generally, the idea is to vote along the line of what we think best serves the shareholders' interests," explained Robert M. Gates, chairman of the independent trustees at Fidelity, who oversee the proxy voting. "If you have a majority independent board at a company,

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then it is really up to the board to decide what's in the shareholders' best interests on the issues."

While Fidelity's clients may or may not agree with Mr. Gates that most of corporate America is operating in the best interests of its stockholders, Fidelity, the fund giant based in Boston, certainly voted its investors' shares as if that were the case.

For example, Fidelity voted against a shareholder proposal at **Prudential Financial** that would have required shareholder approval for executive severance payments exceeding 2.99 times that person's salary and bonus. The fund company sided with management, which said its severance plans were appropriate.

Fidelity also voted against proposals at **Newmont Mining, Raytheon and Union Pacific** that would have required separating the positions of chairman and chief executive at the companies. And the fund giant opposed proposals that appeared on the ballot at a throng of companies — including **Wal-Mart Stores, Wyeth, Verizon Communications, Occidental Petroleum and KLA-Tencor** — that would have required directors to receive support from a majority of shares cast to win election.

All of these proposals were supported by Glass, Lewis & Company, an independent proxy advisory service in San Francisco. So-called majority-vote proposals received considerable support from shareholders in 2006 and many companies have adopted such measures.

"It is disappointing that there is such consistency in the way that mutual funds vote with management more than 9 out of 10 times, even on what you would think would be basic corporate governance items like majority votes for directors," said Paul Hodgson, senior research associate at the Corporate Library, an independent research firm in Portland, Me. "It's obvious that the fund managers are not asking nor listening to, if they get any answers, the way that other individual shareholders or concerned institutions are voting their shares."

When asked to provide statistics on the percentage of Fidelity's total

votes that supported management on proposals or director nominees, Vincent Loporchio, a company spokesman, declined to comment. He said Fidelity prefers to report its record in the context of the number of meetings at which it cast votes, saying Fidelity voted "contrary to one or more of management's recommended votes at 31 percent of all U.S. company meetings at which we cast votes."

It is also Fidelity policy not to discuss specific votes. But both its overwhelming support for directors and its general opposition to shareholder proposals are consistent with proxy voting guidelines posted on Fidelity's Web site.

For example, Fidelity says it will generally vote for incumbent directors and nominees except when they "clearly appear to have failed to exercise reasonable judgment." It also says it typically opposes majority-vote proposals for directors.

Fidelity will oppose anti-takeover provisions proposed by management, moves to increase a company's stock by at least three times the amount outstanding, and stock plans that dilute existing shareholders' stakes at large companies by more than 10 percent over the life of the plan, among other things.

That Fidelity sides with corporate executives on many governance issues does not surprise some shareholder activists, who point out that the company generates enormous profits as an administrator or trustee of corporate retirement plans. That may put Fidelity in the position of trying to serve two masters.

And even though escalating executive compensation disturbs many shareholders, it may not concern Fidelity's well-paid fund managers and wealthy executives. With a net worth of \$7.5 billion as estimated by Forbes magazine, Edward C. Johnson III, Fidelity's chief executive, may not be as worried as other Americans about outsized executive pay reducing his retirement account returns. Nevertheless, Fidelity's pro-management stance troubles some who say the firm is abdicating a crucial watchdog role in boardrooms and corner offices across America.

"We expect money managers to think and vote like interested owners of the shares they manage," said

Frederick E. Rowe Jr., president of Investors for Director Accountability, a shareholder group in Dallas. "Sadly our experience is that most money managers seem to think and vote their own somewhat conflicted interests as money managers. Fidelity is no exception."

Mr. Loporchio, the Fidelity spokesman, denied that conflicts play a role in the company's votes. "The guidelines require that all voting be done without regard to any other Fidelity companies' relationships, business or otherwise, with that company," he said in a statement. He said Fidelity voted against the management of "key clients" more often than it did against "non-key clients."

Mr. Gates of Fidelity's trustee group said the company voted against 30 percent of management proposals this year at corporations that are retirement account clients. He added that Fidelity's board of trustees revised its proxy guidelines in February to address potential conflicts of interest that its huge retirement account operations might pose.

Fidelity now requires its independent trustees to monitor any vote that departs from company guidelines and involves a client of the firm's retirement account operations.

Fidelity voted against management most often on proposals involving employee stock compensation plans, he said. "My recollection is they voted against 55 percent of the proposals last year and that number would have been more like two-thirds but Fidelity entered into negotiations to persuade the companies to conform to our guidelines," he said.

As chairman of the Fidelity trustees, Mr. Gates monitors 328 funds and was paid \$373,000 last year, according to regulatory documents. He juggles fund oversight with his job as president of Texas A&M University.

He is also a director at **Nacco Industries Parker Drilling** and **Brinker International**. He was director of the Central Intelligence Agency from 1991 to 1993 and joined Fidelity's board in 1997.

Some money managers say that it is only appropriate to side with management of companies whose shares you own and believe in. And they say that it is not a money manager's job to try to run the companies they own.

But fund managers have a fiduciary duty to put investor clients' interests ahead of their own. And a troubling sign of Fidelity's approach to this duty emerged at a private meet-

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## **Fidelity votes with management 92.5 percent of the time.**

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Associated Press

Robert M. Gates, chairman of Fidelity's independent trustees.

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ing last May among financial firms and members of Congress; it was held after a hearing of the House Government Reform Committee's subcommittee on regulatory affairs. According to two participants at the meeting, proposals were discussed that would weaken the Sarbanes-Oxley law, which requires companies to have adequate internal controls and make executives accountable for financial disclosures.

**M**ANY corporations have been critical of the law since it was enacted in 2002. According to the two participants at the May meeting, Fidelity's representative was willing to go along with efforts to water down Sarbanes-Oxley — if, in exchange, the fund company would receive an exemption from a section of the law, known as 302, that requires chief executives to attest to the reliability of their companies' financial reports. Fidelity has long objected to this provision, arguing that such certification is onerous and unnecessary because the mutual fund industry already has laws that monitor corporate governance issues.

Calling this account of the meeting inaccurate, Mr. Loporchio said: "We have had concerns about the requirement that thousands of mutual fund filings be certified. We have otherwise taken no position on the certification requirement related to public companies."

Nothing was decided at the meeting. But it would sure be disappointing if the nation's largest fund company was on board for weakening this pro-investor law. □

# SundayBusiness

Sunday, December 24, 2006

GRETCHEN MORGENTON

FAIR GAME

## *A Lump Of Coal Might Suffice*

**H**ERE'S hoping that Hank McKinnell, the former chief executive of Pfizer, chose a giant Sequoia for his Christmas tree this year, because there is no way he could fit the \$200 million gift that his old board gave him a few days ago under a mere Fraser fir.

Since Pfizer dumped Mr. McKinnell last July, we have been awaiting the details of his severance arrangement. We guessed it would be dizzying — his pension alone had been estimated at \$83 million.

But after the company said late last Thursday that the terms of the package would soon emerge — on a day when shareholders, distracted by holiday shopping, might not notice — we knew the amount would be odious.

Here's how Mr. McKinnell's \$200 million package adds up. First is his pension of about \$6.65 million a year for as long as he lives. The company estimates its value at \$82.3 million. Sweet.

Next comes \$78 million in deferred compensation, which includes \$67 million in pay that Mr. McKinnell has set aside over the years. Then there is an estimated \$18.3 million in performance-based

shares. Given Pfizer's recent results, perhaps it would be more accurate if these were identified as failure-based shares.

Tack on \$12 million in severance, vested stock grants worth \$5.8 million and a \$2.15 million bonus and Mr. McKinnell has all the makings of a very, merry Christmas. But that's not all.

Mr. McKinnell, 63, also received \$576,573 worth of medical, dental and life insurance as well

as the unspecified value of continued medical and dental coverage under Pfizer's retiree plans for him and his partner, Joanna Slonecka. Included in this pot is the cost of financial counseling programs. (Maybe he can dip into that amount to help line up some therapy for Pfizer's board.)

The most curious figure of all, though, is \$305,644 — rounded up to the nearest dollar, presumably — that represents the value of Mr. McKinnell's unused vacation days.

**Reminded  
again that  
performance  
and pay are  
not always  
linked.**

"The Pfizer board of directors has been inept," said Frederick E. Rowe Jr., a money manager in Dallas and president of Investors for Director Accountability, a grass-roots organization that organized a vote against directors at Pfizer's shareholder meeting last April. "Over a long period of time, it has obligated Pfizer shareholders to pay Mr. McKinnell staggering sums for continuous, unmitigated failure. This is nothing other than a betrayal of Pfizer employees and shareholders."

Paul Fitzhenry, a Pfizer spokesman, said Friday that the payouts to Mr. McKinnell were the

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company's obligation under an employment contract struck in 2001 when Pfizer shares were at \$46, far above the \$25.97 at which they closed on Friday.

"The stock had risen more than tenfold over the preceding 10 years and Hank McKinnell played a large role in increasing Pfizer share value during that period," Mr. Fitzhenry said. None of Pfizer's directors, including Mr. McKinnell, were available to discuss the exit package, Mr. Fitzhenry added.

According to the regulatory filing that outlined Mr. McKinnell's take, the package was priced as of Dec. 13 and his resignation letter was signed Dec. 18. But the company waited until late on Dec. 21 to file the terms of the deal with the Securities and Exchange Commission.

The \$200 million that Mr. McKinnell walked away with is also indicative of how much executive compensation can remain hidden from shareholders' ken. Recall that Pfizer has prided itself on being an enlightened corporate champion of full disclosure and transparency; its proxy statement last year provided significantly more details on pay than is typical.

Still, that proxy was silent on the \$78 million in deferred compensation owed to Mr. McKinnell. This means shareholders can assume that the amount and nature of what was under wraps at Pfizer is not an exception but rather the rule across corporate America.

Mr. McKinnell's \$200 million is even more disturbing when put next to the roughly \$137 billion in market value that vaporized on his watch. That Mr. McKinnell forced his shareholders to pay \$305,644 for his unused days off after draining them of \$137 billion is downright stupefying.

But this is how too many leaders behave in 2006. They give large numbers of pink slips to employees. They create really big losses for their shareholders. But they make sure they chisel the company's owners for every nickel and dime, including dental coverage, unused vacation days and financial counseling programs.

Contrast Mr. McKinnell with James E. Burke, the former chief executive of **Johnson & Johnson**, who led that company through the Tylenol crisis of 1982, when every bottle of the medicine had to be recalled after seven users were poisoned in Chicago. The brand not only survived, it thrived. And Johnson & Johnson went on to become the dominant health care company in the United States.

Back in 2003, Mr. Burke was honored by Harvard Business School, his alma mater, with an Alumni Achievement Award. "Remember that being a business leader is about giving — not taking," Mr. Burke said



Stephen Chernin/Getty Images

Pfizer's shareholders did not do so well under Hank McKinnell's leadership. But Hank McKinnell did quite well.

in an interview at the time, which is archived on the school's Web site. "We've corrupted the system by hiring boards of directors that feel beholden to the C.E.O.," Mr. Burke said, adding that business executives need to "recreate a trust agenda."

Mr. Burke's views resonate even now, three years later, but the lessons were clearly lost on Mr. McKinnell. And Mr. Burke's thoughts are especially meaningful given that many executives are lobbying hard in Washington and elsewhere to recreate the pre-Enron "trust me" agenda.

At least there is this: while Mr. Burke is recognized as one of the greatest business leaders of all time, Mr. McKinnell will go down in history as something else: the quintessential me-first executive, mismanaging the company and then wringing from his shareholders every penny possible on his way out.

Lest Mr. McKinnell's accomplishments be forgot, Mr. Rowe said Investors for Director Accountability has decided to create an annual prize, beginning in 2007, to recognize the public company board that has enabled the most self-serving performance by a chief executive in America. It will be called the McKinnell Award. Stay tuned to see who the recipient is.

In the meantime, Merry Christmas, Hank. From the shareholders who lost \$137 billion on your watch and the workers who will lose their jobs because of your stewardship. We hope you enjoy the money piled under your tree.

Every last nickel. □