

The Top Stories of 2007 in Executive Compensation

By Jack Dolmat-Connell

Introduction

2007 brought some remarkable stories to the executive compensation forefront. From CEO severance payouts, to shareholder activism through “say on pay”, to women Board members earning more than their male counterparts, this past year in the executive compensation landscape saw abundant action on the news pages. DolmatConnell & Partners has revisited the year, and our 2007 highlights are:

- Home Depot’s Bob Nardelli
- The Subprime Mortgage Scandal and CEO Fallout
- United health CEO Pay Back
- Compensation Consultant Independence
- Say on Pay
- New (Better?) Proxy Disclosure
- CFOs Exempted from Section 162(m) deductions
- Women Board Director Compensation

Home Depot's Bob Nardelli

Early in January 2007, Home Depot's CEO Robert Nardelli resigned under a mutual agreement with the company over a conflict regarding his hefty annual compensation packages. Nardelli had purportedly refused to take major cuts in his pay or to link his pay with shareholder gains. On his way out, Nardelli successfully negotiated a whopping \$210 million retirement package despite his overall less than stellar performance during his six-year tenure at Home Depot. Conflicts arose with his leadership style and high executive turnover. Rep. Barney Frank (D-MA) responded to Nardelli's severance package by saying that it "is further confirmation of the need to deal with the pattern of CEO pay that appears to be out of control." While Nardelli's case is an outlier in the field of severance pay, this story created a huge media blitz and added to widespread perception of out of control CEO pay.

The Subprime Mortgage Scandal and CEO Fallout

The far-reaching consequences of the subprime mortgage losses have extended to executive pay. In the face of a \$9.4 billion loss due to subprime mortgage-linked investments, Morgan Stanley CEO John K. Mack did not receive a bonus for 2007. Mr. Mack has seen his compensation plunge from almost \$40 million in 2006 to \$800,000 in 2007, one of the largest decreases in payment that severely punishes him financially but falls just short of firing him.

Even more substantial are the CEO departures caused by the subprime failure. CEO Charles Prince III left Citigroup in November 2007 after Citigroup realized between \$8 and \$11 billion in losses connected with subprime mortgage investments. Citigroup now is faced with a shareholder suit that alleges that the company and its executives "recklessly purchased subprime loans to be used for future collateralized debt obligations." Prince received no severance pay but left the group with benefits (mostly in deferred stock and restricted stock) valued around \$29.5 million. E. Stanley O'Neal of Merrill Lynch left in October 2007 with again no severance pay but benefits valued at \$161.5 million. Merrill Lynch was hit with an \$8.4 billion third quarter loss related to their subprime investments.

The market is flailing in connection with the subprime fallout and the economy could be headed for a tailspin, but certain executives still walked away with money lining their pockets.

UnitedHealth CEO Pay Back

Minnesota-based UnitedHealth Group Inc. was one of the largest companies embroiled in the stock option backdating scandal. Under former CEO William McGuire's watch, UnitedHealth executives were granted stock options where the grant dates were changed to give an optimally low stock price to allow executives to reap more rewards upon award exercise. In a surprising turn this year, Mr. McGuire agreed to surrender around \$198 million upon his resignation in light of the backdating scandal, and then further agreed to surrender \$420 million in stock option claims and retirement compensation to settle "civil and federal-government claims related to stock-options backdating". Mr. McGuire's forfeiture is one of the largest pay-backs in corporate history. But no need to feel sorry for Mr. McGuire—he will still be able to keep over \$800 million in stock options.

Compensation Consultant Independence

House Representative Henry Waxman (D-CA), who is Chairman of the House Committee on Oversight and Government Reform, released a report in December 2007 that considers serious conflicts of interest by compensation consultants to Fortune 250 companies. After an extensive investigation this year, Waxman's report shows that among Fortune 250 firms, almost half were receiving other services from compensation consulting firms. The report shows that consultants that provided other services to these companies were paid nearly 11 times more for providing other services than they were paid for providing executive compensation advice. Additionally, the report states that, "[t]here appears to be a correlation between the extent of a consultant's conflict of interest and the level of CEO pay. In 2006, the median CEO salary of the Fortune 250 companies that hired compensation consultants with the largest conflicts of interest was 67% higher than the median CEO salary of the companies that did not use conflicted consultants." Proxy reports often do not clearly disclose the additional services provided by the compensation consultant, giving the false impression that the compensation consultants are "independent." The report may give momentum in 2008 and beyond for new SEC regulations or government-backed changes to executive compensation consultant independence.

Say on Pay

Blockbuster Inc. became one of the first companies this year to implement a shareholder resolution to give shareholders an advisory vote on executive pay. The resolutions, known as “say on pay” initiatives, were introduced in proxy votes at over 60 companies in 2007. So far, many companies have not achieved the necessary 50% to ratify the proposals, but other companies, such as Aflac and Verizon Communications, have implemented say on pay initiatives. The say on pay initiatives were instigated by broad-reaching groups. The House of Representatives passed a bill introduced by House Financial Services chairman Rep. Barney Frank (D-MA) that allows shareholders to introduce say on pay proxy votes. Among the most unusual say on pay advocates were the Benedictine Sisters at a Texas monastery, who as part of their mission as community stewards recently attempted to influence Coca-Cola to introduce a non-binding shareholder vote to approve executive pay each year (the vote ultimately did not pass). The increase in say on pay shareholder activism demonstrates a new willingness by companies to engage in dialogue with shareholders on the hot-button issue of executive pay. While still a small step, say on pay will take the executive pay dialogue to a more open and fair level.

New (Better?) Proxy Disclosure

The SEC’s new proxy disclosure rules caused a big wave in 2007 as the proxy season for the first time required more information about executive pay, aimed at increasing investor ability to compare managerial pay at publicly-owned companies. The new SEC rules require a Compensation Discussion & Analysis section that was implemented to clarify the “how” and “why” of executive pay, new charts showing potential payments in connection with executive terminations, and increased disclosure in relation to executive perks. But have the new disclosure rules really helped investors to better understand the mechanics of executive pay?

The new proxies have substantially increased in size, which does not necessarily reflect better information. Charts are often mired in footnotes and addendums that do not help the typical investor understand the story. The SEC has taken a leading role in enforcing changes. Pfizer Inc., recently attempted to reform its entire proxy statement to make it more accessible to investors, using color-coded and easy-to-read charts. The SEC reviewed the draft document and deemed it provided “inadequate disclosure.” Additionally, the SEC sent out around 350 letters at the end of proxy season to various companies requesting more disclosure information including specific performance targets, Peer Group information, specific rationale behind certain compensation choices, and Compensation Committee involvement in compensation decisions. The increased disclosure has revealed some new information previously unavailable, but in an attempt to provide full disclosure, companies have given complicated and unreadable information. The new proxies provide more, but not necessarily better, information to investors.

CFOs Exempted from Section 162(m) Deductions

In June 2007, the SEC released interpretive guidance for the determination of covered employees under Section 162(m) of the Internal Revenue Code. A covered employee under Section 162(m) is allowed \$1 million in deductible compensation, and anything that exceeds that amount is not deductible unless the compensation is performance-based. The covered employees under the deduction limitations have historically been the CEO and the next four highly-compensated employees at a company. However, the June guidelines from the SEC indicated that the CFO was not a covered employee under 162(m), and only the CEO and the next three highly-compensated employees excluding the CEO were subject to the deduction limitation.

This decision deviates from proxy disclosure rules, because the proxy rules require that the CEO, CFO and next three highly-compensated officers' compensations be disclosed. But Section 162(m) will not be applicable to CFOs even though CFO compensation must be disclosed in proxies. Congress may soon look into the modification of Section 162(m) to include CFOs, however, so companies should not use this transitory interpretation as a reason to change CFO compensation under the new rules.

Women Board Director Compensation

The Corporate Library's annual director pay survey included a surprising twist this year: women Board directors earn on average about \$15,000 more annually than their male counterparts. The study looked at about 25,000 directors at over 3,200 companies and found that female directors earn at the median about \$120,000 whereas male directors earn \$104,375. Women are still considered to be "diversity candidates" as Board members. Business Week reported that while 91% of S&P 500 companies have at least one woman on their average of 11-member Board, only 15% of Boards have three or more women directors. But compensation cannot be differed based on individual diversity attributes. What then is the reason for the compensation discrepancy? The Corporate Library attributes it to the fact that companies, eager to have diverse opinions across committees, assign women to more committees and committee chair positions, thereby increasing their compensation from committee fees and retainers. So while 2008 holds the possibility of putting a woman in the White House, 2007 has already shown that women have had increased leadership responsibilities in the Boardroom.

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Readers of this article may wish to use these highlights of 2007 as a starting point to gauge the relevancy and implications for their own company's situation. For example, while your company may not provide a \$210 million severance package for your CEO, you may still want to look at the levels your executive severance packages provide to decide if they are reasonable. Or you may wish to take a better look at your CD&A to ensure that it is in compliance with SEC expectations. For further information on any of these stories and how the implications may affect your company, we invite you to contact us at dcinfo@dolmatconnell.com.



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