CEO Pay Goes for the Platinum Helicopter

High-flying executives' remuneration is back on the radar in the US after a $266 million payday

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WITH a share price 8 per cent below what it was five years ago, and sales down 5 per cent on last year, it might not seem surprising that the chief executive would get the chop. But what shook the company, and the market, was the size of the farewell present: $US210 million ($266 million).

Robert Nardelli has been the poster child for excessive executive remuneration for some time. His departure from Home Depot, America's second-largest retailer, is now a case study in CEO Lotto.

As one union official was quoted as saying: "I wouldn't even say golden parachute. I would say platinum helicopter."

Despite the declining financial indicators, it was an argument over his pay that finally ended his career at the big-box (think Bunnings warehouses) retailer.

Nardelli's package had long been a lightning rod for criticism. In his five years in the job, he had drawn $US63.5 million in salary and bonuses, which included $US21 million in forgiven loans. Home Depot even paid his taxes. His previous year's compensation was $US37 million. Only $US2.1 million was salary; the bulk was options and restricted stock.

Home Depot had handled the criticism of his package with a disastrous annual general meeting in Delaware last May.

There were none of the usual presentations and questions from shareholders; indeed, none of the directors other than Nardelli turned up, citing more important matters back at the company's headquarters in Atlanta. The meeting lasted 30 minutes, with the microphone for shareholders cutting off if they spoke for more than one minute.

An embarrassed board apparently wanted to head off another showdown this May by renegotiating Nardelli's package. Accounts of the negotiations differ: some say he was willing to give up his guaranteed $US3 million minimum bonus, some not. But he was certainly unwilling to give away the most lucrative features of his contract - his pension or share options.

Given the board and Nardelli eventually decided to part ways, you can see why he would be reluctant to give away his passport to America's super-rich class.

And, in his defence, his performance was not as bad as it may appear at first. Under his tenure, overall sales almost doubled and gross operating margins improved. As he boasted, Home Depot was one of only two companies in the Dow Jones index to record more than 20 per cent growth in earnings per share for four consecutive years.

The problem with the share-price measure of his performance is that the company was vastly overvalued when he arrived. Swept up in the sharemarket boom, investors had bid the company share price to 46 times earnings - a ridiculous figure for a mature retailer.

Although there has been outrage at Nardelli's $US210 million payout, the problem lay with the contract negotiated when he joined Home Depot in late 2000.

Home Depot doesn't offer its employees defined-benefit pensions, instead offering Australian-style superannuation contributions. But Nardelli had a defined pension written into his contract, to compensate him for forgoing benefits he would have received at his previous employer, General Electric.

The $US210 million included $US180 million that was part of his sign-on package, including $US77 million in unvested deferred stock awards, $US44 million in vested deferred shares, $US32 million in retirement benefits and $US9 million in earned bonuses.

His departure was greeted with near-rapture by staff, and approval from customers, Wall Street analysts and shareholders (though not about the truckload of cash he left with).

For Nardelli was a man deeply disliked - arrogant, dismissive, the antithesis of a people person.

He was a protege of the legendary Jack Welch at General Electric - but apparently not of the Dale Carnegie school of how to win friends and influence people. He had attempted to change Home Depot's culture of giving individual store managers autonomy, got rid of experienced full-time employees in favour of cheaper part-timers, and driven out almost all the old management. *BusinessWeek* reported that 98 per cent of the company's top 170 executives had gained their positions in the past five years; more than half had come from outside, often from Nardelli's old firm, GE.

No wonder the staff called him Home Despot.

The housing downturn didn't help the company, and Wall Street was unconvinced by Nardelli's move into wholesale supply. Customers said there weren't enough staff and the ones they found didn't know enough to help them.

Home Depot's rival Lowe's prospered, thanks in part to better, newer stores that appealed to female buyers.

It didn't help that Lowe's paid its chief executive a third of what Nardelli was getting, and that its share price was rocketing.

Nardelli's pink slip (should that be golden slip?) is not the only problem for Home Depot. After an internal investigation, the company admitted that for 19 years, until 2000, it had backdated share options for its executives, in the process understating expenses by $US200 million.

Home Depot is one of more than 100 companies that have been caught up in a scandal about backdating of options. The scandal has claimed 18 CEOs so far.

The highest-profile chief executive in the cross-hairs is Steve Jobs, the oracle of Apple. An internally commissioned investigation found he was aware of the grants but did not benefit financially from them.

There may be a link between this backdating and excessive executive remuneration.

Professor Lucian Bebchuk, director of the Harvard Law School's program on corporate governance, has studied the granting of backdated options and excessive executive pay. He found that both were linked to governance problems in companies. In a study with Yaniv Grinstein called *Lucky CEOs*, Bebchuk found that so-called lucky grants of options - those where backdating had not been proved, but where the options were granted on a day when the share price was low - were linked to companies where the board lacked a majority of independent directors.

Bebchuk is a noted critic of American executive remuneration. In his book *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (2004, Harvard University Press), which he co-wrote with Jesse Fried, Bebchuk said: "Flawed compensation arrangements have been widespread, persistent and systemic, and they have stemmed from defects in the underlying governance structure that enable executives to exert considerable influence over their boards."

Among the problems, they found that CEOs were commonly employed under arrangements that failed to distinguish between their performance and general stockmarket rises that were due to industry or market-wide trends.

The problem, they argued, was not just bad apples, or human greed. And the commonly prescribed fix of more independent directors wasn't the entire answer.

The solution was having directors who were vulnerable to shareholder revolts.

"Our analysis indicates that, to address the identified problems, directors must be made not only more independent of insiders but also more dependent on shareholders," they wrote.

In a paper titled *The Myth of the Shareholder Franchise*, published in November, Bebchuk wrote: "The power of shareholders to replace the board … is largely a myth."

Among his suggestions for change: abolish staggered board elections, so the whole board can be voted out at once; shareholders should have the right to place candidates for director on the

company's ballot; majority voting; and reimbursement of candidates' expenses for those who reach a certain threshold of support.

Once, to be incredibly rich, you had to own a company. With the rise in executive salaries, that is no longer necessary. In fact, the rise in executive salaries has shifted significant wealth from the owners of capital to the managers of it.

Bebchuk and Fried estimated that in the five years to 2002, compensation to just the top five executives in 1500 companies in the US was $US100 billion - equal to about 10 per cent of total corporate earnings, up from about 6 per cent of earnings in the five years before.

With the US stockmarket at record highs, executive pay, and the pay of professionals in the financial sector, is on the rise - and with it the perennial issue of the inequality in America.

Before Christmas, Goldman Sachs announced that its bonus pool would be increased to $US16.5 billion - an average of $US623,418 per employee.

Altogether it has been estimated that the big five Wall Street firms - Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley - will pay out between $US36 billion and $US44 billion of bonuses.

As the *New York Daily News* commented: "Goldman's numbers offer a vivid example of the growing gap between the rich and everyone else in America.

"In the city, 1.5 million people live below the poverty line of $US16,000 a year for a single parent with two kids. Goldman's bonus pool could raise each of their incomes by more than $US10,000.

"Something is wrong when one firm's bonus pool is enough to end poverty in America's largest city."

At the same time that top-tier salaries are soaring, the average American worker has failed to capture their share of the good times. Not only has there been a shift in the share of the economy from wage earners to profits, but average wages have not benefited from increased productivity.

A Washington think tank, the Economic Policy Institute, says US productivity grew 17 per cent over the five years to 2005, but the median family income, after inflation, fell 3 per cent over the same period.

The issue of executive pay is likely to become hotter in the months ahead, as the Democrats in Congress look for easy political points to score, and because of a change in disclosure rules that will require companies to reveal their executives' total remuneration, including accumulated pension benefits, deferred compensation and perks, such as use of the company jet.

Nardelli's astounding happy ending at Home Depot has raised the ire of the new Democrat-controlled Congress. The new Democratic chairman of the House Financial Services Committee,

Barney Frank, said his severance package highlighted the need for legislation requiring public companies to allow shareholders to have a say in compensation and severance for senior executives.

"Some defenders of CEO pay argue that CEOs are rewarded for increasing the stock or the overall value of the company," Frank said, "but judging by today's market reaction, Mr Nardelli's contribution to raising Home Depot's stock value consists of quitting and receiving hundreds of millions of dollars to do so.

"It's a sign of being totally out of touch. They [company chiefs] don't understand the extent to which they make the American public angry."