CEOs Under Fire

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On March 13, after meeting with President Bush, Attorney General Alberto Gonzales faced the cameras and gave his initial defense of his role in the firing of U.S. attorneys: "I believe in accountability. Like every CEO of a major organization, I am responsible for what happens at the Department of Justice."

His being a "CEO," however, didn't mean that Gonzales was responsible, exactly: "I accept responsibility for whatever happens in this department. But I have 110,000 people working in the department. Obviously there are going to be decisions made that I'm not aware of all the time." Thus, he argued, he actually shouldn't be held responsible.

Gonzales has used many arguments to justify his role in the firings, but comparing himself to a CEO was probably not the best way to win over the American public. Today, people disdain CEOs, with all their wealth and power -- even more than they did during the "Decade of Greed" in the 1980s. CEOs' reputation is so bad that they rank even lower than politicians in public opinion polls. Last year, about a month after former Enron head Jeffrey Skilling failed to convince a jury that he wasn't responsible for everything in his organization, a poll found that only 17 percent of the public expected CEOs to tell the truth. Compare that with 25 percent for members of Congress in a year marked by lobbying and sex scandals.

The deteriorating view of corporate executives emerges against a backdrop of diminished esteem for business in general. In 2007, 58 percent of Americans believe that corporations don't strike a fair balance between profits and the public interest, according to the Pew Research Center for the People and the Press. That percentage was 48 percent in 1987 and again as recently as 1999.

The rise in the public's derision toward CEOs has been dramatic. In the late 1990s, corporate execs were among the most revered people in America; people credited their entrepreneurship with helping to drive one of the most prosperous decades in U.S. history. Warren Buffet, Bill Gates, and especially Jack Welch were worshipped as geniuses. But after the stock bubble burst, the names in the news were Skilling; Bernard Ebbers of WorldCom; and Dennis Kozlowski, the former Tyco head whose company paid for a birthday party in Sardinia for his wife that featured an ice sculpture of Michelangelo's David "urinating" Stolichnaya vodka.

The focus of the public's ire is money. By any measure, CEO compensation has risen tremendously in recent years. In 1984, the head of Ford Motor, the fourth-biggest corporation in the United States, earned $7 million, or $15 million in today's dollars. In 1987, Lee Iacocca courted controversy when his compensation from Chrysler topped $20 million (equivalent to $38 million today). In 1997, the top earner was Millard Drexler of the Gap, who earned $104 million ($135 million today). In 2002, the highest earner, after inflation, was Larry Ellison of Oracle, whose pay was equal to $804 million today.

But then, controversy has often besieged the top earners. Consider Charles Wang of Computer Associates. In 2000, the year he was the highest-paid CEO in the country (with $650 million in compensation), he was forced to resign after a flurry of lawsuits accused the company's executives of falsifying their earnings.

The flood of fraud and accounting scandals that began with Enron and WorldCom in 2001 has continued for six years, sweeping through more companies and putting more high-profile executives on trial than at any time since the Progressive era of the early 20th century. Even beyond the proportionally tiny number charged with breaking the law, the indictment of CEOs is much broader. A multifront attack -- which the media has joined and some pathbreaking academic research has supported – against exorbitant executive compensation has roused some torpid investors to take action. It has also tapped into a growing public unrest with inequality in America. The contenders for the 2008 presidential election are taking note.

The accounting scandals led to the Sarbanes-Oxley securities law and other regulations that altered corporate behavior at the margins, but experts in the field say that the brewing revolt against pay-gouging could go further. Although the scandals revised the rules "and restructured the whole accounting business, these other changes are more subtle and, I think, ... more significant," said Charles Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware. For the first time in decades, Elson said, "the culture of the boardroom seems to be changing. That really didn't happen" immediately after Enron, when CEOs continued to dominate boards, Elson said. "Boards are beginning to act like owners."

So far, though, the shifts aren't huge -- a handful of companies, under pressure from investor-rights activists, have moved to give shareholders a voice in setting executive compensation, and Congress is moving toward requiring companies to take such action. Elson says, "There is a shift in most boardrooms toward real independence," even if the steps taken are not yet tectonic. "This is being backed up in the courts, which are being much tougher" about protecting investors, he said. "When you are talking about a change in culture, often you can't see that right away."

Featherweight Protest

The May 2006 meeting of Home Depot shareholders may prove to be a turning point in corporate culture. CEO Bob Nardelli had come aboard in 2000, and even though he doubled profits and revenues in five years, the stock price had sagged and shareholders accustomed to big returns were unhappy. Nardelli was one of the highest-paid executives in America, earning $37.1 million in 2005 and $245 million in actual and deferred compensation during his five years. His compensation grew fastest in the years when Home Depot produced the lowest returns for its stockholders.

Dissent and criticism from small shareholders and gadflies is a ritual that most CEOs and corporate boards grudgingly endure at annual meetings. Nonunion companies often attract shareholder activism from organized labor that stems from legitimate internal complaints but ultimately has broader goals. Union activist Richard Ferlauto went to the Home Depot meeting wearing a chicken suit and pushing a quixotic goal – allowing shareholders a nonbinding vote of endorsement on the CEO's compensation. At that point, many other companies had rejected

that idea and none had endorsed it.

Most executives submit to such annoyances at annual meetings, but not Nardelli. First, he saw to it that his hand-picked board of directors did not show up for the meeting, a move that, experts say, may have been unprecedented for a major company. Nardelli sat alone on the stage in front of two large timers that gave questioners 60 seconds to speak and then cut off their mikes. His answers were even briefer, and he effectively refused to address a single difficult question. After about 40 minutes, he ended the meeting and left the stage.

Suddenly, the man in the chicken suit had a lot of allies. In newspapers and on television, business commentators lambasted Nardelli and called for his head. Even The Wall Street Journal's opinion pages condemned the meeting. Nardelli's days were numbered, and he finally resigned in January, walking away with a $210 million retirement package, most of which his board had agreed to earlier.

Ferlauto's cause got new life. Resolutions giving shareholders a nonbinding "say on pay" were actively pushed at 20 companies and adopted at Bristol-Myers Squibb, Blockbuster, Aflac Insurance, and most recently, Verizon Communications. Similar resolutions failed by small margins at Abbott Laboratories, Boeing, and Merck. Elson believes that "say on pay" isn't a cure-all for those who want more accountability on executive pay, but he predicts that many public companies will soon adopt it. "I think it is a sign of how [corporate] culture is changing," he said.

It is a case where business is moving ahead of Congress. In the House, Financial Services Committee Chairman Barney Frank, D-Mass., won approval in April for a new "say on pay" law for all public companies, but the idea has languished in the Senate. Barack Obama, D-Ill., is sponsoring the Senate version of the bill, but Banking Committee Chairman Christopher Dodd, D-Conn. -- a fellow presidential candidate -- issued a tepid statement on May 31 saying that he was looking forward "to reviewing Senator Obama's request." Business groups are dead-set against it, and getting 60 votes to protect the bill against a filibuster seems unlikely. Even scheduling a hearing is not a sure thing.

If Ferlauto represents the (feather-covered) face of the "say on pay" effort, the real father of the idea is Lucian Bebchuk, a Harvard University economist and law professor who, more than any other individual, has supplied the research and rhetorical firepower for the movement to rein in executive pay, mostly in the past six or seven years.

In a blizzard of papers, books, and op-eds, along with congressional testimony and television appearances, Bebchuk has challenged the conventional argument that CEO pay is based on free-market forces in which rational shareholders of a company pay no more than what a particular executive deserves, based on the person's talent and the value that his or her contributions add to the company. Bebchuk argues that CEOs exert "managerial power" that undercuts market forces, mostly by manipulating the board of directors.

The traditional view is that top executives merit generous compensation because of something called the "agency problem." Unlike a small-business owner who is the boss, CEOs of public

companies don't typically own large shares of the business. The company's owners (the shareholders), must provide their "agent" (the CEO) an incentive to work his or her hardest and take on the risk of failure (or even worse risks, such as accusations of malfeasance). Sky-high salaries, according to this view, are the product of two market-based forces -- the supply and demand for highly specialized CEO-quality leadership skills, and the inherent value that this leadership adds to the company, as reflected in profits and overall company health. If the market is working, then CEOs get what they deserve.

Bebchuk and his collaborators, however, argue that the market isn't working, because CEOs have stacked the deck by hiring allies as board members and using pliant boards to keep shareholders in check.

In scholarly papers and books -- particularly his 2004 volume, Pay Without Performance -- Bebchuk piles up his evidence:

* CEO compensation, which once was about 40 or 50 times the earnings of an average worker, has risen to 500 or even 1,000 times the average's worker's pay.

* CEO pay seems to go only up, even when companies do badly and their share prices sink.

* CEOs of U.S. companies make much more than their counterparts in Europe, where there are more rules that inhibit the independence and power of chief executives.

* The pay gap between CEOs and other top executives at their firms is widening. CEOs are getting a larger slice of the executive piece of the pie.

In the past few years, another academic has added his voice to the crusade. He is all but unknown, even to Wall Street-watchers, but his work has been as influential in the backlash against CEOs as Bebchuk's.

Erik Lie, 38, is a professor at the University of Iowa. Born in Norway, he went to college and graduate school in the United States and toiled in obscurity for a decade, researching the fine points of share "buybacks" -- companies' use of spare cash to boost their share prices by buying back some stock, thereby making the remaining shares worth more.

Lie said he had run out of ideas in 2003 when he thought of researching businesses' granting of stock options to executives. An option is the right to buy a share of stock at a specified price within a certain period of time -- the practice is designed to provide an incentive for the executive to boost the share price and thus increase his or her own payoff for the option. During the Internet bubble, when technology companies were highly valued in the stock market but often had no profits, options became a popular way to compensate executives, and in a booming stock market, they eventually dwarfed salary as a way to pay chief executives.

Researchers had noticed that at particular companies, options grants were often followed by an increase in share prices, suggesting that inside information might have influenced the timing of the grants. By compiling huge amounts of data on many companies over many years, Lie proved

that chance alone could not explain the sometimes perfect timing of the options dating for a large number of companies. According to his careful analysis, simple insider trading also could not account for the sometimes uncanny timing of options grants. Lie hypothesized that some companies may have been granting options and then retroactively changing the dates on the options, to ensure that executives would get the highest possible value on their shares.

His research had a huge impact. Using his techniques and others, The Wall Street Journal ran a series of articles on specific companies where the evidence pointed to backdating. Meanwhile, the Securities and Exchange Commission began chasing down Lie's cases of uncanny timing. At last count, 28 people have been charged with breaking the law; four companies have settled charges by paying fines or other penalties; and 140 companies are under investigation, according to an SEC spokesman.

The biggest name in the uproar -- Apple founder and CEO Steve Jobs -- hasn't been charged. His $647 million worth of stock options in 2006 made him, by far, the highest-paid CEO in America. to date, Apple's general counsel and its chief financial officer have resigned; the SEC has charged them with backdating options for Jobs, effectively boosting their value by hundreds of millions of dollars.

To Bebchuk, stock options are just another way that CEOs manipulate boards to take unjustified amounts of compensation. The number of clear-cut abuses may number in the hundreds, and Bebchuk's research indicates that the real scope of fortuitously timed options grants is larger than that.

In a 2006 paper called "Lucky CEOs," he researched the number of times that a company made an options grant at the moment of the lowest price for the stock in a month, a highly unlikely occurrence when left to chance. Over a nine-year period, Bebchuk said, 12 percent of American corporations awarded at least one "lucky" option grant to their CEOs. He found similar results for company directors. Using a variety of research tools, Bebchuk made the case that this "luck" was really the backdating of options, rather than simply trading on inside information. If his research is accurate, the SEC is going to have to hire a lot more investigators.

Tax Leaks

The regulatory crackdown on options is prompting action in Congress and throughout the executive branch.

The Financial Accounting Standards Board, an organization of accountants empowered by the SEC to set accounting rules, closed one big loophole for options in 2005. Until then, companies were not required to count options grants to executives as expenses; therefore, they could shield information about them from the public filings available to shareholders. In a first step toward greater disclosure of executive compensation, the FASB required companies to list these options as expenses in the year they are granted.

But closing that loophole created another one, according to Sen. Carl Levin, D-Mich. At a June 5 hearing, Levin noted that these companies didn't count these grants as expenses for tax purposes

until the CEOs exercised them, often years later, and usually when they were worth much more. Thus, the company's eventual deduction for the options sometimes far exceeded their original value. Levin proposes to require companies to count options as a write-off expense when they are issued. He cited a study using a tiny sample of nine companies that granted options between 2002 and 2006. The initial value of the options, as disclosed to shareholders, was $217 million, but the grants led to tax deductions for the companies of $1.2 billion. In Levin's view, this was $1 billion in corporate profits that should have been taxed. Corporations booked $43 billion in options expenses in 2004 alone, Levin says, meaning that that the amount of lost revenue is huge.

Executives for Occidental Petroleum, KB Home, and Safeway testified at the hearing that they don't figure tax advantages into their granting of options, which they said described as a tool to motivate individual employees. Sen. Norm Coleman, R-Minn., protested that Levin's proposal, if made into law, could have untoward effects: If options are never exercised (as, for example, when the stock drops in value), Levin's "solution" might allow deductions upfront for an expense that a company never really incurs.

Congress, the SEC, accountants, corporate directors, and investors themselves are all engaged in rewriting the rules of corporate governance, based on the widespread conclusion that flaws in these rules account for unjustified increases in CEO compensation. But this conclusion has its skeptics. On the most basic level, neoclassical economists would argue that rational investors would not so easily allow CEOs to loot companies. If managers gain a stranglehold on a corporate board and commenced such looting, this theory goes, investors would flee the stock and the company's value would suffer. But little research exists to demonstrate that investors behave this way. With so much news about CEO abuses these days, investors have had plenty of opportunity to take action -- and most haven't.

In Pay Without Performance, Bebchuk argues that his "managerial power" theory more accurately explains the CEO compensation spike than does the assumption that companies pay these chiefs what the market commands. This latter theory is often called "optimal contracting," because it assumes that boards will set compensation at the level that most benefits shareholders. Bebchuk says that in cases where CEOs exert power over boards, there is no way that compensation could be optimal.

Three business professors who wrote a 64-page critique of Bebchuk's book express a different view. They argue that, even in cases where executives exert power over boards, other safeguards control compensation. The true test is whether the excessive compensation harms shareholders. And using an assortment of tests -- comparing the performance of companies within certain industries, and comparing returns in the United States and abroad -- the authors find no evidence that high executive compensation hurts shareholders. The market, they argue, still functions well in setting executive pay, even when executives control their boards.

So, what can account for the skyrocketing compensation of CEOs? How to explain why companies pay these executives so much more than their average employees? Why do American CEOs far out-earn European ones?

Bigger Is Richer

Bill Gale, director of economic studies at the Brookings Institution, says that Bebchuk and the other critics of CEO pay are making a great impact on public policy partly because Americans have become more broadly sensitive to inequities in income. "Sure, that figures into it," Gale said. "I think there are very legitimate issues about executive pay, but the context is that the public is more concerned about inequality." Recent evidence shows that income in the United States is now more concentrated in the upper 10th of the population than at any time since the 1920s. In 2005, almost all of income gain went to the top 10th, and of that, the lion's share went to the top 1 percent of the population. Researchers aren't sure why this is happening, but they find it to be a pervasive phenomenon.

Many of the possible explanations echo the "managerial power" argument for CEOs: Workers have less power, relative to managers, because of the decline of unions and the threats of trade and outsourcing; managers and other top earners, conversely, have more power. Beyond the economic theories about causes, however, the political debate wrestles with questions about fairness and exploitation. When it comes to professional athletes or heart surgeons, for example, few people dispute that their compensation is set by the forces of supply and demand in the specific markets for those services. But that doesn't stop people from noting how much more athletes make than fans nowadays, or judging that they make "too much."

Forty years ago, before free agency in baseball ended club owners' stranglehold on ballplayers, the average player's salary was a small multiple of the average fan's pay. This proportion has increased dramatically, but that doesn't necessarily mean that players don't deserve their higher salaries. Likewise, the dramatic skewing in the relationship of CEO pay to worker pay, in a society where income has generally become much more unequal than it was in the past, doesn't necessarily constitute evidence that companies are abusing their shareholders. Yet it is often cited as evidence that something is very wrong.

A more crucial piece of evidence for the critics is that CEO pay does not seem to vary with the performance of the company's stock, confirming a steady stream of anecdotes of executives getting raises after share prices have slumped. In his 2004 book, Bebchuk confirms that top compensation packages don't seem to bear any relation to returns for investors. Even when CEOs are paid in options, the potential losses from a drop in the stock aren't a sufficient incentive for them to make money for shareholders. His critics responded, however, that, taking into account a typical CEO's total stock holdings, the losses sustained in any one bad year far outweigh the gains of that year's compensation package. In a sense, with the CEO holding a big chunk of company stock, pay in any single year is incidental -- executives lose big, along with investors, when stock prices sag.

In April, Xavier Gabaix, a young economist at the Massachusetts Institute of Technology, offered an alternative theory to explain the rising CEO pay in the United States. It's simple, he says: Increases in CEO pay, across a large universe of corporations, are related to the size of the firm.

His idea begins with the argument that a CEO's value relates to the talent and effort that that person brings to the company. An executive adds value to a company by boosting its stock price -- a better CEO makes the company more profitable, and that value is reflected in share price. So, if the overall talent at the top hasn't changed, why do many executives earn more year after year? Because the larger the company the larger the return for the CEO's talent. Let's say that a particular manager is better than average, and that this advantage boosts profit by 10 percent. In a $10 billion company with $1 billion in profit, that added value is $100 million. But in a $60 billion company with half the profit margin -- $3 billion -- that advantage adds up to $300 million. If CEO leadership matters, then that extra $200 million should be credited to the CEO, simply because the firm is that much larger. Gabaix suggests that this helps explain why CEOs are often so intent on acquisitions that build the size of the company. Even acquisitions that don't add a lot to profit can add a lot to an executive's worth.

To summarize 50 pages of research, Gabaix finds an almost perfect relationship between CEO pay and company size, measured as its capitalized value. Using data on thousands of public companies between 1980 and 2003, he finds that compensation for CEOs has increased almost exactly 500 percent while the value of the firms has increased by almost exactly 500 percent.

Bebchuk and other critics of CEO pay cite differences between the United States and Europe, where rules of corporate governance -- two-tier boards, and a role for labor unions as part of management -- tend to restrict management independence. Gabaix finds again that differences in firm size and growth rates are almost identical with differences in CEO pay.

For now, though, Gabaix's findings provide little defense against the corporate abuses that have ended up in the courts, and the weak rules that remain under attack. Some investors -- particularly pension funds and other institutional investors -- are asserting themselves on a range of corporate governance issues, so it's curious that they haven't fought harder to curb executive pay. If Bebchuk is right about the pervasiveness of the problem, then almost every person with a share of stock ought to care about it.

A common explanation for investor apathy is that stock ownership is so dispersed that individual investors feel powerless to make changes. But it might also be true that, on average, high salaries don't seem to be hurting investors. Last July, Apple's stock stood at about $50 a share. By January 1, it had increased to about $80. Sometime during that period, Apple directors decided to award CEO Jobs $647 million in compensation for 2006. Since Jobs's pay was disclosed in early May, Apple's stock has risen about 25 percent, to $125 a share.

Jobs is still under investigation for the options backdating that so far has been blamed on subordinates, and most Apple investors are probably aware of the questions raised about Jobs's compensation. And yet, they still cling to their precious Apple stock like they do their trendy new iPods. Either they are missing something crucial about CEO pay, or those of us without Apple stock are.

According to J. Mark Iwry, a lawyer and expert on corporate governance at the Brookings Institution, even though Americans seem exercised about executive compensation, they also

seem profoundly ambivalent. "Investors look at some of these compensation packages and they think that it is too much money, but if it is a company they own, and it is doing well, they feel differently," Iwry said. "One the one hand, people think income should be more equal, sure, but also that entrepreneurship should be rewarded. I'm not sure that is going to change."

But Elson, after a long career pushing for reform, thinks it is happening. The public policy debate about income inequality, he said, could make CEO pay an attractive issue for political candidates in the 2008 presidential election. More likely, though, the public campaign against runaway executive compensation, as played out in the media, will continue to push institutional investors and corporate boards to exercise more restraint. The rise of private equity ownership of large companies would tend to rein in executive pay, Elson said, "although the compensation of fund managers" might then replace CEO pay as the target of scandal.

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* "The culture of the boardroom seems to be changing....Boards are beginning to act like owners."

* Congress ponders "say on pay" rules, and restrictions on how much corporations can deduct for stock options.