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The Crystal Report on Executive Compensation

**by Graef Crystal**

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# EXECUTIVE PAY CONTROLS – BAD IDEA THEN, BAD IDEA NOW

How about this for a deal: We don't bail out the banks to the tune of $700 billion. And we don't have pay controls on executives, either.

I grant the Democrats their point that, to use the words of a famous song of yesteryear, "You can't have one without the other."

But if you're going to implement one silly idea, namely, that no executive in a company helped out by the government should make more than the pay of the president of the United States – currently $400,000 -- then how do you expect to bring in a brilliant manager to help turn the ailing company around ? A chief executive officer like Henry Paulson, who did wonders for his shareholders and pulled down $27 million a year when he headed Goldman Sachs Group Inc. for 7-1/2 years before he became Secretary of the Treasury.

## The Paulson Years

Let's look at Paulson for a bit. First, his pay, then his performance.

During those 7-1/2 years, Paulson earned in the aggregate:

- $4.2 million of base salary – a very low number.
- $67 million of cash bonuses – a very high number.
- $95 million of free shares – a really high number.
- Stock options having by my estimate a present value at grant of $29 million.
- $650,000 of miscellaneous compensation.

That adds up to $196 million, or $26.2 million a year.

An alternative way of looking at his pay is to remove from the above figure the $29 million of hypothethical stock option value and then add in the actual $35 million of option gains he received when he was cashed out just before leaving for Washington. Under that methodology, his total pay rises to $202 million, or $27 million a year.

But shareholders got a lot for all that money.

Paulson , who earlier was a co-CEO, was the one and only on May 3, 1999, when the company went public.  He stepped down on June 28, 2006.

I looked at Goldman's total return performance in seven time windows. The widest window began on May 3, 1999 and ended on June 28, 2006. Then, for the second window, I upped the beginning point by one year, to May 3, 2000 but left the ending point the same. And so on, with the shortest window of the seven being the period beginning May 3, 2005 and ending June 28, 2006.

Here are the results, which show: 1)Goldman's total return; 2)Goldman's excess return (i.e., the amount by which Goldman's return exceeded or was under the return of the Standard & Poors 500 Index); and 3)Goldman's Diluted EPS.

**TOTAL RETURN PERFORMANCE IN NARROWING TIME WINDOWS**

| FROM | TO | GOLDMAN AMNUAL TOTAL RETURN | EXCESS RETURN | DILUTED EPS |
|---|---|---|---|---|
| 5/3/1999 | 6/28/2006 | 16.1% | 15.7% | $5.57 |
| 5/3/2000 | 6/28/2006 | 8.8% | 9.3% | $6.00 |
| 5/3/2001 | 6/28/2006 | 9.4% | 7.7% | $4.26 |
| 5/3/2002 | 6/28/2006 | 17.2% | 11.7% | $4.03 |
| 5/3/2003 | 6/28/2006 | 24.0% | 12.3% | $5.87 |
| 5/3/2004 | 6/28/2006 | 22.2% | 15.1% | $8.92 |
| 5/3/2005 | 6/28/2006 | 35.1% | 26.8% | $11.21 |
| | MEDIAN | 17.2% | 12.3% | |

You can see that Goldman beat the S&P 500 in everyone of the seven time windows, with a median excess return of 12.3 percentage points.

Think for a moment about the widest time window, the one covering the period beginning May 3, 1999 and ending June 28, 2006. Goldman's cumulative total return was 192 percent for the entire period. The cumulative return for the S&P 500: Just 2.9 percent.

I have to put a clothespin on my nose when I stand too close to pay numbers this high. But, hey, if you believe in pay-for-performance as I do, and the CEO's got the performance, well, then, you have to accept, if grudgingly, the results.

As it turns out, Paulson's pay was modest compared to that of his successor Lloyd Blankfein. In his best year, the year ended Nov. 30, 2005, Paulson earned $40 million (including the present value of options granted but excluding option gains). But for the year ended Nov. 30, 2007, Blankfein earned $71 million.

To be fair to Blankfein, Goldman's earnings continued to grow extremely well during his tenure. In the last full year of his CEOship, Paulson produced Diluted EPS of $11.21 a share. For FY2007, the Diluted EPS had risen to $24.73 a share.

**Past Bad Experiences With Pay Controls**

I've been on the scene a long time, and I am here to tell you that clumsy attempts by the Congress and the bureaucrats to reign in executive pay have, for the most part, aggravated the problem, not lessened it.

My first foray into this area occurred in Feb. 1970, when I wrote my first major article – an OpEd piece for *The New York Times.* The plan then was for the government to bail out Lockheed Aircraft, which was an important government contractor but which had lost its shirt on its turkey of a civilian passenger plane, the turprop Lockheed Electra. It's hard to push a turboprop on customers when everyone else is offering pure jets. Besides, the Lockheed plane had a disheartening record of exploding in mid-air.

In that OpEd, I emphasized the same point that I made at the top of this article, namely, that you can't bail out a company and then let it pay whatever it wants to its executives. Hello, the bailed out company is no longer part of the free enterprise system. So something has to be different. Or more specifically, pay has to be a lot lower.

At the end of the article, I quoted from John Donne: "No man is an island. Therefore, never send to know for whom the bell tolls, it tolls for thee." I believe those same words apply today in this current financial crisis.

One good thing came out of that OpEd piece. The day following its publication, I received a call from a famous management consultant of the day, John Diebold (who, among other things, coined the term "automation"). Mr. Diebold liked to hold intimate lunches at his Park Avenue

apartment and to throw questions at each of his guests to provoke discussion and argument. In effect, he was running a salon.

I was flattered by the invitation. So I accepted. I found myself sitting next to a lady wearing Coke –bottle-bottom glasses. She turned to me, offered her hand and said: "Hello, I'm Ayn Rand!" Seems that Mr. Diebold liked to invite people to his luncheon who were unabashed proponents of free enterprise.

Over the ensuing years, I watched the bloody failure of President Nixon's venture into outright pay controls in the mid-1970s. All they did was to constipate the system, and when they ended, pay exploded.

More recently, I watched President Bill Clinton put in his famous $1 million cap. Indeed, I talked to him on the phone for 20 minutes when he was running for president. And I tried to talk him out of limited corporate tax deductions for executive pay. My argument was that doing that only screwed the shareholders and didn't even nick the CEO.

President Clinton made his reputation as a compromiser. So he cut down the coverage of his $1 million pay cap to only the top five executives in public companies who were reported on the company's proxy statement. That sure helped out companies like Goldman who were private. And, effectively, he limited it only to base salaries; and even then you could defer anything above $1 million and pay it out one day after retirement, when the executive was no longer on the proxy statement.

In a nod to pay-for-performance, plans that ostensibly were linked to performance were not restricted in what they could pay. Many commentators believe the explosion in the size of stock option grants was the result of that exemption.

President Clinton, a year ago or so, told *Business Week* that I told him to put in the $1 million pay cap. Like Monica Lewinsky, I became the victim of a memory that, shall we say, resembles a large piece of Swiss cheese.

So I find myself philosophically opposed to both the government bailout of banks and the imposition of executive pay controls.

That doesn't mean, though, that there aren't steps that can be taken at the government level to help forge a better relationship between pay and performance.

**Steps to Reform the System**

I have three thoughts here:

- Mandate that every outside director receive a majority of the votes cast. That way, if a director is chairman of the board's compensation committee, and the shareholders don't like what he is doing, they can tweeze him out of the lineup.

- Find ways to soften the so-called Business Judgment Rule. As things now stand, courts almost always defer to boards – especially in publicly-owned companies. Indeed, in many cases, the first objective of a lawsuit is to try to show a judge that it would be futile to allow a board to form a special committee, hire its own outside counsel and investigate itself. History has shown that self-investigations never seem to me terribly self-critical.

- Sic the Internal Revenue Service on companies that pay excessively. The IRS code says that compensation is deductible to the extent that it is "ordinary, necessary and reasonable". The IRS has heretofore avoided going after publicly-owned company in the manner of someone encountering a cobra. But if a CEO's pay is more standard deviations above the norm than Albert Einstein was in intelligence, why not step in with a targeted lawsuit? If the company loses and deductions are lost, that will bring the plaintiff bar into action. In effect, we don't need to regulate everyone to achieve a goal. We just need to pick out the extreme outliers.

Although people are screaming about executive pay just now, I find that, by and large, things have become better over the last few years.

When I first starting writing critical articles in the late 1980s, I could aim my rifle out the window, fire blindly and was sure to bag an overpaid, underperforming CEO, or even several such CEOs. Now, I find I must work much harder to find my targets. It's not that there's an absence of high pay packages out there. It's rather that there are many fewer ultra-high pay packages today that do not come equipped with a lovely performance record.

I pray the Congress won't go and do something stupid. If they do, compensation consultants will, of course, be having some very great years. But the rest of us will, in the end, suffer for our inability to bring someone like a Hank Paulson in to restore the luster of a now-ruined company.

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley's Boalt School of Law.