

CEOs earn big bonuses for bad year (8/27/09)

As their companies shed jobs and stocks plummeted, hundreds of chief execs collected extra pay last year. Here's how boards justify these rewards.

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As millions of Americans cope with job losses and struggle to make ends meet, there's been only a little belt tightening in the corner offices. Despite terrible performances that cost lots of jobs and produced huge shareholder losses, hundreds of CEOs pocketed millions in bonus pay last year -- thanks to good friends on company boards. Consider the **Ryland Group** (RYL, news, msgs) CEO whose bonus went up in 2008 compared with 2007, though more than a third of the homebuilder's employees got the boot, or the **Honeywell International** (HON, news, msgs) chief who missed the benchmarks for his annual bonus -- and got \$3.5 million anyway.

All told:

- Among all the Fortune 1,000 companies, nearly 400 CEOs got bonuses last year, taking home \$402 million in annual bonus pay, according to Equilar, an executive compensation research firm. But that's only part of the picture; more bonus pay figures will roll in as additional companies file reports on 2008.
- These privileged CEOs got an additional \$66 million in "discretionary" bonus pay. Annual bonuses are linked to some performance target, while boards can hand out discretionary bonuses for whatever reason they choose.
- These bonuses topped off already-large pay packages. CEOs at larger companies earned about \$10 million on average last year, according to Equilar.

How does a CEO earn a big bonus when his company is staggering? Experts chalk it up to a broken pay system. The compensation committees that determine CEO paydays set up vague and flexible criteria that keep bonuses rolling no matter how badly a company performs. "Compensation committees are on automatic pilot," says Timothy Smith of Walden Asset Management, a social and environmental investment shop that monitors compensation. "They continue to reward top management while shareholders and employees suffer."

I hunted through Equilar's list of more than 100 Fortune 1,000 companies that gave CEOs bonuses of more than \$1 million each last year to find some of the most striking examples. Here are five that really stand out -- and that illustrate the common tricks.

Ryland, Qwest move the goal posts

There's always some metric that can be used as an excuse to dole out a bonus. **Ryland** offers a great example. Last year was a horrible year for homebuilders, and the California company performed particularly badly. Ryland lost \$9.33 a share, compared to a loss of \$7.92 the year before. Gross profit margins slipped to 11.6% from 17%. Ryland's stock fell 34%. The company shed 723 employees, 36% of its work force. Ryland chief R. Chad Dreier, though, didn't take a loss. His annual bonus leapt from zero in 2007 to \$2.5 million in 2008 as part of a \$10.9 million pay package. He gained \$6 million more from stock options. How did Dreier earn this largesse? Simple: The

board moved the goal posts. In 2007, bonuses were linked to pretax income. No bonuses were earned on that basis. So in 2008, the board tied bonus pay to changes in net cash flow from Ryland's operating business. Voilà! Ryland met the target, in part because so many jobs were cut. The switcheroo came just in time for Dreier to cash in. He is leaving the CEO job in May.

The board at Denver phone and Internet service provider **Qwest Communications** (Q, news, msgs) made a similar move last year, to the benefit of chairman and chief Edward Mueller. Weighing in on whether shareholders should have an input on executive compensation, with David Hirschmann of the U.S. Chamber of Commerce; Richard Ferlauto of AFSCME and CNBC's Mary Thompson. Qwest had a bad 2008. Revenue declined by just 2%, but earnings per share and net income dropped by 74% and 77%, respectively. Qwest stock fell 43%. Thousands of employees lost their jobs. But Mueller got an annual bonus of \$2.25 million, up from zero in 2007. That was on top of \$8.2 million in salary and other compensation. How did this happen? In part, because in late 2007 the Qwest board switched one of the metrics used to award bonuses. In place of net income, it used a measure of cash flow that gauges earnings before interest, taxes and the accounting charges depreciation and amortization, known as "EBITDA." In a way, the switch makes sense. Execs wouldn't be penalized for a decline in 2008 earnings compared to an artificial jump in 2007 earnings caused by a one-time tax benefit. But did EBITDA really rise enough to justify a big annual bonus? It increased by just 3%, and much of that gain came as the company bolstered cash flow by shedding 3,906 jobs, 11% of Qwest's work force. In effect, Mueller got a boost to his annual bonus for cutting jobs. Company filings say Mueller also got the bonus for the company's sales and cash-flow performance, as well as for forging a partnership with **Verizon Wireless** and new collective bargaining agreements with unions. (If this still seems unfair and you're on Twitter, you can tweet your thoughts to Qwest.)

Covering all the bases

Honeywell International deserves credit for setting hard earnings and cash-flow targets for annual bonuses.

But the aerospace and electronics company also keeps a lengthy list of accomplishments that the board can fall back on to award bonus pay at its own discretion. The board reserves the right to give more weight to any of these objectives whenever it wants, saying bonus benchmarks shouldn't be "reduced to a linear formula."

You probably know where this is going.

Last year, Honeywell missed earnings and cash-flow goals as both sales and earnings growth worsened. Nevertheless, chief David Cote got the fourth-largest discretionary bonus among Fortune 1,000 companies, according to Equilar: \$3.5 million. That was down 17% from the year before, but the bonus was part of a \$30.3 million 2008 pay package for Cote, a former **General Electric** (GE, news, msgs) executive. Honeywell says a key factor in setting bonus pay is "shareowner value creation." This factor must have been played down in the company's flexible formula. Honeywell stock fell 45% last year, performing much worse than the overall market. Honeywell explains that it increased earnings per share by 19% last year, sales were up 6% and the company produced \$3.1 billion in free cash flow. Company filings also say Cote got the bonus in part for completing eight acquisitions and selling four divisions, expanding sales in emerging markets, for "major platform wins" in its aerospace and transport business and for productivity gains.

Deere (DE, news, msgs) is another company using a flexible system that keeps bonus money flowing.

The farm equipment company rewards execs for a form of return on assets. But Deere reasons that because it has high fixed costs in the form of manufacturing plants, the returns needed for a bonus should be lower when sales are lower. After all, when plants are operating at a lower capacity, return on assets naturally declines.

The upshot is that even as earnings growth worsened in 2008 and Deere's stock fell 49% -- much worse than the market -- CEO Robert Lane's bonus went up by 25%, to \$3.6 million, last year.

Lane got one of the biggest bonuses last year among Fortune 1,000 companies, and it was part of a \$22 million pay package. The flexible bonus policy helped Lane, but it's not clear to me how shareholders benefited.

Losses? What losses?

Another way to keep the bonus money flowing is to simply ignore huge losses. **NYSE Euronext** (NYX, news, msgs) offers a great example. Last year was a terrible year for the company, which operates stock exchanges. A profit of \$2.68 a share in 2007 dropped to a loss of \$2.81 per share in 2008, basically a plunge of 200%.

Yet chief Duncan Niederauer had an excellent year. The former **Goldman Sachs** (GS, news, msgs) partner pulled down \$4 million in bonus pay -- part of a \$7 million overall pay package. Niederauer's pay included a \$2 million discretionary bonus, the same as he got the year before. How did the NYSE Euronext board justify a \$4 million bonus when earnings plummeted more than 200%? It simply ignored a \$1.6 billion write-down the company took on its 2007 acquisition of Euronext, an equities exchange company. In fairness to Niederauer, the Euronext purchase was arranged by former chief John Thain (who later went on to head **Merrill Lynch**) before Niederauer replaced him. NYSE Euronext says the company hit most of its performance goals last year, and that on Niederauer's watch NYSE Euronext cut operating expenses significantly and increased revenue by 19%. The company says its pay packages are designed to align the interests of executives and shareholders. But stockholders may wonder how the 67% their shares lost last year align to this exec's \$4 million bonus.

No penalties for bad performance

Indeed, bonus money kept flowing last year because of a common problem with executive pay packages: They reward execs for good performance, but don't really penalize them for bad performance. "There should be downside as well as upside," says Hye-Won Choi, head of governance for **TIAA-CREF**, which manages retirement savings for employees of nonprofits. But, says Choi, too often pay packages are focused on merely retaining execs "as opposed to getting them to achieve business goals." To be fair, some high-profile execs did take less last year, in bonuses as well as salary. But in many cases, the bonuses kept flowing, even when the profits stopped and the stocks plunged.