

Lucian A. Bebchuk

William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance
and Director of the Program on Corporate Governance, Harvard Law School

Jesse M. Fried

Professor of Law and Co-Director of the Berkeley Center for Law, Business and the Economy,
Boalt Hall School of Law, University of California at Berkeley

Robert J. Jackson, Jr.

Law Clerk to Judge Amalya L. Kears, United States Court of Appeals for the Second Circuit
Olin Fellow, Harvard Law School, 2004-2005¹

April 14, 2006

Via Internet Comment Form

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission

Dear Ms. Morris:

This letter provides our comments with respect to the proposed requirements for disclosing executive retirement benefits.

Our comments are based on substantial research concerning executive retirement benefits that we have carried out. In particular, they draw on:

- Lucian A. Bebchuk and Robert J. Jackson, Jr., "Executive Pensions," 30 *Journal of Corporation Law* 823 (2005) [Hereinafter *Executive Pensions*].
- Lucian A. Bebchuk and Jesse M. Fried, "Stealth Compensation via Retirement Benefits," 1 *Berkeley Business Law Journal* 291 (2004) [hereinafter *Stealth Compensation*].
- Lucian A. Bebchuk and Jesse M. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004), chapter 8 [hereinafter, *Pay without Performance*].

We add at the end of this letter the text of *Executive Pensions and Stealth Compensation*, which we incorporate as part of this letter comment.

Existing Problems and the Benefits of the Proposed Rules

We would like to applaud and strongly support the Commission's proposal to expand considerably the disclosure requirements concerning retirement benefits. Our

¹ Our titles are given for identification purposes only; these comments represent our personal views and should not be ascribed to our employers or any of the institutions with which we are affiliated.

research suggests that this area is one in which existing disclosure requirements are especially and seriously insufficient. Expanding disclosure requirements in this area is therefore critical for improving the transparency of executive pay.

Pensions

Because companies have not been reporting a monetary value for executives' pension plans, as the rules have allowed thus far, standard datasets (such as ExecuComp) have not included pension values. *Executive Pensions*, our empirical study, demonstrates that this omission has led investors, researchers, and the media to have a substantial distorted picture of executive pay.

This study analyzes the pension arrangements of CEOs of S&P 500 companies that (i) are now serving and are near the retirement age, or (ii) left their positions during 2003 and the first half of 2004. With respect to the two-thirds of the CEOs that have a pension plan, we found that:

- The executives' pension plans had a median actuarial value of \$15 million;
- The median CEO has a pension plan worth twice as much as the aggregate salary payments received during the service as CEO;
- The ratio of the executives' pension value to the executives' total compensation (including both equity-based and non-equity-based pay) during their service as CEO had a median value of 35%; and
- Including pension values increased the median percentage of the executives' total compensation composed of salary-like payments during and after their service as CEO from 15% to 39%.

In addition, the pension benefits in our sample varied considerably with respect to both their magnitude and their relationship to the executives' overall compensation. Overall, our findings indicate that the standard omission of pension plan values by researchers and the media leads to (i) significant underestimation of the magnitude of executive compensation; (ii) severe distortions in comparisons among executive pay packages; and (iii) significant overestimation of the extent to which executive pay is linked to performance.

Deferred compensation arrangements

Our analysis of standard deferred compensation arrangements suggests that they can provide executives with substantial benefits that are not disclosed to shareholders (*Pay without Performance*, Chapter 8; *Stealth Compensation*, at 127-134). To begin, firms have used the ways in which above-market returns are defined to fail to disclose compensation in cases in which economists would likely view returns as being above-market. More importantly, even when returns are nominally equal to market returns,

executives have obtained large benefits because deferred compensation arrangements shift the tax costs of investment gains.

Because firms have not been required to disclose the large gains that executives have been making from shifting tax liability on investment gains to their firms, it is difficult for outsiders even to estimate — as *Executive Pensions* does for pension benefits — the gains that executives make from deferred compensation plans. Firms generally do not disclose the amount credited to executives' deferred compensation plans, and investors are thus unable to form even a ballpark estimate of the magnitude of stealth compensation provided through such arrangements.

Benefits of the proposed rules

Improving the disclosure of retirement benefits would provide investors with a considerably fuller and more accurate picture of the magnitude and makeup of executives' total compensation. The Commission's proposed rules would also significantly enhance the ability of investors to make accurate comparisons among executives' pay packages.

Furthermore, our work suggests that the proposed rules could well improve the compensation decisions made by firms. Our analysis suggests that it is difficult to explain the heavy use of executive retirement benefits on efficiency grounds (*Stealth Compensation*, pp. 123-124 & 128-132; *Executive Pensions*, pp. 827-832). We are therefore concerned that some firms might have used retirement benefits not because they provide an efficient form of compensation but rather because they provide compensation that is relatively difficult for investors to measure.

Thus, an important potential benefit of the Commission's proposed rules is that they would eliminate existing distortions that might lead firms to use retirement benefits inefficiently. We expect that, after the requirements are adopted and retirement benefits become as transparent to investors as other forms of compensation, firms will gradually reduce their use of retirement benefits relative to other forms of compensation. Whether or not this prediction proves correct, the proposed disclosure requirements will ensure that the choices made by designers of compensation arrangements are not influenced by the relative obscurity of compensation via retirement benefits.

Design Issues

We also wish to comment on a number of specific design issues and to respond to a number of questions raised by the Commission.

Earnings on deferred compensation plans

In response to the Commission's question, we strongly believe that disclosure should not be limited to "above-market" earnings on the amounts invested in deferred compensation plans. As we explain in detail in our work below, executives derive substantial benefits at the expense of the firm even when the plan provides merely "market" returns (*Stealth Benefits*, pp. 132-132). Whereas investment gains on funds invested by an executive in an outside account are taxed, the investment gains in deferred compensation arrangements accumulate tax-free. Essentially, the tax liability is shifted from the executive to the firm.

Increases in Pension Value

In response to the Commission's question, we believe that increases in the actuarial value of pension plans should be included in the total compensation figures disclosed to investors. We advocate such a requirement in our incorporated work (*Executive Pensions*, pp. 854-856; *Stealth Compensation*, pp. 140-141). Such increases represent an increase in the value of the firm's obligation to the executive. A \$1 increase in the actuarial value of an executive's pension value is economically equivalent to the firm's giving the executive a promissory note of \$1.

Supplemental table

In response to the Commission's question, we believe that it would be desirable to require firms to disclose a supplemental table breaking up this figure into its various components. We expect the "all other compensation" figure to be quite substantial for some companies, and investors will be able to get a better picture of the makeup of compensation if they receive information about the extent to which pension plans, deferred compensation plans, and other sources contributed to the "all other compensation" figure.

Retirement plan table

In response to the Commission's questions, we believe that it would indeed be desirable to require a table disclosing information about the value of annual pension benefits. Our incorporated work indicates that pension benefits constitute a substantial fraction of total compensation for many companies, and providing information about executive pensions would thus be useful. In addition to the columns in the table set forth in the Release, it would be desirable to require firms to include a column with the actuarial value of the plan at the end of the company's fiscal year. Investors should get information about the economic benefit that the executive has accumulated via a pension plan.

Post-retirement perks

We are concerned that, under the proposed rules, companies would not be required to monetize and include in total compensation figures the value of post-retirement perks that a firm promised in its contracts with executives. Thus, the proposed rules might give an incentive to shift compensation to post-retirement perks. As the case of Jack Welch vividly illustrated, such contractual rights can be of significant value. A promise to provide each year perks worth \$100,000 after retirement is economically quite similar to a commitment to pay an annual pension of \$100,000 a year. Thus, it is worth considering whether firms should be also required to report and take into account both in reporting total compensation figures and in the supplemental tables the estimated monetary value of such commitments.

Defined compensation plan table

In response to the Commission's questions, we believe that a tabular disclosure with monetary values is desirable. Deferred compensation plans might have been a considerable source of "hidden" compensation in many firms. Furthermore, it would be highly undesirable to limit disclosure to above-market earnings. As explained earlier, executives derive large monetary benefits from deferred compensation plans based on "market" returns. However, firms should be allowed to break the earnings column into two columns, one reporting "above-market" earnings and one reporting "market" earnings.

We wish to conclude by commending the Commission again for putting forward a proposal that will substantially improve the disclosure of executive retirement benefits. Please contact Lucian Bebchuk at (617) 495-3138 or Bebchuk@law.harvard.edu if we can provide further assistance.

Lucian A. Bebchuk
Jesse M. Fried
Robert J. Jackson, Jr.

cc: Hon. Christopher Cox, Chairman, U.S. Securities and Exchange Commission
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Cynthia A. Glassman, Commissioner
Hon. Annette L. Nazareth, Commissioner
John W. White, Director, Division of Corporation Finance
Brian G. Cartwright, General Counsel

Executive Pensions*

Lucian A. Bebchuk** & Robert J. Jackson, Jr.***

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** William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance, Harvard Law School; Research Associate, National Bureau of Economic Research.

*** Law Clerk to Judge Amalya L. Kearse, United States Court of Appeals for the Second Circuit, 2005-2006; Olin Fellow in Law and Economics, Harvard Law School, 2004-2005.

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I. INTRODUCTION

When Fannie Mae CEO Franklin Raines was pushed out in December 2004, he departed with a generous package of retirement benefits. Fannie Mae will pay Raines an annual pension of \$1.4 million for the rest of his life and the life of his surviving spouse. The actuarial value of this pension benefit—the present value of the stream of payments Fannie Mae shareholders should expect to make to Raines over time—is about \$24 million. This pension value constituted a significant fraction of Raines's total compensation at Fannie Mae, and it substantially weakened the link between Raines's pay and his performance.¹ How often do pension plans comprise a substantial fraction of an executive's total pay? And how important are such payments to a complete assessment of the executive compensation landscape? These are the questions that we investigate in this Article.

Existing disclosure rules complicate these seemingly straightforward questions because they do not require companies to value the pensions to which executives are entitled.² *Pay without Performance*, a recent book co-authored by one of us argues that

1. For a detailed analysis of Raines's retirement benefits, see Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807 (2005).

2. Although proxy rules require some disclosure of executive pension benefits, see Executive Compensation Disclosure, Securities Act Release No. 6962, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056 (Oct. 16, 1992), the rules do *not* require that issuers disclose the *cost* of these pensions to their

firms use retirement benefits to provide executives with substantial amounts of “stealth compensation”, that is, pay not transparent to shareholders, that is largely decoupled from performance.³ The “camouflage” role of retirement benefits might partly explain their heavy use. Whatever explains the prevalence of pension plans, assessing their magnitude and effects on the link between pay and performance is critical to obtaining a complete picture of the executive compensation landscape.

The press has from time to time described the pension arrangements of particular executives in detail.⁴ Recently, for example, the media have discussed the pensions that Franklin Raines and Carly Fiorina received after departing from their respective firms.⁵ But prior research, media coverage, and existing data sets have not provided systematic evidence about the magnitude and variance of pension values—and their effects on the sensitivity of executive compensation to performance—in a representative sample of companies.⁶

Standard data sets of executive pay generally include only those components of compensation for which a precise monetary value has been disclosed in firms’ public filings. Estimating pension values requires additional research and financial analysis, and standard databases therefore do not include compensation paid through pension plans. This omission would not lead to significant distortions in analysis of executive pay if (1) pension plan values were not significant relative to total executive pay; or (2) pension plan values did not vary much among executives. In this Article, we examine whether

shareholders. Because it can be difficult for investors to ascertain the value of these pension benefits from the firms’ limited disclosures, *see infra* text accompanying notes 12-15, shareholders are often unaware of the magnitude of these benefits.

3. *See* LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

4. *See, e.g.*, Michael Barbaro, *A King’s Ransom in Retirement Benefits; GE Pays Ex-CEO Millions a Year in Pension, Perks*, WASH. POST, Sept. 7, 2002, at E1 (detailing the significance of Jack Welch’s pension benefits); *see also* Christina Binkley & Joann S. Lublin, *Management: IIT Brass to Get ‘Golden Bungee’ in Takeover*, WALL ST. J., Feb. 12, 1998, at B1 (noting that \$165 million was earmarked by the company for executive severance and pension benefits in the event of a change of control); Daniel Kadlec, *How to Get Paid: Stock Options Still Make Sense, But the Boss is Getting Other Goodies*, TIME, Jan. 27, 2003, at A20 (describing “boosting pension benefits by giving credit” for additional service time as the “latest wrinkle in CEO pay”); Gretchen Morgenson, *Jackpot Du Jour: It Pays to Quit*, N.Y. TIMES, Oct. 31, 2004, at C1 (describing substantial executive pay in the form of pension, long-term incentive, and change-of-control arrangements).

5. *See* Geoffrey Colvin, *Outraged Over CEO Exit Packages? You’re Too Late*, FORTUNE, Mar. 7, 2005, at 62 (criticizing Fiorina’s severance arrangements); David S. Hilzenrath, *Fannie Mae Begins Paying Benefits to Former Executives*, WASH. POST, Feb. 9, 2005, at E2 (describing a decision by regulators “to begin releasing pension and deferred-compensation benefits to [Fannie Mae’s] former chief executive and chief financial officer”); Jenny Wiggins, *Fund Files Suit Over Fannie Mae Executive Pay-Offs*, FIN. TIMES, Jan. 20, 2005, at 20 (discussing pension fund’s attempt to stop “former executives” from “receiving millions of dollars in severance payments”); *see also* Eric Dash, *The New Executive Bonanza: Retirement*, N.Y. TIMES, Apr. 3, 2005, § 3 (Magazine), at 1 (discussing, among other examples, the costs of generous pensions provided to the CEOs of Exxon Mobil, Pfizer, and UnitedHealth Group).

6. The only other attempt to systematically study executive pensions of which we are aware is in Rangarajan K. Sundaram & David L. Yermack, *Pay Me Later: Inside Debt and Its Role in Managerial Compensation* (N.Y. Univ., Law & Econ. Working Paper No. 05-08, 2005), available at <http://ssrn.com/abstract=717102>. A main focus of the Sundaram-Yermack study is on the possibility that pensions serve the beneficial role of aligning the interests of executives with those of debtholders, an issue that we discuss in Part III.C below.

these assumptions are valid; and, thus, whether the exclusion of pension values from analysis of executive compensation has undermined our understanding of the magnitude and performance sensitivity of executive pay.

The events of recent years have increased the attention given to executive compensation by investors and the media, and it has been suggested that this additional scrutiny may provide a check on pay levels and ensure that executive compensation is related to firm performance.⁷ As long as investors, researchers, and the media do not have a complete and accurate picture of the magnitude and makeup of pay, however, their ability to evaluate pay arrangements will necessarily be limited. In this Article, we seek to both highlight the inaccuracy of existing assessments and to make an empirical contribution toward improving them.

To do so, this Article provides evidence about the magnitude and variance of executives' pension plan benefits. We study a sample composed of (1) CEOs of S&P 500 companies who left their positions during 2003 and the first five months of 2004; and (2) current CEOs who are at, or close to, the retirement age at which they will become entitled to a full pension benefit. We find that (1) pension values are on average quite substantial; (2) these values vary considerably among the executives in our sample; and (3) omitting them introduces significant inaccuracies in assessments of the magnitude and performance sensitivity of executive pay.

These findings indicate that the opaqueness of pension values leads to substantial distortions of the picture that investors have of the magnitude and makeup of total pay. They thus underscore the importance of reforming current disclosure rules. We therefore discuss new disclosure requirements that would improve investors' understanding of the role of pensions in executive compensation.⁸ We argue that firms should be required to disclose annually (1) the present monetary value of each executive's pension entitlement; and (2) the year-over-year increase in the value of this benefit based upon the executive's additional service and any increases in the executive's compensation. Furthermore, the annual increase in the value of pension benefits should be included in the summary compensation tables that most analysts use in assessing the magnitude of executive pay across firms.⁹

Although these disclosure requirements would impose minimal costs upon firms, they would greatly improve the quality of information available to investors. Furthermore, requiring firms to disclose the substantial amounts of performance-insensitive pay provided through pension benefits could well induce firms to improve pay practices. Increased transparency may not only serve as a check on total compensation

7. See, e.g., *Fat Cats Turn to Low Fat: CEO Pay*, *ECONOMIST*, Mar. 5, 2005 (noting "encouraging aspects" among results from a recent survey in CEO pay); Adrian Michaels, *Off the Leash: What Will Bring Executive Pay Under Control?*, *FIN. TIMES*, Aug. 24, 2004, at 15 (noting that most examples of excessive CEO pay come from the "pre-reform era").

8. Our proposals are based in part on those put forward in Lucian A. Bebchuk & Jesse M. Fried, *Stealth Compensation via Retirement Benefits*, 1 *BERKELEY BUS. L. J.* 291 (2004).

9. As this Article went to press, the Securities and Exchange Commission (SEC) was beginning to consider an expansion of existing disclosure requirements that would likely improve the transparency of retirement benefits. See *Executive Compensation and Related Party Disclosure*, 71 *Fed. Reg.* 6542, 6552 (proposed Feb. 8, 2006) (to be codified at 17 C.F.R.) (proposing that firms be required to disclose increases in the value of executives' retirement assets). We hope that the rules ultimately adopted by the SEC include the measures we discuss below for improving the transparency of executive pay.

levels, but also encourage firms to use forms of compensation that are more closely linked to performance.

The remainder of this Article is organized as follows. Part II describes how current disclosure rules enable firms to use pension benefits as a form of stealth compensation. Part III explains why the heavy use of executive pensions is unlikely to be efficient. Part IV discusses in detail several examples of CEO pension packages to illustrate the potential significance of pension compensation in assessing total executive pay. Part V provides evidence about the magnitude of pension benefits both in absolute terms and relative to other forms of compensation. Part VI considers the effects of pension benefits on the link between executive pay and performance. Part VII discusses the policy implications of our analysis and disclosure requirements that could, at minimal cost, improve the information available to investors about the magnitude and effects of pension benefits. Part VIII concludes.

II. THE NON-TRANSPARENCY OF PENSION PAY

Pension plans are an important feature of contemporary executive compensation.¹⁰ The amounts of the annual payments available under these plans are usually based on the number of years an executive has served with the company and the executive's pre-retirement compensation. In general, then, as an executive's salary and tenure increase, so do the executive's annual pension benefits. Pension payments, like salary, are therefore largely decoupled from firm performance.¹¹

In their annual proxy filings, firms must publish a summary compensation table providing dollar values for the various forms of compensation paid to the current CEO and the four other highest-paid executives of the firm. These figures are the most salient indicators of executive compensation in public firms. They are easily accessible to the media, shareholders, and researchers. As a result, standard databases of executive compensation—including the ExecuComp database, which both financial economists and compensation consultants use to assess executive pay systematically—are based on the highly visible figures set forth in these tables.

If executive pensions were structured as defined-contribution plans—with companies contributing a specified amount to accounts that will be made available to executives upon their retirements—firms would have to report these contributions in their summary compensation tables. But under the defined-*benefit* approach commonly used by public companies, annual increases in the value of an executive's retirement assets are largely hidden from view; firms are not required to include such increases in their summary compensation tables. A person examining compensation tables alone would therefore be unable to detect the steady buildup in the value of an executive's pension benefits.

Furthermore, disclosure requirements obligate firms to include only those amounts paid to *current* executives in the summary compensation tables. Because most executives

10. For a detailed description of pension practices and disclosures in general, see BEBCHUK & FRIED, *supra* note 3, ch. 9.

11. In addition, it is not uncommon for firms to credit executives with additional years of service at the time of their retirement, ratcheting up the final payout under the plan's formula. In our sample, for instance, the CEOs of Hercules and Delta benefited from this practice.

are no longer employed by the firm when their pension payments begin, payments to these retired executives need not be included in the published tables. Thus, the value of an executive's defined-benefit pension plan *never* appears—either when pension payments are promised or when they are delivered—in the summary compensation tables from which the media and researchers collect most of their information about executive compensation.

For this reason, executive pension plans have sometimes been marketed to corporate compensation committees specifically as a means for increasing compensation “off the radar screen of shareholders.”¹² According to media reports, some directors have voted to adopt such plans only after being reassured that the monetary value of the benefits would not have to be stated in the company's disclosures.¹³ Although the value of an executive's pension benefits does not appear in public disclosures, the existence of the pension plans themselves and the method for determining the amount of annual benefits must be disclosed in the firm's SEC filings.¹⁴ In this Article, we use these disclosures to estimate the value of pension plans awarded to the CEOs in our sample. But such estimates are not accessible to outsiders without closely analyzing company disclosures and making a series of actuarial assumptions and calculations.

Because of the limitations of existing disclosure requirements, the monetary values of executive pension plans have not been included in the standard databases that financial economists use for research on executive compensation. The commonly used ExecuComp data set, for example, includes only those compensation components for which firms disclose a monetary value. And, because the media also uses standard executive pay data sets, pension plan values have not been included in reports on CEO pay published annually in the financial press.¹⁵ To what extent has this omission distorted perceptions about the magnitude and structure of executive pay? This is a question that we seek to answer in this Article.

III. THE PUZZLE OF EXECUTIVE PENSIONS

Before proceeding to an empirical investigation of executive pensions, we would like to discuss possible explanations for the heavy use of these benefits. Boards and executives negotiating at arm's-length can be expected to structure pay in an efficient way; if an alternative form of compensation could increase the total pie available to the contracting parties, they could both be made better off by switching to it. We therefore consider three arguments that might justify pensions as an efficient form of executive pay. We conclude that none of the considered efficiency explanations is persuasive.

12. Liz Pulliam Weston, *The Nation; The Fall of Enron; Despite Recession, Perks for Top Executives Grow; Pay: Hidden Benefits Mushroom as Employees' Retirement Plans Shrink*, L.A. TIMES, Feb. 1, 2002, at A1 (quoting Cynthia Richson, Director of Corporate Governance for the State of Wisconsin Investment Board).

13. See, e.g., Glenn Howatt, *HealthPartners Ex-CEO Reaped Board's Favors; Secret Deals Contributed to \$5.5 Million Package*, STAR TRIB. (Minneapolis-St. Paul), Jan. 17, 2003, at 1A. According to this report, the HealthPartners board adopted a defined-benefit pension plan for the CEO “after receiving assurances that the supplemental retirement plan wouldn't have to be reported to the public.” *Id.*

14. For an example of one such disclosure requirement, see *supra* note 2.

15. See, e.g., Matthew Boyle, *2003 Executive Compensation Report, When Will They Stop?*, FORTUNE, May 3, 2004, at 123 (examining climbing pay of Fortune 500 executives, but excluding pension values); Louis Lavelle, *Executive Pay*, BUS. WK., Apr. 19, 2004, at 106 (same).

Although obtaining a better picture of the magnitude of executive pensions would be useful in any event, the questions we raise with respect to the efficiency of this form of compensation underscore the need to do so.

A. Tax Benefits?

The use of executive pensions might seem appropriate given that firms offer pension plans to many non-executive employees. In contrast to executive pensions, however, the pension plans used for non-executive employees are designed to capture the benefits from favorable tax treatment of “qualified” pension plans. Firms get a current deduction for contributing funds to a qualified employee plan, whereas employees do not pay income taxes until they retire and start getting payouts from the plan.¹⁶ The funds invested by the firm grow tax free until the employee retires, with neither the firm nor the employees paying any taxes on the investments’ appreciation in value. The qualified plans offered to non-executive employees thus provide them with tax benefits at no cost to the firm.

However, because of the limits on how much money can be placed in a qualified pension plan for each employee, firms cannot use qualified plans to provide executives with pensions that approach the magnitude of their annual compensation.¹⁷ For this reason, firms provide pensions to executives mainly through nonqualified “supplemental” executive retirement plans (SERPs). These SERPs do not enjoy a tax subsidy, however, and the investment income generated by SERPs is immediately subject to taxation. The effect of the SERP is largely to shift some of the executive’s tax burden to the firm. Whether such a shift reduces or increases the combined tax bill of the executive and the firm depends on their respective tax rates and investment opportunities.¹⁸

There are good reasons to doubt that it is generally efficient for the company to bear the executive’s tax burden. For one thing, given that the long-term capital gains tax rate paid by most individuals is lower than the marginal corporate tax rate paid by many companies, such a shift is likely to be *inefficient* in many cases. More importantly, it is telling that firms that provide SERPs to executives generally do not offer such plans to other employees. If SERPs were tax-efficient, one would expect companies to offer similar nonqualified plans to their non-executive employees. However, firms generally do not do so.¹⁹ This fact suggests that, absent the tax subsidy provided to qualified plans, using nonqualified retirement benefits is generally not a tax-efficient way to compensate employees. Thus, companies’ common practice of offering nonqualified SERPs to executives is difficult to explain on tax-efficiency grounds.

B. Reduction in Risk-Bearing Costs?

In addition to shifting the burden of paying taxes on investment gains, SERPs also

16. See 26 U.S.C. § 402(a) (2000).

17. See *id.* § 415 (b) (setting forth limits on contributions to qualified plans).

18. See, e.g., MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 181-83 (2004) (describing the assumptions under which such an arrangement would be tax-efficient).

19. See, e.g., Paul Hodgson, *Poor Disclosure and Elitism: The Problems With Executive Benefits*, IVEY BUS. J., Sept. 1, 2004, at 1, available at http://www.iveybusinessjournal.com/view_article.asp?intArticle_ID+512 (noting that non-executive employees do not have access to SERPs and non-qualified deferred compensation plans). None of the SERPs included in our study provided benefits to non-executive employees.

shift the risk of poor investment performance from the executive to the company. Executives' pension plans are *defined-benefit* plans, which guarantee fixed payments to the executive for life and thus shift the risk of investment performance entirely to the firm and its shareholders. No matter how poorly the firm and its investments perform, the executive is guaranteed a specified lifelong stream of payments. Thus, putting taxes aside, it might be suggested that pension plans produce an efficient reduction in executives' risk-bearing costs by shifting risk to shareholders who are better able to bear it.

This explanation, however, is difficult to reconcile with the fact that firms have been shifting from defined-benefit plans to defined-contribution plans in their compensation plans for non-executive employees.²⁰ If defined-benefit plans produce a more efficient allocation of risks in contracts between companies and their executives, one would expect them to be similarly preferable for contracts between companies and their non-executive employees. Indeed, if anything, one would expect defined-benefit plans to be more valuable to regular employees—and thus to produce a greater reduction in risk-bearing costs—than they are to executives. Relative to executives, regular employees are likely to be more dependent on their companies' retirement plans to meet their financial needs and therefore less able to bear the investment risks associated with defined-contribution plans. Thus, the fact that many companies offer defined-benefit plans to their executives but not to regular employees casts doubt on this explanation for the widespread use of executive pensions.

C. Aligning the Interests of Executives and Debtholders?

Providing a substantial part of executives' compensation through pensions does not appear designed to provide executives with incentives to enhance share value. In a recent paper, however, Sundaram and Yermack argue that executive pensions can be understood as a mechanism for aligning the interests of executives not with shareholders but rather with those of debtholders.²¹ According to this explanation, by providing executives with compensation in the form of a debt of the firm, firms give executives incentives to increase debtholder value by avoiding risk-increasing actions that could increase the likelihood of default.²²

We are not persuaded that this debt-serving explanation can account for the heavy use of executive pensions described here. First, a standard view in financial economics is that executives are likely to behave in a more risk-averse fashion than would be in the interest of diversified shareholders, and that a useful consequence of option plans is that they encourage executives to act less conservatively.²³ For those who hold this view,

20. See, e.g., David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. DAVIS L. REV. 187, 192 n.21 (2005) ("In the past thirty years, most private pension plans, such as those sponsored by a corporate employer, have shifted from defined benefit plans to defined contribution plans.").

21. See Sundaram & Yermack, *supra* note 6, at 18-21.

22. For a theoretical model analyzing how executive compensation could be designed to serve debtholders' interests, see, e.g., Alex Edmans, *The Role of Debt in Optimal Managerial Compensation* (unpublished paper, Mar. 2006), available at <http://ssrn.com/abstract=758508>.

23. See, e.g., WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 266-67 (6th ed. 1996).

compensating executives with debt of the firm could neutralize some of the beneficial effects of option grants and lead executives to be too conservative.

Second, even if it were desirable to align the interests of executives with those of the company's debtholders, it is unclear why such incentives need to be provided through pensions rather than simply by providing executives with compensation made of a mix of equity and debt securities (or a mix of options on these types of securities). Such compensation could align the interests of executives with the firm's debtholders and shareholders in a more precise manner.

Third, the debt-serving explanation is premised on the assumption that executive pensions will be treated in the same way in insolvency as will the claims of other creditors. Broadly speaking, however, this is simply not the case. Firms often use arrangements that shield SERP assets from the firm's general creditors.²⁴ Firms also often give executives the contractual right to get in cash the actuarial value of their pension—and thus terminate their status as long-term debtholders—at the time of their retirement.²⁵ And firms going through Chapter 11 reorganization often assume, in full, the company's obligations toward executives promised a defined-benefit pension even when paying only part of the claims of financial creditors.²⁶

Finally, if executive pensions were designed to serve debtholders, one would expect firms to commit to using them in the agreements accompanying public debt issuances, private debt placements, or bank loans. But such terms are not commonly included in such agreements, and we are unaware of any case in which they have been included.

D. Camouflage?

While the efficiency benefits of providing executives with defined-benefit SERPs are far from clear, such plans do considerably reduce the visibility of a substantial amount of performance-insensitive compensation. When designers of pay arrangements are interested in reducing the salience of the total amount of compensation, or the extent to which it is insensitive to performance, they might find executive pensions useful. A camouflage motive might lead to the inclusion of a pension component even where pensions do not produce efficiency benefits. Indeed, a camouflage motive might do so even when including pensions would be less efficient than providing the same compensation value in other forms.

24. See I.R.S. Priv. Ltr. Rul. 98100005 (Dec. 3, 1997) (noting that such arrangements are increasingly used).

25. This statement is based on our conversations with Dave Gordon, a compensation lawyer with Clark Consulting, who has a great deal of experience in this area. In his experience, a substantial fraction of SERPs provide executives with the option of taking the actuarial value of their plan as a lump-sum amount upon retirement. When a lump sum option is available, the rate of return on long-term treasury bonds is commonly used as the discount rate for calculating the present value of future pension payments.

26. Recent examples of companies that underwent Chapter 11 reorganization and fully assumed such obligations are Comdisco and Harvard Industries, whose reorganization plans can be found at http://lopucki.law.ucla.edu/BRD_documents/Comdisco/Plan.pdf and http://lopucki.law.ucla.edu/BRD_documents/Harvard%20-%20plan.pdf. In our conversations with Dave Gordon, he told us that, in his experience, it is common for unfunded pension obligations to executives to survive Chapter 11 bankruptcy. See *supra* note 25.

IV. MOTIVATING EXAMPLES

The discussion in Parts II and III highlights the importance of obtaining a quantitative sense of the magnitude of executive pensions and the fraction of total pay they comprise. Before turning to a systematic assessment of this subject, this Part discusses in detail several examples of pension benefits enjoyed by CEOs. These examples raise the possibility that executive pensions might be a significant form of compensation, and thus set the stage for the more systematic examination conducted in Part V.

A. Pfizer's \$80 Million Pension Benefit

Hank McKinnell has served as Pfizer's CEO since 2001. He is a current Chairman of the Business Roundtable and former co-chair of the Business Roundtable's Corporate Governance Task Force. In November 2003, the Business Roundtable issued a statement entitled "Principles of Executive Compensation" prepared by the Task Force co-chaired by McKinnell.²⁷ According to one of these principles, "[c]orporations should provide complete, accurate, understandable, and timely disclosure to stockholders concerning all significant elements of compensation and compensation practices."²⁸ The principles call on companies to disclose compensation in a way that is "transparent and understandable to stockholders," addressing both "the form and amount of executive compensation" as well as "the relationship of executive compensation packages to corporate goals and strategy."²⁹

During his tenure as CEO, McKinnell has received a total salary of approximately \$5 million. His total compensation as CEO, at the time of this writing, added up to approximately \$67 million.³⁰ McKinnell's salary and total compensation as CEO do not stand out when compared to CEO pay at peer firms. But these numbers tell only half of the compensation story; the value of McKinnell's pension plan is greater than the total compensation he has received during his years as CEO.

At 62, McKinnell is three years away from eligibility for retirement under his company's plan. Assuming conservatively that his compensation will not increase before his retirement, and using the pension tables provided in Pfizer's annual proxy, we

27. BUS. ROUNDTABLE, EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY (2003), available at <http://www.businessroundtable.org/pdf/ExecutiveCompensationPrinciples.pdf> [hereinafter EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY]; see also Transcript of Telephone Media Briefing, Business Roundtable (Nov. 17, 2003), available at <http://brt.org/newsroom/document.aspx?qs=5286BF807822B0F1AD250D46BFC5B280A80> (presentation of the adopted principles by Hank McKinnell, Franklin Raines, and John Castellani).

28. EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY, *supra* note 27, at 2.

29. *Id.* at 13-14.

30. Throughout this Article, we use the term "total compensation" to refer to both equity compensation (valued at the sum of the grant-date value of options and the value of restricted shares) as well as non-equity compensation. We have drawn all of our salary and total compensation figures directly from ExecuComp's database. All compensation from years before 2003 has been adjusted for inflation using the annual change in the Consumer Price Index. Note that because ExecuComp contained only data from 1992 to 2003 when we carried out our analysis, these results exclude compensation received in years outside this period. For additional discussion of our methodology for comparing pension values to executives' total compensation, see *infra* notes 62 and 67.

estimate that McKinnell will receive an annual pension of \$6.5 million upon his retirement.³¹ It is worth noting that Pfizer's proxy statement discloses neither the actuarial value of McKinnell's pension benefits nor the amount of the annual payment. To value this pension, therefore, a reader would have to carefully review Pfizer's disclosures to determine how the firm will calculate the annual payment, and then make an actuarial assessment of the cost of these payments over the remainder of McKinnell's life.

Moreover, investors seeking to place a monetary value on McKinnell's pension plan would require additional information to do so. As is the case with many CEOs, his pension will be paid in the form of a joint-life annuity, guaranteeing a 50% benefit to his surviving spouse in the event of his death. Thus, the actuarial value of his pension plan depends on whether he is married and, if so, the age of his spouse. The proxy statement does not provide any information on these matters. We have been unable in our research to determine whether McKinnell is in fact married,³² and the company declined a request that it provide the information about McKinnell's status necessary to calculate the value of his retirement benefit.³³

If McKinnell is not married, we estimate the actuarial value of his pension plan at approximately \$71.5 million.³⁴ If he was indeed recently married, the extent to which the value of his pension has increased depends on the age of his spouse. For example, assuming that McKinnell's spouse is the same age as he is, we estimate that the marriage has increased the value of his pension by \$11.6 million, bringing the total amount to approximately \$83 million. In either case, understanding the value of McKinnell's retirement benefits, which do not appear to be disclosed to investors in the "transparent and understandable" way recommended by the Business Roundtable, is critical for investors seeking to gain a complete picture of his overall compensation.³⁵

B. UnitedHealth Group: Making CEO Retention More Difficult

William McGuire became CEO of UnitedHealth Group in October 1999. In 2003, he earned a base salary of \$2.1 million and received total compensation of approximately \$10 million.³⁶ Again, however, McGuire's annual pay is only part of the story.

McGuire is entitled to substantial retirement benefits. UnitedHealth will pay him approximately \$5.1 million per year upon his retirement for the remainder of his life, and it will pay approximately \$2.5 million each year to his surviving spouse.³⁷ Assuming

31. See PFIZER INC., NOTICE OF ANNUAL MEETING OF SHAREHOLDERS, PROXY STATEMENT AND 2004 FINANCIAL REPORT 55 (2005), available at http://www.pfizer.com/pfizer/download/investors/financial/proxy_0310_05.pdf (using the company's pension plan table to calculate a hypothetical annual benefit and assuming that Dr. McKinnell's 2004 compensation is indicative of the total compensation figure upon which his pension benefit will be based).

32. See Amy Barrett, *Pfizer's Funk*, BUS. WK., Feb. 28, 2005, at 72 (providing resume of "Pfizer lifer" Henry A. McKinnell, Jr.).

33. Telephone Interview with Pfizer Media Relations Department (Apr. 8, 2005).

34. Our methodology for calculating the actuarial value of pension plans is described *infra* at text accompanying notes 55 through 57.

35. EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY, *supra* note 27, at 13.

36. See UnitedHealth Group, Proxy Statement (Form DEF 14A), at 18 (Apr. 9, 2004).

37. *Id.* at 26.

McGuire is married to a woman his age, we estimate the present value of his pension benefit at approximately \$45 million, more than four times his total compensation in 2003.

An interesting feature of McGuire's pension plan is that, once in place, the plan's design might make it *more* costly for the company to retain him. Companies often refer to executive retention as one of the goals of their compensation arrangements, but McGuire's plan does not seem to serve this goal. Under the terms of the plan, the company will be obligated to begin paying McGuire's annual benefit upon termination of his employment "for any reason."³⁸ Unlike most executives, who must wait until a designated retirement age—usually 65—before collecting pension benefits, McGuire, who is now just 57 years old, can begin receiving these substantial payments whenever he chooses to retire.

From McGuire's perspective, then, working for an additional year *costs* him \$5.1 million in forgone pension payments. Thus, UnitedHealth must pay him \$5.1 million each year in order for him to break even with respect to his decision not to retire. That is, McGuire will be financially rewarded for choosing to work only after the company spends \$5.1 million to neutralize the effects of his entitlement to large pension benefits whenever he leaves.³⁹

C. Black & Decker: The Significance of Pensions to Shareholder Value

While McGuire and McKinnell are entitled to substantial pension benefits in absolute terms, their companies have large market capitalizations, and their pension benefits comprise only a small fraction of their firms' substantial market values. For smaller companies, however, executives' pension values might be significant relative to overall firm value. Nolan Archibald, Black & Decker's CEO, will be entitled to annual pension payments upon his retirement at age 60.⁴⁰ Assuming conservatively that his compensation will not increase before his retirement, his annual pension payment will be approximately \$2.5 million. We estimate the present value of his retirement benefits at \$38.3 million.⁴¹

These pension benefits are hardly negligible to the shareholders' bottom line. At the time of this writing, Black & Decker's market capitalization stood at \$6.75 billion.⁴²

38. *Id.* at 25-26.

39. It might be suggested that at the time McGuire was promised his generous retirement benefits, the large actuarial value of the plan could have been helpful in inducing him to serve as CEO. For any given actuarial benefit the company wanted to provide ex ante, however, the company could have avoided the perverse effect described here by providing a larger annual payment beginning at a stipulated retirement age, rather than giving McGuire an annual incentive to retire from the firm.

40. Black & Decker Corp., Proxy Statement (Form DEF 14A), at 14, 16-17 (Mar. 14, 2005), available at <http://www.ir.bdk.com/phoenix.zhtml?c=100780&p=irol-sec>. Note that although Black & Decker's pension plan calls for a retirement age of 65, its SERP has a "normal retirement age" of 60. *Id.* at 17. Because the majority of Mr. Archibald's benefits will be paid through the latter program, we used a retirement age of 60 in valuing his pension.

41. For a description of the methodology we used to calculate the actuarial value of pension plans, see *infra* text accompanying notes 55 through 57.

42. We calculated the firm's market capitalization on the basis of outstanding shares and share price as of March 10, 2006.

Archibald's pension *alone*, then, was worth approximately 0.57% of the total value of the firm that he operates. Archibald's example makes clear that the magnitude of pension benefits can be substantial even in the context of overall firm size. Interestingly, as recently as 2003, Archibald's pension value constituted a substantially higher percentage of Black & Decker's market capitalization. As of December 31, 2003, Black & Decker's market capitalization was approximately \$3.8 billion, and the value of Archibald's pension was therefore equal to about 1% of the firm's value.⁴³ Clearly, pension values can be significant relative not only to total executive pay but also relative to total firm value.

D. Home Depot: High Pensions, Brief Tenure

The preceding examples described executives who had lengthy tenure with their companies. As our final example illustrates, however, some executives are able to accumulate rather large retirement benefits even before they accrue lengthy service with their firms.

Robert Nardelli joined Home Depot in December 2000 to become its new President and CEO. In 2003 he received total compensation of approximately \$22 million.⁴⁴ Three years into his tenure, however, Nardelli, who is 56 years old, is already entitled to annual payments of approximately \$3.25 million upon his retirement at age 62.⁴⁵ Even assuming that Nardelli's compensation level does not increase before he turns 62, we estimate the present value of his pension entitlement at approximately \$33 million. Thus, if Nardelli leaves the company upon reaching retirement age, he will receive approximately \$4 million in retirement benefits for each year of service as CEO. This figure will increase, of course, if Nardelli's salary or bonus increases before he retires.

Moreover, even if Nardelli leaves the firm now, he will still be entitled to receive annual payments starting at age 62. In such a case, as Home Depot's proxy statement indicates, Nardelli will receive only "discounted benefits," but the statement provides no information about the size of this discount. Furthermore, the company declined our request to provide information about the size of the discount.⁴⁶ Assuming that the discount is approximately 33%, for example, Nardelli can depart Home Depot after just four years of service with retirement benefits of \$22 million, or more than \$5 million in pension benefits alone for each year he served as CEO. Of course, the exact figure depends on the magnitude of the discount, which Home Depot has chosen not to disclose to investors, making it even more difficult for shareholders to appreciate the significance of these benefits and their effects on firm value.

43. This percentage declined between December 2003 and April 2005 as a consequence of an increase in the price of Black & Decker stock during this period.

44. THE HOME DEPOT, PROXY STATEMENT AND NOTICE OF 2004 ANNUAL MEETING OF STOCKHOLDERS 26 (2004), available at <http://ir.homedepot.com/downloads/hd2004proxy.pdf>.

45. *Id.* at 33. We estimated Mr. Nardelli's annual benefit by applying the company's formula for the benefit to his 2003 compensation.

46. Telephone Interview with Home Depot Media Relations Department (Apr. 8, 2005).

V. THE SIGNIFICANCE OF PENSIONS

The above examples suggest that an analysis of executive pay that excludes retirement benefits might tell only part of the story. To examine whether this is indeed the case, we turn now to a more systematic study of the magnitude of these benefits and their effects on the total magnitude and structure of executive compensation.

A. Sample

The precise value of an executive's pension plan usually does not crystallize until the executive approaches retirement. Executives who will remain at their firms for extended additional periods may well experience changes (usually increases) in the magnitude of their annual pension amount. Therefore, to get a good sense of the role that pension values play in the overall picture of executive pay, it is useful to focus on executives whose final retirement benefits can be estimated with relative accuracy. Therefore, our sample includes executives who either (1) have already departed their firms, or (2) are likely to retire in the relatively near term.

Our study therefore includes two sets of executives. Our first sample was generated by searching ExecuComp's database for CEOs at S&P 500 companies who departed their firms during 2003 or during the first five months of 2004.⁴⁷ The second sample included all CEOs in the ExecuComp database at S&P 500 companies who were between 63 and 67 years old on December 31, 2003, the most recent date for which we had data available.

Our first sample of retired executives is set forth in Table 1 below. Among this first group of executives, 28 CEOs, or 68%, were members of a company-sponsored pension plan. Thus, the incidence of pension plans in our sample is comparable to some recent estimates of the prevalence of such plans among CEOs of public firms.⁴⁸ The CEOs in our first sample were, on average, approximately 62 years old and served an average term of seven years as CEO prior to their departures. Because the group contains only S&P 500 issuers, the mean market capitalization of the companies in our sample is rather large, at more than \$21 billion. The sample nevertheless includes a relatively diverse collection of companies, with values ranging from just over \$1 billion to more than \$250 billion.⁴⁹

Our second sample is set forth in Table 2 below. The ExecuComp database included 36 CEOs of S&P 500 companies between the ages of 63 and 67. Among this group, 23 CEOs, or 64%, were members of a company-sponsored pension plan.⁵⁰ Unsurprisingly, the CEOs in our second sample have a slightly higher average age (64.6 years) than the

47. We selected this timeframe because ExecuComp's most recent update at the time of this writing included only data through May 2004.

48. The incidence of pension plans in this sample is comparable to a figure provided by Clark Consulting, which recently estimated that 70% of companies used defined-benefit pension plans in 2003. See CLARK CONSULTING, TENTH ANNUAL SURVEY OF EXECUTIVE BENEFITS, available at <http://www.clarkconsulting.com/knowledgecenter/articles/benefits/10thannualsurvey.doc>.

49. Because we have drawn market value data from the ExecuComp database for this group of executives, note that all values represent the issuers' market values at the end of 2003.

50. The incidence of pension plans in this sample, then, was also consistent with analysts' estimates of the incidence of pension plans generally. See CLARK CONSULTING, *supra* note 48.

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executives in our first sample. The issuers in our second sample also have a slightly higher mean market value of \$26.1 billion, although this sample, too, consists of a broad range of companies, with values ranging from \$3.5 billion to \$271 billion.

TABLE 1: RECENTLY DEPARTED S&P 500 EXECUTIVES WITH PENSION BENEFITS

Issuer Name	Market Value	Executive	Age	Departure Date	Length of Service (Years)
Allegheny Technologies Inc.	1,066,854,000	Murdy	65	9/30/03	2.28
Ambac Financial	7,414,668,000	Lassiter	60	1/27/04	12.93
Ameren Corp.	7,470,446,000	Mueller	65	12/31/03	10.14
Anadarko Petroleum Corp.	12,798,307,000	Allison, Jr.	65	1/1/02	15.48
Bard (C.R.) Inc.	4,213,625,000	Longfield	65	8/1/03	9.30
Boeing Co.	33,721,102,000	Condit	63	12/1/03	7.70
Caterpillar Inc.	28,661,824,000	Barton	65	1/31/04	5.07
Clorox Co.	9,243,705,000	Sullivan	65	7/1/03	11.33
Citigroup Inc.	250,402,188,000	Weill	70	10/1/03	5.83
Coca-Cola	9,948,707,000	Kline	64	1/1/04	2.76
Dana Corp.	2,727,122,000	Magliochetti	60	9/22/03	4.69
Delta Air Lines Inc.	1,458,535,000	Mullin	61	1/1/04	6.48
Duke Energy Corp.	18,977,189,000	Priory	57	11/1/03	6.51
FirstEnergy Corp.	11,462,387,000	Burg	56	12/22/03	4.72
Freeport-McMoRan Copper	7,226,601,000	Moffett	65	12/1/03	19.61
Hercules Inc.	1,352,809,000	Joyce	69	11/25/03	2.59
Int'l Paper Co.	20,712,932,000	Dillon	66	10/31/03	7.69
Jefferson-Pilot	7,144,436,000	Stonecipher	63	2/29/04	11.16
MBNA Corp.	31,750,148,000	Cawley	64	12/30/03	1.18
Moody's Corp.	9,009,840,000	Rutherford, Jr.	65	10/1/03	3.04
Motorola Inc.	33,500,770,000	Galvin	54	1/5/04	7.11
New York Times	7,118,277,000	Lewis	56	12/31/04	7.31
Progress Energy Inc.	11,091,642,000	Cavanaugh III	65	2/29/04	7.52
Rockwell Automation	4,851,026,000	Davis, Jr.	65	2/4/04	6.44
Symbol Tech.	3,905,069,000	Bravman	47	12/30/03	1.43
Texas Instruments	50,845,762,000	Engibous	51	5/1/04	7.98
Thomas & Betts Corp.	1,338,287,000	Dunnigan	66	1/16/04	3.49
Waste Mgmt Inc.	17,240,904,000	Myers	63	3/1/04	4.37
Mean Values	21,666,255,786		62		7.00
Median Values	9,126,772,500		65		6.49

TABLE 2: CURRENTLY SERVING S&P 500 CEOs BETWEEN AGES 63 AND 67

Issuer Name	Market Value	Executive	Age	Date Became CEO	Length of Service-Years ⁵¹
Aon Corp.	7,507,775,000	Ryan	66	8/1/82	23.0
Avery Dennison	6,188,529,000	Neal	63	5/1/98	7.0
Colgate-Palmolive Co.	26,888,861,000	Mark	65	5/1/84	21.2
Cooper Industries Ltd.	5,407,881,000	Riley, Jr.	63	9/1/95	9.7
Countrywide Financial Corp.	13,977,486,000	Mozilo	65	2/1/98	7.3
Dow Chemical	38,266,641,000	Stavropoulos	64	12/15/02	2.4
Exxon Mobil Corp.	271,001,813,000	Raymond	65	4/28/93	12.1
Gannett Co.	24,167,889,000	McCorkindale	64	6/1/00	4.9
Genuine Parts Co.	5,775,738,000	Prince	65	4/1/89	16.3
Harley-Davidson	14,400,212,000	Bleustein	64	6/1/97	8.0
Keyspan Corp.	5,853,408,000	Catell	67	5/1/98	7.0
Knight-Ridder Inc.	6,181,554,000	Ridder	63	3/24/95	10.2
Masco Corp.	12,694,996,000	Manoogian	67	1/1/85	20.6
Merck & Co.	102,794,859,000	Gilmartin	63	6/16/94	11.0
Nisource Inc.	6,069,212,000	Neale	64	3/1/93	12.3
Norfolk Southern	9,233,409,000	Goode	63	9/1/92	12.8
Scientific-Atlanta Inc.	3,551,945,000	McDonald	63	7/15/93	11.9
Sempra Energy	6,800,654,000	Baum	63	6/1/00	4.9
SouthTrust Corp.	10,863,623,000	Malone, Jr. ⁵²	67	1/1/81	24.9
Teradyne Inc.	4,869,603,000	Chamillard	65	5/16/97	8.0
Txu Corp.	7,682,671,000	Nye	66	5/1/95	10.1
Unisys Corp.	4,906,692,000	Weinbach	64	9/23/97	7.7
Valero Energy Corp.	5,573,219,000	Greehey	67	1/1/97	8.4
Mean Values	26,115,594,348		64.6		10.8
Median Values	7,507,775,000		64.0		9.9

51. We calculated the executives' length of service through and including August 2005. We have drawn the date on which each executive became CEO from ExecuComp, which uses the first date of the month for these purposes if public disclosures do not reveal the date of the appointment.

52. In November 2004, SouthTrust was sold to Wachovia Bank, and Malone retired shortly thereafter. Malone's post-retirement compensation has since become a subject of some controversy. See, e.g., Gretchen Morgenson, *Go for Platinum*, N.Y. TIMES, Feb. 5, 2006, at A2.

Taken together, these samples provide a picture of the magnitude of the costs of executive pension plans to shareholders. The first sample, which consists only of retired CEOs, permits us to estimate the magnitudes of pensions that shareholders have already begun to pay. The second sample, which consists of CEOs who are approaching retirement, permits us to assess the approximate costs of pensions that shareholders can be expected to start paying before too long.

B. Annual Pension Values

After identifying the set of executives and issuers in each sample, we estimated the annual pension benefit of each executive by reviewing the issuers' proxy materials, 8-Ks, and the executives' employment agreements. These materials often disclose either the executives' annual pension benefits, which are commonly based upon their length of service and selected categories of compensation, or at least the formula used by the firm to calculate this benefit.⁵³ We also adjusted the annual value of the executives' pension benefits for "grossing-up" provisions that entitle participants to have the company cover the tax liability generated by pension benefits.⁵⁴ Our estimates of the annual payments also included additional grants of "service credit" by the issuers' boards of directors, which in several cases increased the executives' retirement benefits considerably. For example, in our first sample, William H. Joyce was granted 15 years of service credit when he became CEO of Hercules, Inc., at an anticipated cost of nearly \$5 million.

Tables 3 and 4 below set forth our estimates of the CEOs' annual pension benefits in each of the two samples we examine. As Table 3 indicates, the average annual payment for our sample of retired executives is \$1.1 million. Charles Cawley, former CEO of MBNA Corporation, is entitled to the highest annual pension payment in this group, at \$2.3 million per year. Table 4 provides our results for the sample of current executives approaching retirement age. These executives had an average annual pension benefit of \$1.5 million. The executive with the highest annual benefits among our sample of current CEOs, Lee Raymond of Exxon Mobil, is entitled to \$5.7 million per year.

53. In those cases in which the exact amount of the executive's annual benefit was not disclosed, we assumed that the benefit would be calculated on the basis of the executive's compensation in the year of service preceding his retirement. In all of these cases, we calculated the executive's annual benefit based upon the categories of compensation that the issuer's pension plan includes when calculating benefits.

54. In those cases that required "grossing up" of annual benefits, we conservatively assumed that federal and state income taxes subject retiring CEOs to a marginal tax rate of 35%.

TABLE 3: THE VALUE OF RETIRED CEOs' PENSION PLANS

Issuer Name	Executive	Annual Pension	Actuarial Value of Pension
Allegheny Technologies Inc.	Murdy	818,983	10,433,234
Ambac Financial	Lassiter	1,950,000	19,463,885
Ameren Corp.	Mueller	360,000	4,586,104
Anadarko Petroleum Corp.	Allison, Jr.	1,634,200	20,818,314
Bard (C.R.) Inc.	Longfield	1,174,428	18,075,353
Boeing Co.	Condit	1,419,600	16,403,208
Caterpillar Inc.	Barton	1,312,500	16,720,171
Clorox Co.	Sullivan	1,760,000	22,960,578
Citigroup Inc.	Weill	1,061,226	11,838,822
Coca-Cola	Kline	480,000	5,823,624
Dana Corp.	Magliochetti	1,132,488	11,303,863
Delta Air Lines Inc.	Mullin	480,000	6,751,188
Duke Energy Corp.	Priory	544,552	4,695,298
FirstEnergy Corp.	Burg	558,055	8,663,537
Freeport-McMoRan Copper	Moffett	1,400,000	25,234,900
Hercules Inc.	Joyce	477,390	5,470,710
Int'l Paper Co.	Dillon	1,489,554	18,365,143
Jefferson-Pilot	Stonecipher	2,272,143	26,254,146
MBNA Corp.	Cawley	2,274,000	27,589,420
Moody's Corp.	Rutherford, Jr.	950,000	12,102,270
Motorola Inc.	Galvin	1,507,692	41,283,263
New York Times	Lewis	750,000	6,158,841
Progress Energy Inc.	Cavanaugh III	1,045,168	13,314,530
Rockwell Automation	Davis, Jr.	1,165,879	15,002,428
Symbol Tech.	Bravman	600,000	3,302,733
Texas Instruments	Engibous	742,306	4,776,122
Thomas & Betts Corp.	Dunnigan	1,807,500	26,185,101
Waste Management Inc.	Myers	923,077	19,808,226
Mean Values		1,146,098	15,120,893

TABLE 4: THE VALUE OF CURRENT CEOs' PENSION PLANS

Issuer Name	Executive	Annual Pension (\$)	Actuarial Value of Pension (\$)
Aon Corp.	Ryan	379,611	4,835,932
Avery Dennison	Neal	1,047,387	13,663,952
Colgate-Palmolive Co.	Mark	2,160,000	35,759,000
Cooper Indust. Ltd.	Riley, Jr.	1,066,000	13,579,913
Countrywide Fin. Corp.	Mozilo	2,171,358	22,537,954
Dow Chem.	Stavropoulos	1,457,000	18,561,033
Exxon Mobil Corp.	Raymond	5,760,000	73,377,666
Gannett Co.	McCorkindale	2,140,000	27,261,841
Genuine Parts Co.	Prince	925,040	11,784,249
Harley-Davidson	Bleustein	1,750,000	22,757,959
Keyspan Corp.	Catell	1,248,750	15,035,833
Knight-Ridder Inc.	Ridder	793,743	10,354,936
Masco Corp.	Manoogian	508,057	6,117,324
Merck & Co.	Gilmartin	1,568,000	19,975,082
Nisource Inc.	Neale	483,000	6,153,023
Norfolk Southern	Goode	1,231,737	15,691,355
Scientific-Atlanta Inc.	McDonald	1,123,101	14,307,422
Sempra Energy	Baum	836,288	13,520,536
SouthTrust Corp.	Malone, Jr.	3,765,115	45,334,489
Teradyne Inc.	Chamillard	513,400	6,540,243
Txu Corp.	Nye	1,995,511	24,603,196
Unisys Corp.	Weinbach	1,000,000	13,004,256
Valero Energy Corp.	Greehey	1,354,000	16,302,991
Mean Values		1,533,787	19,611,312

C. Costs of Retirement Benefits: Actuarial Values of Pension Plans

After identifying each executive's annual pension benefit, we calculated the value of these income streams by estimating the price of a life annuity instrument⁵⁵ purchased at the applicable retirement age and providing an annual payment equal to the executive's benefit.⁵⁶ In those cases in which the company's pension plan provided benefits to the

55. Because we did not expect minor offsets required by some pension plans in our sample to be significant, we did not attempt to deduct those offsets from the estimates set forth here. Several of the pension plans in our sample, for example, require deductions for Social Security payments to which the executives will be entitled during their retirements. These benefits are likely to be quite small relative to annual pension payments.

56. These calculations, which depended in part on the executive's gender and state of residence, were in many cases performed by using an Internet mechanism for pricing annuities. See Instant Annuity Price Calculator, <http://www.immediateannuities.com> (last visited Mar. 23, 2006). For simplicity, we assumed that

executive's spouse on a joint-survivor basis, we calculated the value of the pension by pricing an annuity providing for joint-survivor benefits purchased when the executive reached retirement age.⁵⁷ All but one member of our first sample are entitled to pension benefits at the age of 65.⁵⁸ Because most of the executives in this first sample will not be entitled to receive the annual benefit until they reach the age of 65, we discounted⁵⁹ the value of their pension benefits to present-value dollars over the time period between their departure and the year the executive will reach the retirement age.⁶⁰

Tables 3 and 4 above set forth the actuarial values of the pension benefits of the CEOs in our samples. CEO pension values in our first sample, which includes only

executives would reside or retire in the state in which, according to ExecuComp, the firm maintains its headquarters.

57. We used this methodology to calculate the value of the pension benefit in every case but one. In that case, Richard Bravman, former CEO of Symbol Technologies, was awarded a 15-year stream of payments rather than a life benefit. To estimate the value of that benefit, we simply calculated the value of a 15-year annuity in the amount of Mr. Bravman's benefit at a discount rate of 5%.

58. In most cases, the issuer's proxy materials explicitly indicated that the executive would not be entitled to pension benefits until he reached the pension plan's normal retirement age. In one case, however, Motorola CEO Christopher Galvin's pension plan called for payments beginning at the age of 55, or shortly after his retirement. Payments in advance of the standard retirement age were also used in the much-publicized case of Franklin Raines, which was not included in our analysis because Raines's resignation took place outside our sample timeframe. See Bebchuk & Fried, *supra* note 1. Of course, because such arrangements significantly increase the number of actuarially likely payments in the pensioner's income stream, they can increase the value of the pension asset substantially.

59. In calculating the present value of the pensions of CEOs who have not yet retired, we assumed that the amount of the executive's annual benefit will not increase between his departure and the retirement age. This is a conservative assumption because several executives in our sample continued to accrue service-time credit, thereby increasing the value of their pensions, by serving as an outside consultant to the company or as a member of the company's board of directors. For example, G. Thomas Baker of International Game Technology became Chairman of that company's board after his resignation. Richard Bravman of Symbol Technologies remained a senior advisor to that company's new CEO at the time of his retirement. Although we expect that both executives would continue to accrue service credit as a result of their continued employment, we have not increased their estimated annual pension benefit as a consequence of these arrangements.

In discounting the value of pension assets for executives who have not yet retired, we assumed a discount rate of 5%. Sundaram and Yermack, *supra* note 6, at 7, suggest that this rate might be lower than is appropriate for companies with a significant likelihood of default. However, several firms have established trusts to ensure that executive pensions will be secure even in the event that the firm declares bankruptcy. See, e.g., Theo Francis & Ellen E. Schultz, *Guess Whose Retirement Benefits Aren't Endangered?: Many Companies Set Up Trusts to Protect Huge Pensions for Top Executives*, PITTSBURGH POST-GAZETTE, Apr. 6, 2003, at B-1 (discussing how Delta Air Lines and other companies "actually turn the [pension funds] over to the executives, or to special trusts set up in their names"). Furthermore, as we have noted, see *supra* text accompanying note 26, even when executives' pensions are unsecured, firms going through Chapter 11 bankruptcy often choose to assume fully such obligations.

Given these considerations, and especially in view of our conservative assumptions with respect to the change in benefits between the date of calculation and the date of eligibility for annual payments, there is little basis for expecting our methodology to result in overestimation of the present value of executives' pensions.

60. For instance, after the death of Dana Corporation executive Joseph Magliochetti, his spouse chose a lump-sum payment equal to the present value of the annual benefit to which Magliochetti was entitled. To calculate the comparable annual benefit in this situation, we simply calculated the future value of the lump-sum payment in this case and then computed the actuarially necessary annual payments required to finance an annuity with this value. This approach is simply the converse of the analysis we used to calculate the total actuarial value of a stream of payments in cases in which the issuer disclosed the value of each payment in the stream rather than the value of the lump sum. See *supra* text accompanying notes 55-57.

retired executives, had an average value of about \$15 million; pension benefits for all 28 executives in this sample totaled more than \$423 million. The current CEOs featured in our second sample were, on average, entitled to even more substantial benefits. As Table 4 shows, the average actuarial value of the current executives' pension benefits exceeded \$19 million. The 23 executives in this group were entitled to approximately \$451 million in total benefits. Taken together, then, our sample of 51 current and retired CEOs is entitled to pension benefits worth over \$800 million.

Table 5 below provides summary statistics for each of our samples as well as summary data for the combined sample of 51 executives. The median actuarial value of the pension benefits in our first sample was about \$14 million; the median for our second sample, as well as for the 51 executives in our sample overall, was approximately \$15 million.⁶¹

TABLE 5: MAGNITUDE AND VARIABILITY OF PENSION VALUES

Sample Statistics	Annual Pension Amounts	Actuarial Value of Pensions
<i>Retired CEOs (28)</i>		
Median	1,096,857	14,158,479
Mean	1,146,098	15,120,893
Standard Deviation	549,307	9,117,543
Minimum	360,000	3,302,733
Maximum	2,274,000	41,283,263
<i>Current CEOs (23)</i>		
Median	1,231,737	15,035,833
Mean	1,533,787	19,611,312
Standard Deviation	1,193,181	15,141,154
Minimum	379,611	4,835,932
Maximum	5,760,000	73,377,666
<i>Combined Sample (51)</i>		
Median	1,132,488	15,002,428
Mean	1,320,938	17,145,984
Standard Deviation	909,569	12,282,278
Minimum	360,000	3,302,733
Maximum	5,760,000	73,377,666

Importantly, there is substantial variance within each sample and across the combined set of 51 executives as a whole. As Table 5 shows, the annual pension amount ranges from a low of \$360,000 to a high of nearly \$2.3 million in our first sample of retired CEOs, and ranges from a low of about \$380,000 to a high of nearly \$5.8 million in

61. In discussing the summary statistics in this and subsequent tables, we will focus on median figures in order to avoid distortions caused by outliers in the sample.

our second sample of currently serving executives nearing retirement age. This substantial variation among executives indicates that the exclusion of pensions from analysis of executive compensation is likely not only to skew analysis of the *magnitude* of executive pay but also distort comparisons *among* executives. Because the effect of pension payments on executives' compensation varies considerably among individual CEOs, analyses of executive pay that omit pension values are likely to produce comparisons among executives that do not reflect an accurate ranking of the executives' total compensation.

D. Relative Significance of Pension Values

Having observed the value of pension benefits in each of our samples in absolute terms, we turn now to examining the significance of these values in the context of executives' overall pay. Table 6 presents a comparison between the pension benefits we valued and other components of executive compensation in each sample and for the combined group of 51 executives in our study.

1. Ratios of Pension Values to Salaries Received During CEO Tenure

The first column in Table 6 compares the executives' pension values to the base salaries the executives received throughout their tenures as CEOs.⁶² The median ratio of pension value to base salary was 2.2:1 for the first sample of retired executives; 1.9:1 for the second sample of current executives; and 2.1:1 for the overall group of 51 executives in our study.

In addition, the variation of the relationship of the CEOs' pensions to their salaries was substantial within each of the samples and in the group as a whole. This ratio ranged from 0.6:1 to 9.2:1 in the first sample and from 0.4:1 to 16.0:1 in the second sample. The executive with the highest ratio of pension value to CEO salary was Robert Catell of Keyspan Corporation, whose pension is worth more than 16.0 times the sum of all salary payments he has received as CEO.

62. We calculated the executives' total base salaries during their service as CEOs using ExecuComp's base salary data for each executive between 1992 and 2003, and by using the database's "CEO" field to determine whether the executive was the CEO during a particular year. Therefore, these ratios exclude compensation the executives received before 1992. Each executive's compensation was adjusted to 2003 dollars using the CPI.

TABLE 6: RATIOS OF PENSION BENEFITS TO NON-EQUITY COMPENSATION

Sample Statistics	Pension/ CEO Career Salary ⁶³	Pension/ Career Salary ⁶⁴	Pension/CEO Career Non- Equity ⁶⁵	Pension/ Career Non- Equity ⁶⁶
<i>Retired CEOs (28)</i>				
Median	2.2	1.6	0.8	0.6
Mean	2.8	1.9	1.1	0.8
Standard Deviation	1.9	1.1	0.9	0.6
Minimum	0.6	0.5	0.1	0.1
Maximum	9.2	5.1	3.4	2.4
<i>Current CEOs (23)</i>				
Median	1.9	1.6	0.7	0.6
Mean	2.8	1.9	1.1	0.7
Standard Deviation	3.1	1.1	1.4	0.5
Minimum	0.4	0.4	0.2	0.2
Maximum	16.0	5.4	7.2	2.9
<i>Combined Sample (51)</i>				
Median	2.1	1.6	0.8	0.6
Mean	2.8	1.9	1.1	0.7
Standard Deviation	2.5	1.1	1.1	0.6
Minimum	0.4	0.4	0.1	0.1
Maximum	16.0	5.4	7.2	2.9

63. "CEO Career Salary" refers to the executive's base salary as reported by ExecuComp between 1992 and 2003 for all years in which the executive served as CEO, adjusted according to the Bureau of Labor Statistics' estimate of the annual growth in the Consumer Products Index (CPI) between 1992 and 2003.

64. "Career Salary" refers to the executive's total base salary as reported by ExecuComp between 1992 and 2003, regardless of whether the executive was serving as CEO, adjusted according to the CPI.

65. "CEO Career Non-Equity" refers to the executive's total compensation, including options at issuance value, as reported by ExecuComp between 1992 and 2003 for all years in which the executive served as CEO, less restricted stock and option grants, adjusted according to the CPI.

66. "Career Non-Equity" refers to the executive's total compensation, including options at issuance value, as reported by ExecuComp between 1992 and 2003, regardless of whether the executive served as CEO, less restricted stock and option grants in each year and adjusted according to the CPI.

2. Ratios of Pensions to Salaries Throughout Tenure with the Firm

Because some of the CEOs in each sample served with their companies prior to their appointments as CEOs, the second column in Table 6 provides our results for the ratio between each executive's pension value and the salary he received during his entire tenure at the company through 2003. The median ratio between pension value and salary during the executives' careers with their firms was approximately 1.6:1 in each of our samples, and the median ratio was also 1.6:1 for the entire group of 51 executives. Again, there was significant variance within each of the samples. The ratio of pension value to total career salary ranged from 0.5:1 to 5.1:1 in our first sample, and from 0.4:1 to 5.4:1 in our second sample. After Robert Catell, who again had the highest ratio, the CEO with the second-highest ratio was Maury Myers of Waste Management, Inc., whose pension is worth more than 5.1:1 the total salary he has received during his career at the firm.

3. Ratios of Pensions to Non-Equity Compensation During CEOs' Tenure

The third column in Table 6 focuses on the ratio of executives' pension values to the non-equity compensation the executives received during their tenure as CEO.⁶⁷ The median value of this ratio was 0.8:1 for our first sample of retired executives, 0.7:1 for our sample of current CEOs, and 0.8:1 for our group of executives as a whole. There was, again, significant variance among executives: the ratio ranged from 0.1:1 to 3.4:1 in our first sample, and from 0.2:1 to 7.2:1 in our second sample.

4. Ratios of Pensions to Non-Equity Compensation Throughout Firm Tenure

The fourth column of Table 6 also compares pension values to non-equity compensation, but includes non-equity compensation received throughout the executives' tenure with their firms—regardless of whether the compensation was received during the executives' service as the CEO or in another executive position. Even when we include this compensation in our comparison between pension values and non-equity pay, pensions remain a significant factor. The median ratio between pension values and non-equity compensation received throughout the executives' tenure with their firms was approximately 0.6:1 for both of our samples of executives as well as for the overall group. In other words, the median CEO in our sample had a pension asset worth approximately 60% of the value of all the non-equity compensation received during his tenure at the firm.

In addition, there was considerable variance in the relationship between the executives' pensions and their non-equity compensation. Among all executives with

67. We calculated the executives' non-equity compensation during their tenures as CEOs using ExecuComp's data for the executives' total compensation, including the value of options at the date they were granted and reducing that total compensation figure by the Black-Scholes value of the options at the date of issuance and the value of any restricted stock grants. In one case, to correct for a reporting error in ExecuComp's database, we were required to use the executive's compensation based upon the exercise value, rather than the issuance value, of equity compensation. Because exercise value was typically less than issuance value both overall and in this executive's case, this, too, is a conservative assumption. Note also that for our sample of currently serving executives, all compensation data includes only results through December 2003.

pensions in our data set, this ratio ranged from 0.1:1 to 2.9:1. Catell was again the leader among all 51 executives with a ratio of approximately 2.9:1 between his pension and his total non-equity compensation. Kevin Dunnigan, CEO of Thomas & Betts Corporation, was close behind with a ratio of approximately 2.4:1.

5. Ratios of Pensions to Total Executive Compensation

Finally, we compared the values of the executives' pensions to the *total* compensation, including equity-based compensation, that the executives received before their retirement.⁶⁸ Table 7 below presents the results of this analysis.

TABLE 7: SIGNIFICANCE OF PENSIONS RELATIVE TO TOTAL COMPENSATION

Sample Statistics	Pension/CEO Career Total Comp. ⁶⁹	Pension/Career Total Comp. ⁷⁰
<i>Retired CEOs (28)</i>		
Median	35.3%	30.7%
Mean	44.4%	32.9%
Standard Deviation	33.4%	22.5%
Minimum	1.6%	1.1%
Maximum	139.9%	114.7%
<i>Current CEOs (23)</i>		
Median	27.8%	27.7%
Mean	53.0%	35.0%
Standard Deviation	91.0%	29.2%
Minimum	5.8%	5.4%
Maximum	458.0%	136.6%
<i>Combined Sample (51)</i>		
Median	34.5%	30.2%
Mean	48.3%	33.8%
Standard Deviation	65.3%	25.5%
Minimum	1.6%	1.1%
Maximum	458.0%	136.6%

The first column of Table 7 shows pension values as a percentage of the total compensation the executives received as CEOs. The median ratio between the

68. To calculate the CEOs' total compensation, we used ExecuComp's total compensation data, including the value of stock options and restricted stock at the issuance date, and adjusted each value to 2003 dollars using the CPI. For a more detailed description of our methodology for valuing total executive compensation, see *supra* notes 62 and 67 and accompanying text.

69. "CEO Career Total Comp." refers to the executive's total compensation, including options at issuance value between 1992 and 2003, during years of CEO service only.

70. "Career Total Comp." refers to the executive's total compensation, including options at issuance value between 1992 and 2003, regardless of whether the executive served as CEO.

executives' pensions and total compensation was 35.3% in our first sample, 27.8% in our second sample, and 34.5% in the overall group of executives in our study. Table 7 therefore indicates that the executives' pensions represented a considerable proportion of their total compensation during their service as CEOs. Table 7 also indicates that there was considerable variance among executives with respect to the ratio between executive pensions and total compensation. Again, Robert Catell led all executives in our sample, with a pension benefit worth more than 458.0% of the value of the total compensation he has received during his tenure as CEO.

The second column in Table 7 measures the relationship between executive pensions and total compensation, but includes *all* compensation received during the executives' careers with their companies, including any service prior to their appointments as CEO. Even when pre-CEO compensation was included, the relationship between pensions and total career compensation remained significant. The median ratio between the executives' pensions and the total compensation they received throughout their careers was 30.7% for our first sample of retired executives, 27.7% for our sample of currently serving CEOs, and 30.2% for all executives included in our study. The ratio ranged from a low of 1.1% to a high of 136.6% among all of the executives in our group. Catell again led all CEOs, with Kevin Dunnigan of Thomas & Betts Corporation close behind with pension benefits worth 114.7% of the total compensation he has received during his career at the firm. In both these cases, then, the CEOs' pensions were worth more than all the compensation they received during their tenure at their respective firms.

Thus, excluding pension benefits from analysis of executive pay leads to significant underestimation of the magnitude of executive compensation overall. Among the CEOs with pensions in our study, excluding pension values for the median executive ignores an element that increases the executive's pay throughout his tenure at the firm by about 30%. In addition, the significant variance among executives with respect to the relationship between pensions and total executive pay indicates that analysis of executive compensation that excludes pensions is likely to lead to substantially inaccurate comparisons among CEOs. For example, excluding pension values for Sanford Weill of Citibank results in excluding compensation that increases his total pay by just 1.1%. In contrast, excluding pension values for Robert Catell at Keyspan results in ignoring compensation that increases his total pay while at the firm by 136.6%.

Moreover, excluding pension benefits also distorts comparisons between those executives who have pensions and the significant number of executives who are not entitled to annual pension payments.⁷¹ Thus, in any comparative ranking of executives' total compensation, the exclusion of pension values leads to significant underestimation of the relative position of executives with substantial pension values and overestimation of the relative positions of executives with low pension values or no pension plan at all.

VI. PENSIONS AND THE LINK BETWEEN PAY AND PERFORMANCE

The value of pension benefits is, to a large extent, unrelated to the performance of

71. Note that, among the executives in our first sample of retired CEOs, approximately 32% had no pension benefits of any kind; and, within our second sample of currently serving CEOs, approximately 36% of executives had no disclosed pension benefits. *See supra* text accompanying notes 48 and 50.

the firm during the executive's tenure. The annual pension amount depends to a significant extent (and sometimes exclusively) on the base salary that the CEO received in the years preceding his or her departure. Some benefit formulas are also based on bonus compensation, but even in these cases the pension benefit is frequently based on the executive's *target* bonus rather than the actual bonus paid, decoupling the benefit from the executive's performance.

Thus, excluding the substantial compensation provided via pensions from analysis of executive pay results in systematic underestimation of the extent to which pay is based on salary-like payments—that is, payments of salary during the executive's service as CEO and pension payments following his retirement. To get a sense of the magnitude of this underestimation, we compared the composition of the executives' pay when their pension values were and were not included in the analysis. The results of these comparisons are presented in Table 8 below.

A. Effect of Pensions on the Proportion of CEOs' Salary-Like Payments

As Table 8 shows, including pension values in executives' total pay greatly increases the fraction of total compensation that is paid through salary-like payments. Before including pensions, the median CEOs in our first, second, and overall samples received 15.6%, 14.7%, and 15.3%, respectively, of their total CEO compensation in the form of salary-like payments. When we included pensions as an additional source of salary-like payments, however, the median ratio between salary-like payments and total CEO compensation increased to 39.1% for the first sample, 38.9% for the second sample, and 38.9% for the overall group of CEOs.

Importantly, there was also substantial variance among executives with respect to the effect pensions had upon the fraction of their total compensation paid through salary-like payments. In the case of Glen Barton, former CEO of Caterpillar, for example, including pensions increased the fraction of total compensation earned through salary-like payments from 19.9% to 49.7%. Furthermore, as the second column of Table 8 shows, inclusion of pension values substantially increased not only the mean and median levels but also the variance among executives with respect to the ratio between salary-like payments and total compensation.

B. Effect of Pensions on the Proportion of CEOs' Non-Equity Compensation

The third and fourth columns in Table 8 display summary statistics for the ratios between executives' non-equity compensation⁷² and their total compensation during their service as CEOs. As the third column of Table 8 indicates, the median CEO in our first, second, and overall samples received 42.0%, 49.9%, and 43.9% of his pay, respectively, in the form of non-equity compensation when pension amounts were excluded. As the fourth column of Table 8 shows, however, these ratios increased significantly when we included pensions as a form of non-equity compensation.

72. For a description of our methodology for assessing non-equity compensation, see *supra* note 67.

TABLE 8: SIGNIFICANCE OF PENSIONS RELATIVE TO NON-EQUITY COMPENSATION

	Ratios of CEO Salary-Like Compensation to Total CEO Compensation		Ratios of CEO Non-Equity Compensation to Total CEO Compensation	
	CEO Salary/ Total CEO Comp. ⁷³ (Pensions not Included)	CEO Salary and Pension/Total CEO Comp. ⁷⁴ (Pensions Included)	CEO Non- Equity Comp. /Total CEO Comp. ⁷⁵ (Pensions not Included)	CEO Non-Equity Comp. and Pension/CEO Comp. ⁷⁶ (Pensions Included)
<i>Retired CEOs</i> (28)				
Median	15.6%	39.1%	42.0%	60.4%
Mean	16.2%	38.9%	42.0%	57.2%
St. Dev.	8.6%	15.9%	17.5%	17.7%
Minimum	1.4%	3.0%	14.5%	15.8%
Maximum	47.0%	69.6%	78.7%	90.8%
<i>Current CEOs</i> (23)				
Median	14.7%	38.9%	49.9%	65.2%
Mean	16.8%	38.2%	48.3%	60.6%
St. Dev.	7.3%	16.2%	17.0%	18.0%
Minimum	6.3%	13.3%	18.3%	22.8%
Maximum	33.9%	87.2%	82.1%	93.4%
<i>Combined Sample(51)</i>				
Median	15.3%	38.9%	43.9%	61.0%
Mean	16.5%	38.6%	44.8%	58.8%
St. Dev.	8.0%	15.9%	17.4%	17.7%
Minimum	1.4%	3.0%	14.5%	15.8%

73. "CEO Salary/Total CEO Comp." represents the ratio of base salary received during years of CEO service to the total compensation received during years of CEO service. In this column, all compensation figures exclude pension values.

74. "CEO Salary and Pension/Total CEO Comp." represents the ratio of the present value of base salary received during years of CEO service plus pension payments to total compensation received during years of CEO service plus pension payments.

75. "CEO Non-Equity Comp./Total CEO Comp." represents the ratio of the present value of non-equity compensation received during years of CEO service to total compensation received during years of CEO service. In this column, all compensation figures exclude pension values.

76. "CEO Non-Equity Comp. and Pension/CEO Comp." represents the ratio of the present value of non-equity compensation received during years of CEO service and pension payments to total compensation received during years of CEO service plus pension payments.

Maximum	47.0%	87.2%	82.1%	93.4%
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The median ratio between non-equity pay and total compensation received during service as CEO was 60.4% in our first sample, 65.2% in our second sample, and 61.0% for the group of 51 executives in our study when pensions were included. Thus, including pensions in non-equity compensation for our entire sample of executives increased the median ratio of non-equity compensation to total executive pay from 43.9% to 61.0%. Again, there was significant variance among executives with respect to the extent to which including pensions increased the ratio of non-equity compensation to total compensation. In the case of Douglas McCorkindale at Gannett Co., for example, including his pension increased the ratio of non-equity compensation to total compensation during his service as CEO from 30.4% to 55.5%; for Jim Murdy of Allegheny Technologies, however, the effect was less significant, increasing the ratio from 78.7% to 90.8%.

VII. POLICY IMPLICATIONS

A. Investors' Current Misperceptions

The evidence presented in the preceding Part indicates that the omission of pension values from standard data sets—and, as a result, from the compensation figures generally used by financial economists and the media—significantly undermines the accuracy of existing estimates of executive pay. There are three important ways in which this omission has clouded shareholders' understanding of executive compensation.

(1) *Underestimation of Total Executive Pay*: It has often been argued that existing analysis overestimates the value of executive compensation because the Black-Scholes approach to option valuation overestimates the value of options to risk-averse, undiversified executives.⁷⁷ However, this Article suggests that for executives who benefit from pension plans, existing estimates might underestimate the total value of executives' pay packages. Across our sample of more than 50 S&P 500 companies, the value of executives' pension plans added, on average, more than 48% to total pay during the executives' service as CEO.

(2) *Distorted Comparisons Among Executives*: Because pension values are often quite substantial, and because their size varies significantly among executives, the omission of pensions results in significant inaccuracies in comparisons of pay among executives. Including pension values could significantly alter existing rankings of executives in terms of compensation. Similarly, excluding pension values might have distorted the findings of research seeking to identify how executive pay is correlated with various characteristics of the firm or its executives and directors.⁷⁸ Such distortions are particularly likely if pension values are not distributed randomly, but rather are

77. See, e.g., Joseph E. Bachelder, *Comments on Pay without Performance*, 30 J. CORP. L. 777 (2005); Brian Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. ECON. 1, 5 (2002) (discussing the "magnitude of the divergence between the cost and value of options"); Lisa K. Meulbroek, *The Efficiency of Equity-Linked Compensation: Understanding the Full Cost of Awarding Executive Stock Options*, 30 FIN. MGMT. 5, 8 (2001).

78. For a survey of such studies, see BEBCHUK & FRIED, *supra* note 3, ch. 6.

significantly correlated with various attributes of the company and its executives and directors. How pension values are related to such attributes is an important question that would be worth studying in subsequent research.

(3) *Overestimation of the Pay-Performance Correlation*: The omission of pension values has also led to overestimation of the extent to which total executive pay is correlated with performance. First, note that omission of pension values has led to substantial misperceptions regarding the magnitude of CEO pay provided through salary-like payments. It is widely thought that most executive compensation is linked in some way to performance because base salary comprises a relatively small part of total executive pay.⁷⁹ Across our entire sample, for example, salary comprises on average approximately 17% of the total compensation paid to the departing executive during his service as CEO. However, once we take into account pension values, the picture changes significantly. When pensions were included for all of the executives in our sample, the fraction of compensation paid in salary-like payments rose to approximately 39%.

Researchers have often observed that executive pay has, over the past decade, shifted significantly towards equity-based compensation,⁸⁰ which is regarded as more closely linked to performance than other types of compensation.⁸¹ Once pension values are included in the total compensation paid to executives, however, equity-based compensation no longer represents the principal component of executive pay (although it remains a substantial component of total compensation). For all of the executives in our sample, equity-based compensation provides on average only 41% of total compensation when pensions are included, compared with 55% of total compensation when pensions are omitted.

B. Making Executive Pensions Transparent

Our findings highlight the importance of adopting disclosure requirements that would compel public firms to make the value of executives' pensions fully transparent. The omission of pension values from analysis of executive compensation results from the approach that the SEC has taken to executive pay disclosure. It is far from clear why compensation paid in the form of pensions should not be disclosed in the same manner as any other form of executive pay. Because SEC rules do not require firms to disclose the value of the pension entitlements provided to executives each year, firms have been able to provide large amounts of compensation via pensions, away from the glare of full disclosure. And, because firms are required to provide a monetary value only for current payments, as well as compensation in the form of options and share grants, companies have not provided adequate information with respect to the monetary value of pension

79. See, e.g., Adam Bryant, *Earning It: How Companies Make the Boss Buy Stock, but Soften the Pinch*, N.Y. TIMES, Feb. 1, 1998, at A1 (discussing how companies require executives to own stock but also seek to "ease any discomfort for their executives").

80. See, e.g., Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It's Not How Much You Pay, But How*, in MICHAEL C. JENSEN, FOUNDATIONS OF ORGANIZATIONAL STRATEGY 270 (1998). For an empirical examination of the different rates at which equity-based and non-equity based compensation have grown during the past decade, see Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283 (2005).

81. It is worth noting that under existing practices, equity-based compensation is less tightly linked to performance than is commonly appreciated. See BEBCHUK & FRIED, *supra* note 3, chs. 11-14.

benefits, creating the misperceptions we have identified here.

To be sure, the evidence we have provided does not indicate that the firms in our study did not disclose information about the monetary values of executives' pensions in order to hide these values from investors. Because firms are not required to disclose such information, issuers may simply be pursuing a "lawyerly" approach to disclosure, providing only the information that the SEC requires. For our purposes, however, it is important to recognize that, as long as issuers are not required to disclose fully the values of executive pensions, we should expect firms to not make such disclosures—and that this practice will deny investors, researchers, and the media access to accurate assessments of the magnitude and makeup of executive compensation.

To address this problem, then, it is necessary for the SEC to require each firm to disclose annually the value of pension benefits to which its CEO and four other highest-paid officers will be entitled upon their retirement. In particular, firms should be required to place a monetary value on both (1) the annual benefit to be paid under the pension plan and (2) the actuarial value of the entire pension in view of the executive's age, marital status, and other information relevant to the financial value of the pension. Firms should also be required to disclose the value of the pension in the event that the executive chooses to retire from the firm before reaching retirement age—rather than relying on the ambiguous reference to "discounted" benefits that is the current practice for most firms.⁸²

Furthermore, in addition to disclosing the annual benefit and the actuarial value of the entire pension, firms should be required to disclose annually any change in the value of the pension from the previously reported amount. As we have indicated, the annual value of pension benefits typically increases as executives accumulate additional salary and tenure at the firm, often leading to increases in the actuarial value of executives' retirement benefits. The SEC should require that these increases be reported in the summary compensation tables that firms must provide in their proxy statements. Because these increases in actuarial plan value are functionally similar to other compensation paid by the firm as a result of the executive's work in that year, these payments should be presented in the summary table so that shareholders and researchers have straightforward access to the aggregate value of the executive's total compensation in a given year.

We do not expect that complying with these additional disclosure requirements will impose any meaningful costs on firms.⁸³ Firms generally already have low-cost access to the information necessary to value retirement benefits, including the executive's age, the ages of his beneficiaries, and the annual benefit to be paid under the pension plan. Undoubtedly, firms can obtain this information at lower cost than can shareholders or researchers.⁸⁴

The enhanced transparency generated by these additional disclosures would

82. For an example of the valuation difficulties caused by ambiguous reference to "discounted" benefits in the event of an early executive departure, see *supra* text accompanying notes 45 through 47.

83. For a detailed analysis of the low costs generally associated with mandatory disclosure of the type we propose here, see Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World* 8-10 (Harvard Law & Econ. Discussion Paper No. 492, 2005), available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_492.pdf.

84. For an economic justification of mandatory disclosure grounded in the notion that firms are the lowest-cost obtainers of most information relevant to securities valuation, see Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048-49 (1995).

significantly improve the information available to investors concerning the magnitude and makeup of total executive pay. Furthermore, these disclosures could also contribute to beneficial changes in compensation practices by preventing firms from providing executives with large amounts of performance-insensitive compensation away from the scrutiny of public disclosure. First, the disclosures could strengthen existing checks on total compensation levels. Boards and compensation committees that are concerned about investor and media reactions to an increase in total pay levels will no longer be able to increase compensation through pension payments without having the additional pay register on investors' radar screens.

Moreover, we expect that if investors become aware of the value of pension plans and the extent to which they increase the fraction of total pay comprised of salary-like payments, outside scrutiny could put pressure on firms to link pay and firm performance more closely. Our analysis indicates that the exclusion of pensions from analysis of executive pay has led shareholders not only to underestimate the magnitude of executive compensation but also to overestimate the link between pay and firm performance. By correcting such misperceptions, these disclosure requirements might induce firms to shift compensation from salary-like payments to more performance-sensitive forms of compensation.

Thus, improved disclosure of the value of executive pension plans would, at a minimum, significantly improve the accuracy of investor information regarding the magnitude and makeup of compensation, and could also contribute to the improvement of compensation practices, all while imposing minimal compliance costs upon firms. We see no reasonable basis for opposing disclosure requirements that would make the costs of pensions for shareholders fully transparent. The case for more rigorous disclosure requirements is compelling.

VIII. CONCLUSION

In this Article, we have provided empirical evidence regarding the magnitude and variability of executive pension benefits. Our analysis demonstrates how the omission of pension benefits from compensation figures generally used by investors, researchers, and the media has led to substantial underestimation of the magnitude and performance-insensitivity of total executive pay. This evidence highlights the importance of adopting additional disclosure requirements designed to make the value of pension arrangements transparent to investors.

Before closing, we should stress an important reason why our findings might systematically *underestimate* the inaccuracies introduced by the current omission of retirement benefits from standard estimates of executive pay. This Article has focused on one important type of retirement benefit: defined-benefit pension plans. But executives receive other types of retirement benefits that are currently not included in the data sets used by researchers and the media to analyze executive pay.

First, many executives receive substantial post-retirement perquisites, including payments for consulting services that may well represent compensation for services rendered before their retirement.⁸⁵ More importantly, executives may also derive

85. For example, Henry Silverman of Cendant, who does not have a traditional pension benefit, is entitled

significant benefits from deferred compensation arrangements that enable them to pass the tax costs of investment gains to their firms.⁸⁶ Because firms do not have to disclose the amounts invested by executives in such programs, it is difficult for outsiders even to estimate, as we have done here for pension benefits, the gains made by executives from such plans.

For these reasons, additional research is needed to examine such benefits more closely. Without more information about benefits from deferred compensation arrangements, we will be unable to put executives' retirement benefits fully on the radar screen. The analysis presented here, however, provides empirical evidence that retirement benefits can have a substantial effect on our understanding of executive compensation and demonstrates the importance of disclosure requirements designed to make executives' retirement benefits fully transparent to investors.

upon his departure from the firm to receive consulting fees of approximately \$1 million per year for the rest of his life. See Cendant Corp., Proxy Statement (DEF 14A), at 32 (Mar. 1, 2005), available at http://www.cendant.com/investors/financial-data/annual-report-archive/2004-annual-report/assets/documents/annualreports/2004/CD_Proxy_2004.pdf.

86. For a detailed description of deferred compensation arrangements and the costs they impose on firms, see BEBCHUK & FRIED, *supra* note 3, ch. 8.

Stealth Compensation via Retirement Benefits

Lucian Arye Bebchuk[†] and Jesse M. Fried[‡]

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[†] William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance, Harvard Law School, and Research Associate, National Bureau of Economic Research.

[‡]Professor of Law, University of California at Berkeley (Boalt Hall). © 2004, Lucian Bebchuk and Jesse Fried. All rights reserved.

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Stealth Compensation via Retirement Benefits

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Lucian Arye Bebchuk and Jesse M. Fried

This Article analyzes an important form of “stealth compensation” provided to managers of public companies. We show how boards have been able to camouflage large amounts of executive compensation through the use of retirement benefits and payments. Our study illustrates the significant role that camouflage and stealth compensation play in the design of compensation arrangements. It also highlights the importance of having information about compensation arrangements not only publicly available but also communicated in a way that is transparent and accessible to outsiders.

To improve the transparency of executives’ retirement payments and benefits, we propose several changes in current disclosure requirements. Among other things, firms should be required to report to investors each year the dollar value of all the retirement benefits to which their executives become entitled. For example, firms should disclose to investors the annual buildup in the actuarial value of executives’ retirement plans, as well as the tax savings reaped by executives at the company’s expense through the use of deferred compensation arrangements. Firms should also disclose to investors each year the present value of all the retirement benefits their top executives have accumulated.

I. INTRODUCTION

This Article focuses on an important form of “stealth compensation” provided to managers of public companies. We show how designers of compensation arrangements for these managers have been able to camouflage large amount of executive compensation through the use of retirement benefits and payments. Our study highlights the significant role that camouflage and stealth compensation play in the design of compensation arrangements. Our study also highlights the importance of ensuring that information about compensation arrangements not only be placed in the public domain but also be communicated in a way that is transparent and accessible to outsiders.

We begin by discussing the critical role of outrage costs and camouflage in the setting of executive compensation. Managers have considerable influence over their pay and use their influence to extract pay that is both higher and less performance sensitive than arm’s-length bargaining with the board would produce. The difference between what managers’ power enables them to receive and what they would receive under arm’s-length bargaining constitutes “rents.” Managers’ ability to extract rents, however, is hardly unlimited. When

a board approves a compensation arrangement that favors managers at the expense of shareholders, executives and directors will bear certain economic and social costs. The magnitude of these costs will depend on how the arrangement is perceived by outsiders whose views matter to the directors and executives. An arrangement that is perceived as outrageous might reduce shareholders' willingness to support incumbents in a proxy contest or takeover bid, might lead to shareholder pressure on managers and directors, and might embarrass directors and managers or harm their reputations. The more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve it and the more hesitant managers will be to propose it in the first place.

The critical role of outsiders' perception of executives' compensation, and the significance of outrage costs, explain the importance of "camouflage." The desire to minimize outrage gives designers of compensation arrangements a strong incentive to try to obscure and justify—or, more generally, to camouflage—both the level and performance-insensitivity of executive compensation. Camouflage thus allows executives to reap benefits at the expense of shareholders. More importantly, attempts to camouflage can lead to the adoption of inefficient compensation structures that harm managers' incentives and in turn company performance, imposing even greater costs on shareholders.

We discuss elsewhere how various forms of non-retirement compensation, including bonuses, stock option plans, and executive loans, have been designed with an eye to camouflaging rents and minimizing outrage.¹ In this Article, we examine how retirement arrangements have often been designed in a way that serves this goal. As disclosure requirements for executive salaries, bonuses, and long-term compensation have become stricter, firms have increasingly turned to post-retirement payments and benefits as ways to compensate managers. Post-retirement value has been provided to executives through four main channels: retirement pensions, deferred compensation, post-retirement perks, and guaranteed consulting fees. As we will explain, these methods enable firms to provide a substantial amount of performance-insensitive value in a less transparent form than, say, salary. Firms have used these channels to make less transparent both the total amount of compensation received by managers and the extent to which pay is decoupled from managers' own performance.

Before describing outrage costs and camouflage in more detail and discussing each of the four channels, we should note two attributes they all

1. See Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 795-837 (2002); Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 81-87 (Summer, 2003); LUCIAN ARYE BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* chs. 9-14 (Harvard University Press, 2004).

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share. First, these arrangements differ substantially from those that firms elect to provide to other employees. Although firms often provide pensions and deferred compensation to lower-level employees, they do so only to the extent that these arrangements receive a tax subsidy. This pattern suggests that, absent such a subsidy, pensions and deferred compensation are generally not efficient. Yet most of the arrangements provided to executives do not enjoy similar tax advantages. Furthermore, consistent with economists' belief that in-kind benefits are inefficient, firms do not generally provide retired employees with coverage for specified consumption expenses. Such benefits are, however, given to high-level executives. And although firms occasionally use retired employees as consultants when the need arises, they generally do not guarantee lifetime consulting fees to any employees other than executives.

The second shared attribute of these various retirement payments is that they all make it possible to obscure large amounts of performance-decoupled compensation. As we shall see, firms do not have to disclose the value transferred to executives through these channels in the same way that other forms of compensation—such as salary, bonuses, and stock options—must be disclosed. Retirement payments hence offer what might be called “stealth compensation.”² Indeed, the dollar figures used by the media in reporting compensation levels, and by financial economists in their studies, usually do not include the large value provided to executives through retirement benefits.

The remainder of this Article proceeds as follows. Part II describes the importance of outrage costs and camouflage in the setting of executive compensation. Part III discusses the widespread use of supplemental executive retirement plans (SERPs). It explains how SERPs differ from the pension benefits provided to regular employees and how they can be used to camouflage a significant amount of performance-insensitive compensation to executives. Part IV discusses the deferred compensation arrangements offered to managers. It describes how these plans differ from the 401(k) plans offered to other employees and how these plans, like SERPs, are used to provide a significant amount of performance-decoupled pay to executives in a way that is largely hidden from view. Part V considers the use of post-retirement perks and consulting contracts. Part VI explains why increased transparency of retirement arrangements would be beneficial to shareholders and proposes several changes to the disclosure requirements for retirement payments and benefits. Part VII concludes.

2. We borrow the term “stealth compensation” from Robert Monks, who used it to refer to executives' stock option compensation because that form of payment is not expensed on the firm's income statement. ROBERT A. G. MONKS, *THE EMPEROR'S NIGHTINGALE: RESTORING THE INTEGRITY OF THE CORPORATION IN THE AGE OF SHAREHOLDER ACTIVISM* 59-62 (Perseus Books, 1999).

II. OUTRAGE COSTS AND CAMOUFLAGE

This Part explores the role and significance of outrage costs and camouflage in the setting of executive compensation. Section II.A explains why outsiders' perceptions and the possibility of outrage are of concern to boards when they fashion pay packages for managers. Section II.B describes the key role of camouflage in the design of compensation arrangements. Section II.C provides empirical evidence on the effect of outrage and camouflage on managerial pay.

A. The Importance of Outsiders' Perceptions

As we discuss and document in great detail elsewhere,³ top executives have considerable influence on their own pay arrangements. Although directors are supposed to negotiate with executives at arm's-length, they have both financial and non-financial incentives to provide managers with pay arrangements that favor managers at the expense of shareholders. A variety of psychological and social factors acting on the directors reinforce these incentives to serve managers' interests. Moreover, neither shareholder pressure nor market forces have been able to effectively constrain managerial influence over pay.

Managers have used their power to extract pay that is both higher and less performance-sensitive than arm's-length bargaining with the board would produce. The difference between what managers' influence enables them to receive, and what they would receive under arm's-length bargaining, is called "rents." The rents captured by managers come in both the form of higher pay and reduced pressure to generate value for shareholders.

However, managers' ability to extract these rents is hardly unlimited. When a board approves a compensation arrangement that favors managers at the expense of shareholders, executives and directors may bear certain economic and social costs. Although market forces, the need for board approval, and social sanctions do not altogether prevent deviations from arm's-length contracting, they do, as we explain below, place some constraints on managers' ability to obtain favorable compensation packages, and the tightness of these constraints depends on outsiders' perceptions of these pay arrangements.

In the face of these constraints, how far firms will go in favoring managers will depend not only on how much contemplated arrangements will actually favor executives, but also on how these arrangements will be perceived by outsiders. Whether directors and managers are deterred from adopting a given compensation arrangement depends on the extent to which it will be viewed by

3. See Bebchuk et al., *Managerial Power*, *supra* note 1, at 764-783; Bebchuk & Fried, *Executive Compensation*, *supra* note 1, at 73-75; BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 1, at ch. 2.

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relevant outsiders as unjustified or even abusive or egregious. We have broadly referred to negative reactions by outsiders as “outrage,” even though some of them may amount to criticism not reaching the level of outrage, and to the costs that such reactions impose on managers and directors as “outrage costs.”⁴ The more widespread and strong these negative reactions are—that is, the greater the outrage—the larger the costs to directors and managers. When the potential outrage costs are large enough, they will deter the adoption of arrangements that managers would otherwise favor. Arrangements that are deterred in this way can be regarded as ones that violate the “outrage constraint.”

Why should perceptions—and, in particular, outrage—matter? To begin with, the extent to which markets penalize managers and directors for the adoption of particular arrangements depends on how these arrangements are perceived. Consider the market for corporate control. This market may penalize the adoption of arrangements by increasing the vulnerability of managers and directors to a control contest. Such a penalty is likely to be significant only if the firm adopts compensation arrangements that appear sufficiently outrageous. Institutional investors may view such arrangements as a strong signal that the executives or directors are relatively insensitive to shareholder interests. These investors may become less likely to support the incumbents should a hostile takeover or a proxy fight occur. In this manner, through the operation of the market for corporate control, outrage over compensation can impose a penalty on managers and directors.

Consider also the labor market and the reputation of managers and directors in this market. Reputational damage might have an adverse effect on the future career prospects of managers and directors. It might also affect their current business dealings with others outside the firm. Indeed, some outside directors join boards partly for the prestige and connections that the posts provide, and gaining a bad reputation could eliminate these benefits and impose costs instead. Reputational losses to managers and directors will likely be significant, however, only if their firms adopt compensation arrangements that generate sufficiently negative reactions—that is, sufficient outrage. An arrangement that fails to serve shareholders would be unlikely to impose such costs as long as it falls within the range of what is perceived as conventional and legitimate.

Indeed, we believe that arrangements that are perceived as abusive or outrageous impose on executives greater costs than an analysis based solely on the above market incentives suggests. That is, we believe that constraints on rent extraction are somewhat tighter than suggested by an analysis of the (limited) market penalties that outrageous compensation arrangements involve.

4. See Bebchuk et al., *Managerial Power*, *supra* note 1, at 786-88; Bebchuk & Fried, *Executive Compensation*, *supra* note 1, at 75-76; BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 1, at ch. 5.

As we have explained elsewhere,⁵ directors are affected not only by “narrow” interests of a *homo economicus*, but also by various social and psychological factors (such as collegiality, loyalty, and so forth) that pull them in the direction of favoring executives. Similarly, there are social and psychological factors that increase the costs that managers and directors incur from adopting arrangements that are viewed by outsiders as sufficiently outrageous.

Managers and directors likely care about the extent to which relevant social and professional groups view them with approval and esteem. Directors are also likely to prefer to avoid criticism or ridicule from the social or professional groups whose opinions they value—even if such criticism or ridicule does not involve any economic losses for them.⁶ As a result, even if the economic incentives provided by the markets for corporate control and managerial labor would be insufficient to deter managers from seeking certain outrageous compensation, fear of embarrassment or criticism could discourage managers from doing so. When former General Electric CEO Jack Welch made headlines by giving up much of the retirement perks to which he was contractually entitled—including the free use of a corporate jet and a New York apartment—he was undoubtedly seeking to protect the approval and esteem he had earlier enjoyed at the expense of his narrow economic interests.⁷

Clearly, for outrage to impose significant costs, it must be sufficiently widespread among a relevant group of observers. It is not enough for a small group of researchers or arbitrageurs to identify a compensation scheme as egregiously bad for shareholders. For executives or directors to be adversely affected in a material way by market penalties or social costs, the outrage must be shared by those outsiders whose views matter most to them: the institutional investor community, the business media, and social and professional groups to which directors and managers belong.

B. Camouflage

The main costs to directors and managers of adopting compensation arrangements that favor managers, then, depend mainly not on how costly the arrangements actually are to shareholders, but on how costly the arrangements are *perceived* to be by important outsiders. Perceptions matter. This brings us to another concept that is critical for understanding the compensation landscape: camouflage.

Because perceptions are so important, the designers of compensation plans

5. See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 1, at ch. 2.

6. JAY W. LORSCH & ELIZABETH M. MACIVER, *PAWNS OR POTENTATES? THE REALITY OF AMERICA'S CORPORATE BOARDS* 23–31 (Harvard Business School Press, 1989).

7. See Matthew Brelis, *GE, Welch Agree to Slash His Perks: Retired CEO Will Retain Office, Staff, Lose Many Benefits*, BOSTON GLOBE, Sept. 17, 2002, at D1.

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can limit outside criticism and outrage by dressing, packaging, or hiding—in short, camouflaging—rent extraction. The more reasonable and defensible a package appears, the more rents managers can enjoy without facing significant outrage. Accordingly, under the managerial power approach, managers will prefer compensation practices that obscure the total amount of compensation, that appear to be more performance based than they actually are, and that package pay in ways that make it easier to justify and defend.

The greater the ability of plan designers to engage in camouflage, the more they can be expected to do so. Before 1992, the SEC required firms to report executive compensation to the public but allowed them to do so in the format of their choosing. Not surprisingly, firms took full advantage of their discretion to obscure the amount and form of their pay. An SEC official describes the pre-1992 state of affairs as follows:

The information [in the executive compensation section] was wholly unintelligible [T]he typical compensation disclosure ran ten to fourteen pages. Depending on the company's attitude toward disclosure, you might get reference to a \$3,500,081 pay package spelled out rather than in numbers. That gives you an idea of the nature of the disclosures: it was legalistic, turgid, and opaque; the numbers were buried somewhere in the fourteen pages. Someone once gave a series of institutional investor analysts a proxy statement and asked them to compute the compensation received by the executives covered in the proxy statement. No two analysts came up with the same number. The numbers that were calculated varied widely.⁸

In 1992, the SEC tightened its disclosure rules by providing standards for how information about executive pay must be presented. The standardized compensation tables that firms now must use have made camouflage more difficult. As we describe elsewhere, however, the 1992 disclosure requirements have hardly brought an end to firms' ability to camouflage the amount and form of executive pay.⁹

One might reasonably ask how, if rent extraction is camouflaged, any observer (including this Article's authors) can determine that executives are enjoying rents. In theory, rent extraction could be camouflaged so well that it becomes absolutely undetectable. In fact, camouflage is successful as long as the rent extraction is not apparent to those outside observers whose outrage would be particularly costly for directors and managers, even if other observers are aware that the executives are enjoying large rents.

Thus, the notion of camouflage is consistent with the possibility that an outsider might identify the hidden rents of a compensation arrangement. Such a conclusion would simply reflect the observer's judgment, not yet widely shared, that the compensation program is distorted in favor of managers. In

8. Linda C. Quinn, *Executive Compensation under the New SEC Disclosure Requirements*, 63 U. CIN. L. REV. 769, 770-71 (1995).

9. See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 1, at chs. 6-14.

time, of course, such conclusions might become widely accepted, in which case the rent extraction will no longer be camouflaged. But a given form of rent extraction might continue to be camouflaged long after it has been recognized by some observers.

C. Outrage and Camouflage at Work

Some critics of our earlier work argued that the idea of outrage costs, and the related idea of camouflage are not empirically testable.¹⁰ This, however, is not the case. There is evidence that directors and executives are indeed influenced—in compensation and other types of decisions—by strong outside criticism and outrage. And there is evidence that they engage in camouflage.

To begin with, there is evidence that shareholder precatory resolutions that criticize managers' high compensation have an impact. Although such resolutions are nonbinding and generally fail to pass anyway, their appearance may shine a critical light on problematic aspects of the firm's executive compensation policies and make them less opaque. Indeed, a study by Randall Thomas and Kenneth Martin examined the effect of pay-related precatory resolutions during the mid-1990s and found that they had a moderating influence on subsequent compensation decisions.¹¹ The study found that during the two-year period following the passage of shareholder resolutions criticizing executive pay in particular firms, total compensation (adjusted for industry) in those firms declined by a statistically significant average of \$2.7 million. In a subsequent study, the researchers also found that higher negative votes on management-sponsored proposals to ratify an option plan slowed the increase in CEO compensation in subsequent years.¹²

Another study, by Alexander Dyck and Luigi Zingales, documents the effects of media scrutiny on corporate decisions in general. The authors found that such attention leads firms to adopt more environmentally friendly policies, for example. As for issues of corporate governance, they also found that media attention reduces the amount of value that controlling shareholders siphon off.¹³

A well-known example of how outside criticism affects governance decisions involves the campaign of shareholder activist Robert Monks against

10. See, e.g., Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 847-69 (2002); Holman W. Jenkins, Jr., *Business World: Outrageous CEO Pay Revisited*, WALL ST. J., Oct. 2, 2002, at A17.

11. Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1021-65 (1999).

12. Kenneth J. Martin & Randall S. Thomas, *When Is Enough, Enough? Market Reaction to Highly Dilutive Stock Option Plans and the Subsequent Impact on CEO Compensation*, J. CORP. FIN. (forthcoming 2005).

13. Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of the Media* (2002) (working paper, Harvard Business School & University of Chicago); Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004).

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the directors of Sears. During the late 1980s and early 1990s, Monks urged the Sears board to adopt various proposals to improve the firm's dismal performance. In April 1992, having been repeatedly ignored by the board, Monks took out an advertisement in the *Wall Street Journal* titled "The Non-performing Assets of Sears" and identified the directors by name. The presumably embarrassed directors then adopted many of Monks's proposals, generating an abnormal stock price return (the change in stock price adjusted for overall stock market movements) of almost 10% when the changes were announced.¹⁴

Another example is the California State Pension Fund for Public Employees' (CalPERS) practice of identifying poorly run companies. For some years, CalPERS put poorly performing firms on what it called its "focus list" and suggested various ways to improve their corporate governance practices, such as making compensation and nominating committees fully independent. In many cases, firms placed on the list implemented some of the requested changes. Then, in 1991, after several CEOs told CalPERS that being less antagonistic would be even more effective, CalPERS decided to adopt a "kinder, gentler" approach that did not involve public shaming.¹⁵ Absent the threat of adverse publicity, however, firms approached by CalPERS were actually much less cooperative. The then-CEO of CalPERS, Dale Hanson, said at the time, "It has shown us that a number of companies won't move unless they have to deal with the problem because it's in the public eye." In 1992, CalPERS reinstated its policy of publicly shaming uncooperative firms.¹⁶

In fact, CalPERS' policy of shaming has had a measurable effect on targeted corporations. Yi-Lin Wu found that firms put on CalPERS' poor governance focus list were subsequently more likely to reduce the number of inside directors on their boards. These firms were also more likely to experience CEO turnover.¹⁷ Shaming also appears to have adversely affected the careers of inside directors that left the targeted firms' boards. They were much less likely than inside directors departing nontargeted firms to land other board positions.¹⁸ As this study makes clear, negative publicity—or outrage—does impose costs.

Finally, and perhaps most importantly, there is substantial evidence of camouflage activities. A testable implication of the camouflage idea is that

14. ROBERT MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 399-411 (Blackwell Publishers, 2d ed., 2001).

15. Judith H. Dobrzynski, *CalPERS Is Ready to Roar, but Will CEOs Listen?*, *BUS. WK.*, Mar. 30, 1992, at 44.

16. *Id.*

17. Yi-Lin Wu, *The Impact of Public Opinion on Board Structure Changes, Director Career Progression, and CEO Turnover: Evidence from CalPERS' Corporate Governance Program*, 10 *J. CORP. FIN.* 199 (2004).

18. *Id.*

when compensation arrangements deviate from arm's-length bargains, they should do so in a way that makes the amount of pay or the insensitivity of pay to performance less visible. This prediction is borne out by actual compensation practices. As we have shown elsewhere, many common non-retirement compensation practices—such as company loans and the structure of conventional options—provide camouflage benefits.¹⁹ And as we will explain below, the four channels through which executives are paid after retirement also serve to obscure a significant amount of compensation.

III. RETIREMENT PENSIONS

Many employees are covered by pension plans that provide payments to workers after retirement. At first glance, it seems only natural for firms to provide such benefits to their executives. A closer look, however, raises serious questions about whether the extensive use of executive pensions as a form of compensation reflects arm's-length bargaining. Part III.A describes the difference between executive retirement pensions and the retirement benefits offered to ordinary workers. Part III.B explains how the executive pensions are used to camouflage a substantial amount of performance-decoupled executive pay.

A. Differences from Regular Pensions

Most of the pension plans used for employees are designed to be “qualified” for favorable tax treatment. The firm gets a current deduction for contributing funds to a qualified plan for employees—the same deduction it would have received had it paid the amount of the contribution to workers in the form of salary. Workers, however, do not pay income taxes on the pension money until they retire and begin receiving payouts from the plan. In the meantime, the funds invested by the firm grow tax-free. Neither the firm nor the employees must pay any taxes while the plan's investments increase in value. Thus, the plans provide a tax benefit to employees at no cost to the firm.²⁰

19. See BEBCHUK AND FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at chs. 9-14.

20. To illustrate how the tax subsidy provided to a qualified plan operates, consider the following examples involving a hypothetical firm and employee. Assume that both face a 40% tax rate on all of their income, including capital gains. Also assume that both are able to earn, between the pre-retirement period and retirement period, a pretax return of 100% on their investments.

Example 1: The employee invests for retirement outside a qualified plan. Suppose the firm pays the employee \$100 in the pre-retirement period. The firm deducts \$100 from its taxable income, reducing its tax liability by \$40. The employee pays \$40 in taxes, takes the after-tax income of \$60, and invests it. The \$60 grows to \$120 by the retirement period—a gain of \$60. This \$60 gain triggers a tax liability of \$24 (40% of \$60), leaving the employee with \$96 (\$60 + \$36) when the employee retires.

Example 2: The firm invests for the employee's retirement under a qualified plan. Now suppose the firm contributes the \$100 to a qualified pension plan in the pre-retirement period. The firm again deducts

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Given the opportunity, boards might well prefer to offer executives qualified retirement plans. A qualified pension plan, however, can use only about \$200,000 of annual compensation as the basis for determining benefits under the plan. For example, a plan that promises to pay all retirees, annually, 50% of the compensation earned during their last year of service cannot pay a retired executive more than \$100,000 annually, even if the executive earned \$1 million of compensation during that final year. As a result, firms cannot use qualified plans to provide executives with pensions that are similar in size to their annual compensation. For this reason, most firms also provide executives with nonqualified “supplemental” executive retirement plans (SERPs).²¹

SERPs differ from typical qualified pension plans in two critical ways. First, they do not receive the favorable tax treatment enjoyed by qualified plans; no investment income goes untaxed under a SERP. The company pays taxes on the income it must generate in order to pay the executive in retirement. If the money had been distributed as salary, on the other hand, the executive who invested the money for retirement would have had to pay taxes on any income generated. The effect of the SERP, therefore, is to shift some of the executive’s tax burden to the firm.²²

If the employee and the firm are subject to the same tax rate and are able to earn the same pretax rate of return on their investments, a SERP cannot reduce the total amount of taxes paid by the parties. For every dollar the employee’s tax burden is reduced, the firm’s tax burden is increased by one dollar. Unlike a qualified plan, the SERP would not reduce the parties’ total tax burden.²³

\$100 from its taxable income, reducing its tax liability by \$40. The \$100 grows to \$200 by the time of the employee’s retirement—a gain of \$100. The \$200 is distributed to the employee, who pays a tax of \$80 (40% of \$200), leaving the employee with \$120, or \$24 more than in Example 1, in which the employee had received \$100 from the firm in the pre-retirement period and saved for retirement. The gain to the employee does not come at the expense of the employer: in both examples, the employer incurs an aftertax cost of \$60 in the pre-retirement period.

21. Clark Consulting reports that approximately 70 percent of responding firms use SERPs. *Executive Benefits: A Survey of Current Trends: 2003 Results*, Clark Consulting, (Clark Consulting, North Barrington, IL), Jan. 2004, at 1, available at <http://www.clarkconsulting.com/knowledgecenter/articles/benefits/10thannualsurvey.doc> (last visited Nov. 11, 2004) [hereinafter Clark Consulting].

22. A firm can shelter from taxation the investment income on funds set aside for financing executive pensions by investing these funds in life insurance policies on the lives of its executives and other employees. However, because of the fees that must be paid to the insurance company, this tax-sheltering mechanism involves significant costs, which are borne by the company rather than the executive. If, on the other hand, the executive received the funds to begin with, the executive would also be able to shelter the investment returns from taxation by purchasing a variable annuity, at no cost to the company.

23. To illustrate the effect of a SERP on the tax burdens of the parties, consider the following example and explanation, which builds on the examples provided in note 20. Assume again that both the firm and the executive face a 40% tax rate on all of their income, including capital gains. And assume that both are able to earn, between the pre-retirement and retirement periods, a pretax return of 100% on their investments.

Example 3: The firm invests for the executive’s retirement under a nonqualified plan. Suppose a firm seeks to use a SERP to give an executive the same retirement payment that it gives the employee in

In reality, of course, the situation is more complicated.²⁴ In many cases, the total tax liability faced by the parties will be affected by whether the executive or the firm saves for the executive's retirement. Even if the firm and the executive are able to earn the same return on their investments, they may face different tax rates. Suppose, for example, that an executive investing personal funds for retirement in the stock market is paying a low long-term capital-gains tax rate of 15%, while the firm pays taxes on the income generated for the executive's retirement at a corporate tax rate of 35%. In such a case, using SERPs would be tax-inefficient and would *increase* the total amount of taxes paid by the two parties. On the other hand, if the firm had no taxable earnings and was not expected to pay taxes for a considerable amount of time, the reverse might be true: shifting retirement savings from the executive to the firm might be tax-efficient.²⁵

Similarly, even if the firm and the executive face the same tax rate, the investment returns available to the firm may be higher than those available to the executive. For example, firms having difficulty raising capital may enjoy a higher expected rate of return on new investments than the market generally. (This is unlikely to be the case for companies with easy access to capital, as such companies are unlikely to have unutilized investments with returns much higher than the market.) If the firm has better investment opportunities, having

example 2 using a qualified plan. As in the case of the employee, the firm sets aside \$100 to fund the executive's pension, which grows to \$200 by the time the executive retires. The \$200 is distributed to the executive, who, like the employee, pays a 40% tax on the retirement distribution—a tax of \$80. This leaves the executive, like the employee in example 2, with \$120, \$24 more than the employee in example 1 made.

Now consider the effect of the SERP on the firm. In examples 1 and 2, discussed in note 2, the firm reduces its tax liability by \$40 in the pre-retirement period when it pays the worker \$100 or contributes \$100 to the worker's qualified pension plan. In example 3, the firm reduces its tax liability by \$80 in the retirement period when it pays the executive \$200. However, the firm must add to its taxable income in the retirement period the \$100 gain on the funds it previously invested for the executive's retirement, and this *increases* the firm's tax liability in the retirement period by \$40. The net effect of the \$200 payment to the executive and the \$100 gain is to reduce the firm's tax liability by \$40 during the retirement period.

Had the firm reduced its tax liability by \$40 in the pre-retirement period, rather than during the retirement period, it could have invested the \$40 and earned a pretax return of \$40 (100%) by the retirement period. That \$40 would also have been taxed at 40%, leaving the firm with \$64. But by reducing its tax liability in the retirement period, the firm has only an extra \$40, \$24 less. The firm is thus worse off than in example 2, in which it received the same \$40 reduction in its tax liability in the pre-retirement period. The \$24 gain to the executive from the use of a nonqualified plan designed to put the executive in the same position as an employee under a qualified retirement plan comes at the expense of the firm.

24. For an explanation of the tax effects of using arrangements such as SERPs to defer compensation under various scenarios, see MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 181-185 (Prentice Hall, 2d ed., 2002).

25. The tax efficiency of a SERP will also be affected by expected changes in the firm's (or the executive's) tax rate change over time. For example, if the firm is losing money and thus unable to get a current tax benefit by deducting executive compensation in the current period, but is expected to be subject to a higher tax rate in the future, deferring an executive's compensation will be tax efficient, all else being equal.

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it invest for the executive's retirement will be efficient for both parties, even if their tax rates are identical.

However, there is no reason to believe that, absent a tax subsidy, it is generally efficient to have the firm save for the executive. On the contrary, there are good reasons to think that it is *inefficient* for many firms to save for their executives' retirement, given individuals' low long-term capital-gains tax rate. It is telling that firms providing SERPs to executives do not offer nonqualified retirement plans to other employees. Consider the case where it is efficient for a firm to provide a SERP to its executives because the firm has better investment opportunities than they do. In such a case, it should also be efficient for the firm to provide nonqualified retirement to its nonexecutive employees who supplement their qualified pensions with personal retirement savings. However, firms rarely, if ever, do so. This fact suggests that, absent the tax subsidy provided to qualified plans, using nonqualified retirement benefits is commonly not an efficient way to compensate employees. Yet in 2002, more than 70% of firms provided nonqualified SERPs to their executives.²⁶

The second important difference between executive SERPs and qualified pension plans for nonexecutive employees concerns the risk borne by the firm and by the participant. Qualified pension plans offered to new lower-level employees are usually based on a *defined contribution*. The firm commits to contribute a specified amount each year. The value available to an employee upon retirement depends on the performance of the plan's investments. The risk of poor investment performance falls entirely on the employee.

In contrast, SERPs offered to executives are *defined-benefit* plans, which guarantee fixed payments to the executive for life. All of the CEOs in the S&P ExecuComp database have defined-benefit plans.²⁷ These plans shift the risk of investment performance entirely to the firm and its shareholders. No matter how poorly the firm and its investments perform, the executive is guaranteed a specified lifelong stream of payments.

Given that arm's-length negotiations with most employees lead to defined-contribution arrangements, why should arm's-length bargaining with executives yield such a different result? If anything, there are reasons to believe that defined-benefit plans should be *more* valuable to regular employees—and thus offer a more efficient form of compensation—than they are to executives. Unlike most executives, ordinary employees are unlikely to accumulate substantial wealth over their lifetimes. They are likely to be more dependent on their pensions to meet their financial needs in retirement and therefore less able

26. See Clark Consulting, *supra* note 21.

27. STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION 175 (Academic Press, 2002).

to bear the investment risks associated with defined-contribution plans. In contrast, executives faced with defined-contribution plans could easily insure themselves against poor investment performance by using some of their already high salaries and option-based compensation to buy fixed annuities that would provide them with guaranteed payments. If only one of the two groups were to receive defined-benefit plans, arm's-length contracting would predict that group to be nonexecutive employees, not executives.

B. Camouflage Benefits

Although the efficiency benefits of providing executives with defined-benefit SERPs are far from clear, such plans do considerably reduce the visibility of a substantial amount of performance-insensitive compensation.

SERP payments are usually based on years of service and pre-retirement cash compensation. The higher the executive's salary and the longer the period of employment, the higher the payout. SERP payments—like salary—are therefore largely decoupled from the executive's own performance. Many firms have also credited executives with years they did not actually serve, ratcheting up the final payout under the plan's formula.²⁸

In their annual public filings, firms must publish a summary compensation table indicating the dollar value of different forms of compensation received by the current CEO and the four other highest-paid executives of the firm. The numbers in these tables are the most visible indicators of executive compensation in public firms. They are easily accessible to the media and others reading the public filings. Indeed, the standard databases of executive compensation, which are used by both financial economists and compensation consultants, are based on these numbers.

If an executive's pensions were structured as a defined contribution plan, the firm's annual contributions to the executive's account would be reported in the summary compensation table. An important camouflage benefit of SERPs is that the annual increase in the present value of an executive's defined benefit plan—due to pay raises and the addition of another year of service—is largely hidden from view: firms are not required to include this increase in value in the compensation tables. A person examining the compensation tables would not see the steady buildup in value of an executive's SERP.

Furthermore, and importantly, disclosure requirements require firms to include in their summary compensation tables only amounts paid to their current executives. Because the executives are no longer employed by the firm when the pension payments begin, the payments need not be included in the published tables. Thus, the value of an executive's defined-benefit SERP never

28. See, e.g., Mike Blahnik, *A Credit for Work Not Served; Years Added to Pensions as Part of Executives' Job Perks*, STAR TRIB. (Minneapolis), May 18, 2003, at 1A.

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appears in the place where the media and researchers collect most of their information about executive compensation. In addition, because the value of an executive's pension payouts is obscured, the performance insensitivity of such payments also gets little notice.

Consider a situation in which a CEO serves a company for ten years and then receives annually, for life, a payment that equals a large fraction of the salary earned during the last year of service. In such a case, the total value of the pension payments may in the end exceed the total value of the salary received during the CEO's actual tenure. Unlike the salary amounts, however, the value of the pension payments will never appear in the firm's published compensation tables.

For example, when IBM CEO Louis Gerstner retired after about nine years of service, he was entitled to a \$1,140,000 annual pension beginning at age sixty.²⁹ The actuarial value of this annuity was of a similar order of magnitude as the approximately \$18 million in salary he received during his nine years as CEO. IBM, however, was not required to include the pension in the summary compensation table or even place a dollar value on it.³⁰

Not surprisingly, SERP plans are designed and marketed specifically as ways to increase compensation "off the radar screen of shareholders."³¹ Indeed, according to media reports, some directors have voted to adopt SERPs only after being reassured that the amounts involved do not have to be reported to the public.³²

To be sure, although neither the increase in value of the SERP plan before retirement nor the amount of payments after retirement appears in the compensation tables, the existence of SERPs, and the formulas under which payouts are made, must be disclosed in the firm's SEC filings.³³ But it is

29. See International Business Machines, SEC Filing 14A, Definitive Proxy Statement, 18, Mar. 12, 2001, available at <http://www.sec.gov/Archives/edgar/data/51143/000100547701001864/0001005477-01-001864-index.htm> (last visited Nov. 14, 2004).

30. To take another example, GE's former CEO, Jack Welch, left his firm with an annual pension of almost \$10 million. See Paul Hodgson, The Corporate Library, *Golden Parachutes and Cushioned Landings*, in The Corporate Library, Feb. 1, 2003, at 14, available at <http://www.thecorporatelibrary.com/Products-and-Services/store/publications/default.asp> (last visited Nov. 14, 2004). The large actuarial value of the stream of promised pension payments never appeared in the firm's compensation tables.

31. Liz Pulliam Weston, *Despite Recession, Perks for Top Executives Grow; Pay: Hidden Benefits Mushroom as Employees' Retirement Plans Shrink*, L.A. TIMES, Feb. 1, 2002, at A1 (quoting Cynthia Richson).

32. The *Star Tribune* reported that the HealthPartners board adopted a SERP for the CEO "after receiving assurances that the supplemental retirement plan wouldn't have to be reported to the public" and "rejecting a suggestion that awards in the plan be tied to company performance." Glenn Howatt, *HealthPartners Ex-CEO Reaped Board's Favors; Secret Deals Contributed to \$5.5 Million Package*, STAR TRIB. (Minneapolis), Jan. 17, 2003, at 1A.

33. In addition, firms are required to file a letter with the Labor Department indicating the number of executive pension plans and the number of participants. However, not all firms comply with this requirement. Ellen E. Schultz, *Big Send-Off: As Firms Pare Pensions for Most, They Boost Those for Executives*, WALL ST. J., June 20, 2001, at A1.

difficult for anyone without actuarial or financial training to estimate with precision the value—and thus the cost to the company—of these future payments.³⁴ As noted above, firms are not required to supply, and usually do not provide, any estimate of the dollar value of a particular executive's defined-benefit pension plan. The lack of easy access to the monetary values of these substantial benefits presumably explains their absence from the standard databases used for research on executive compensation.

Indeed, it is often difficult even to figure out the total SERP liability of a firm with respect to its executives as a group. A firm must report only one figure: the sum of the liabilities associated with all of its employee pension plans that are “unfunded” or “underfunded” (that is, plans for which the firm does not have assets set aside to cover the plans' liabilities fully).³⁵ The Financial Accounting Standards Board (FASB) does not require that liabilities associated with SERPs be itemized separately.³⁶ Thus, firms can simply report one number that represents all the liabilities associated with underfunded qualified plans and unfunded SERPs.

Although they are not required to do so, some firms do report the total obligations arising under SERPs. These figures can be staggering. In 2000, for example, GE reported a \$1.13 billion pension liability for all of its executives.³⁷ Unfortunately, GE did not report what portion of this amount was due specifically to its CEO and other top executives. Most companies do not even break down pension liabilities into separate categories for executives and other employees.

It is worth noting at least one way in which executives' plans may not be as advantageous to their beneficiaries as the plans of lower-level employees. Firms using qualified plans are required, as a condition for favorable tax treatment, to set aside assets to ensure that they can pay their liabilities under the plans. Given that executives' SERP plans would not qualify for the favorable tax treatment even if they were so funded, firms do not bother funding SERP plans. Executives' retirement benefits are thus at greater risk of nonpayment than the benefits of ordinary workers—and Congress is considering legislation that would make it difficult for firms to shelter executives from this risk.³⁸

34. See Joann S. Lublin, *Executive Pay (A Special Report): Under the Radar*, WALL ST. J., Apr. 11, 2002, at B7; Anne Fisher, *Proxies: The Treasure Is Still Buried*, FORTUNE, June 8, 1998, at 285.

35. EMPLOYERS' DISCLOSURE ABOUT PENSIONS AND OTHER POSTRETIREMENT BENEFITS, Statement of Financial Accounting Standards No. 132, B21 (Financial Accounting Standards Bd. 2003), § 36 available at <http://www.fasb.org/fas132r.pdf> (last visited Nov. 11, 2004).

36. EMPLOYERS' ACCOUNTING FOR PENSIONS, Statement of Financial Accounting Standards No. 87, (Financial Accounting Standards Bd. 1985), available at <http://www.fasb.org/pdf/fas87.pdf> (last visited Nov. 11, 2004).

37. Schultz, *supra* note 33.

38. In June 2004, the U.S. House of Representatives passed the American Jobs Creation Act of 2004, which penalizes firms using certain types of trusts to protect deferred compensation from the

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In the past, however, firms facing financial problems have often purchased insurance policies that guaranteed payment of executive retirement benefits, transferred the money to a designated trust, or taken other steps to guarantee the benefits against insolvency.³⁹ Delta Airlines, for example, set up an executive-protecting arrangement shortly after September 11, 2001, when the solvency of the airline industry appeared to be in danger.⁴⁰ Although putting the money beyond the reach of the firm's creditors triggers a tax liability for the executive, firms often "gross up" the payment to cover part or all of that liability.⁴¹ It was reported in 1991 that approximately fifty major companies had set up fully guaranteed executive pension plans.⁴² This practice may have been much more widespread; many firms, fearing criticism that they are insulating managers from the effects of their own failures, have failed to announce the existence of such guarantees.⁴³

IV. DEFERRED COMPENSATION

Deferred compensation is a second technique used to transfer large amounts of mostly performance-insensitive value to executives without attracting much shareholder attention. Many firms offer programs that permit executives, or sometimes even require them, to defer receipt of compensation until some future date. In the meantime, the deferred compensation "builds" according to a formula devised by the firm. Executives do not pay taxes on the original compensation or on the accumulated increase until they receive payment, which often occurs after they leave the company. At that time, the firm takes a tax deduction for the amount paid. Most large companies have plans of this kind.⁴⁴

Deferred compensation plans can take different forms. Some firms require that managers receiving salary in excess of \$1 million, which would otherwise be nondeductible under Section 162(m) of the Internal Revenue Code, defer the excess. Other firms have purely elective plans. Some arrangements permit

firms' creditors. The U.S. Senate passed a similar bill in May 2004, which was signed by President Bush on October 22, 2004.

39. Clark/Bardes Consulting reported in 2001 that 86% of firms surveyed use security devices to protect SERPs to the greatest extent possible. Clark/Bardes Consulting, *Executive Benefits: A Survey of Current Trends - 2001 Results*, J. DEFERRED COMP., 33, available at <http://www.clarkconsulting.com/knowledgecenter/articles/benefits/20020305.pdf> (last visited Nov. 15, 2004); Ron Suskind, *More Executives Get Pension Guarantees to Protect against Takeovers, Failures*, WALL ST. J., Jul. 5, 1991, at B1; Theo Francis & Ellen Schultz, *As Workers Face Pension Cuts, Executives Get Rescued*, WALL ST. J., Apr. 3, 2003, at C1.

40. Francis & Schultz, *supra* note 39.

41. *Id.*

42. Suskind, *supra* note 39.

43. *Id.*

44. Clark Consulting reports that close to 93% of firms responding to a survey said they had such plans in 2002. Clark Consulting, *supra* note 21.

deferral of salary only, while others also allow deferral of long-term incentive compensation and gains from the exercise of stock options or from the sale of restricted stock. Companies frequently provide matching contributions, with the amounts varying from firm to firm. At some companies, contributions are awarded at the board's discretion. At others, they are determined by formulas.⁴⁵

Plans also differ in how the deferred compensation is "invested," that is, how the amount owed to the executive at the end of the deferral period is determined. Many companies provide a guaranteed rate of return (or a guaranteed minimum rate) on the funds.⁴⁶ Firms have often granted extra benefits to executives by providing rates of return that are higher than the market rate. For example, in 2001, at a time when one-year Treasury bills offered returns of 3.39% to 4.63%, both GE and Enron guaranteed executives a 12% rate of return. Other firms have offered a market return plus a premium. For example, Lucent has offered the return on the ten-year Treasury bill plus 5%.⁴⁷ Congress is now considering legislation aimed at preventing firms from providing executives with above-market returns in their deferred-compensation plans. Although the adoption of such legislation would eliminate this particular benefit to managers, deferred compensation plans would still provide executives with significant other financial and camouflage advantages as we discuss below. Part IV.A identifies the differences between executive deferred compensation arrangements and the 401(k) plans offered to other employees. Part IV.B describes the camouflage benefits of executive deferred compensation arrangements.

A. Differences from 401(k) Plans

Deferred-compensation arrangements appear analogous to the familiar 401(k) plans used by many employees. But, just as SERPs differ from the qualified retirement plans offered to lower-level employees, there are some important differences between executives' deferred compensation and 401(k) plans.

To begin with, the 401(k) plans give workers an opportunity to put money in designated investment instruments; whatever the investments, employees get the same pretax returns they would receive by investing in similar instruments outside the 401(k) plan. In contrast, executives' deferred-compensation arrangements often provide higher returns than those available in the market.

In addition, 401(k) plans are given a tax subsidy, while executive deferred-

45. For example, when Sears, Roebuck & Co. executives postpone bonuses and long-term incentive pay, they receive an additional contribution equal to 20% of the amount deferred. Ellen E. Schultz & Theo Francis, *Buried Treasure: Well-Hidden Perk Means Big Money for Top Executives*, WALL ST. J., Oct. 11, 2002, at A1, A9.

46. Weston, *supra* note 31.

47. Lublin, *supra* note 34; Weston, *supra* note 31.

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compensation plans are not. Under a 401(k) plan, a fraction of the employee's salary is placed in a tax-deferred account. The firm may also make a separate contribution to the account. As in a qualified retirement arrangement, the funds are invested and grow tax-free. Neither the firm nor the employee pays taxes on the income and capital gain generated in the account. Employees do not pay taxes on the contributions or the increase until they withdraw the funds. The employer, on the other hand, gets a deduction for both its contribution and the employee's contribution to the 401(k) plan. By placing current compensation in a 401(k) account, the employee gains the benefit of tax deferral without the employer's loss of a tax deduction.⁴⁸

Firms could provide deferred compensation to executives through 401(k) plans. However, there are limits on how much money can be contributed annually to a 401(k) account. For the tax year 2004, employees covered by such a plan ordinarily cannot defer more than \$13,000 of compensation.⁴⁹ In order to provide executives with amounts exceeding this limit, firms implement deferred-compensation arrangements outside the tax-advantaged framework of 401(k) plans. Executives' deferred compensation is therefore not based solely, or even primarily, on 401(k) plans.

Rather than contribute a portion of the executive's compensation to an account where the investment grows tax-free, the firm simply withholds part of the executive's pay and credits the executive each year with a prespecified return on the money, allowing it to "grow" over time. The withheld compensation, along with the appreciation credited to it by the firm, is paid to the executive at a later date.

The company pays taxes on the income it must generate in order to pay the executive the promised buildup of the deferred compensation. If, on the other

48. To illustrate how the tax subsidy provided to a 401(k) operates, consider the following examples involving a hypothetical firm and employee. As in the SERP examples found in note 20 (examples 1 and 2), assume that both the firm and the employee face a 40% tax rate on all of their income. Assume also that both are able to earn, between the pre-retirement and retirement periods, a pretax return of 100% on their investments.

Example 4: The employee saves outside the 401(k) plan. Suppose the firm pays the employee \$100 in the pre-retirement period. The firm deducts \$100 from its taxable income, reducing its tax liability by \$40. The employee pays \$40 in taxes, and invests the aftertax income of \$60 in an ordinary, nonqualified investment account. By the retirement period, the \$60 grows to \$120—a gain of \$60. The employee pays a tax of \$24 on the gain (40% of \$60), leading to an aftertax gain of \$36. The employee is thus able to withdraw a total of \$96 (\$60 + \$36).

Example 5: The employee saves under a 401(k) plan. Now suppose that the employee contributes \$100 of compensation income to a 401(k) account. The firm again deducts \$100 from its taxable income, reducing its tax liability by \$40. The \$100 grows to \$200 by the time the employee withdraws the funds from the 401(k) account. The employee pays a tax of \$80 (40% of \$200), leaving the employee with \$120—\$24 more than in example 4, where the employee received \$100 from the firm in the preretirement period and saved the money outside the 401(k) plan. The \$24 gain to the employee does not come at the expense of the employer. In both examples, the employer pays the employee \$100 in the pre-retirement period, thereby reducing its taxable income by \$100 and its tax liability by \$40.

49. I.R.C. § 402(g)(1)(B).

hand, the deferred compensation had been distributed when it was originally owed the executive, the executive would have invested the money and paid taxes on any income or capital gains subsequently generated. Thus, as in the case of a SERP, the effect of executive deferred compensation is to shift some of the executive's tax burden to the firm.⁵⁰

If the employee and the firm are subject to the same tax rate and are able to earn the same pretax rate of return on their investments, executive deferred compensation, like a SERP, cannot reduce the parties' joint tax burden. While every dollar of deferred compensation lowers the executive's taxes, it boosts the firm's taxes by one dollar. Like a SERP, and unlike qualified 401(k) and retirement plans, deferred-compensation plans for executives provide no tax-efficiency benefit when the firm and the executive share the same tax rate and investment opportunities.⁵¹

As in the case of SERPs, of course, there will be many cases in which deferred compensation outside 401(k) plans can increase or reduce the total amount of value available to the executive and the firm.⁵² The firm and the executive may face different tax rates. Even if the firm and the executive face

50. A company can shelter from taxation investment income on funds set aside for financing executive pensions by investing these funds in insurance policies on the lives of its executives and other employees, but this will impose other costs on the firm. See SCHOLLES ET AL., *supra* note 24, at 181-185.

51. To illustrate the effect of executive deferred-compensation arrangements on the tax burdens of the parties, consider the following example and explanation, which refer to examples 4 and 5 provided in note 48.

Example 6: The firm offers the executive deferred compensation outside a 401(k) plan. Assume, as in examples 4 and 5, that both the firm and the executive face a 40% tax rate on all of their income, including capital gains. And assume that both are able to earn, between the pre-retirement and retirement periods, a pretax return of 100% on their investments.

Suppose the firm seeks to use deferred compensation to give an executive the same (100%) return that the firm provides the employee in example 5 using a 401(k) plan. As in the case of the employee, the firm sets aside \$100, which grows to \$200 by the time the executive withdraws the deferred compensation and the buildup credited to the designated amount of deferred compensation. The \$200 is distributed to the executive. Like the employee, the executive pays 40% tax on the retirement distribution—a tax of \$80. This leaves the executive, like the employee in example 5, with \$120, or \$24 more than the employee saving on his own ended up with in example 4.

Now, let us consider the effect of the executive's deferred compensation arrangement on the firm. In examples 4 and 5, the firm reduces its tax liability by \$40 in the pre-retirement period when it pays the worker \$100 or contributes \$100 to the worker's qualified pension plan. In example 6, the firm reduces its tax liability by \$80 in the retirement period when it pays the executive \$200. However, the firm must add to its taxable income in the retirement period the \$100 generated to boost the executive's withdrawal payout from \$100 to \$200—which in turn increases the firm's tax liability by \$40. The net effect of the \$100 gain and the \$200 payment to the executive is to reduce the firm's tax liability by \$40 during the retirement period. The firm is thus worse off than in example 2, where it received the same reduction in its tax liability in the pre-retirement period.

Had the firm reduced its tax liability by \$40 in the earlier period, it could have invested the \$40 and earned a pretax return of \$40 (100%) by the retirement period. The \$40 would have been taxed at 40%, leaving the firm with \$64. By reducing its tax liability in the retirement period, the firm has only an extra \$40, or \$24 less. Thus, the \$24 gain to the executive from the use of a deferred-compensation arrangement designed to put the executive in the same position as an employee under a qualified 401(k) comes at the expense of the firm.

52. For an explanation of the tax effects of deferred compensation under various scenarios, see SCHOLLES ET AL., *supra* note 24, at 181-85.

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the same tax rate, the investment returns available to the firm may be higher than those available to the executive (although, as we noted in our discussion of SERPs, this is unlikely to be the case for companies with easy access to capital). However, there is no reason to believe that, absent the tax subsidy provided by qualified plans, there is generally a benefit to the parties when the firm defers the executive's compensation. In many cases, the tax burden on the firm is greater than the tax benefit to the executive, increasing the total tax that the two parties pay to the government.

Consider, for example, the case in which an executive of a profitable company is promised a return that is linked to a stock index. If the executive invests the money in shares of a stock index fund, the gains will be taxed at the long-term federal capital-gains rate, which in the highest bracket is 15% (as of 2004).⁵³ If, instead, the firm invests the money—in those shares, other investments, or its own business—the gains could be taxed at the marginal corporate rate of 35%.⁵⁴

Thus, it is puzzling that over 90% of firms offer deferred-compensation programs to their executives.⁵⁵ As in the case of SERPs, there are good reasons to think that, in many firms, such programs are not an efficient form of compensation. It is curious that firms offering nonqualified deferred-compensation arrangements to executives do not offer such nonqualified plans to other employees. After all, if nonqualified deferred compensation is an efficient form of compensation for the executives of certain firms—say, because the firms have better investment opportunities than the executives—nonqualified deferred compensation should also be an efficient form of compensation for the nonexecutive employees of these firms. But firms rarely, if ever, provide nonexecutive employees with the option of nonqualified deferred-compensation arrangements in addition to their 401(k) plans. This pattern suggests that, in most cases, offering nonqualified deferred compensation to an executive does not increase the joint wealth of the executive and the firm.

53. I.R.C. § 1.

54. I.R.C. § 11. As in the case of SERPs, a firm can reduce the tax cost of deferred compensation by using company-owned life insurance. Under this strategy, the firm uses after-tax dollars to buy insurance on the lives of its executives and other employees. Part of the premium is invested, increasing the "cash value" of the policy. The policy is then cashed out when funds are needed to pay deferred compensation. The tax savings come from life insurance policies' capacity to shelter from taxes the buildup of the cash value. However, because the insurance company charges fees, the use of a life insurance policy to avoid taxes gives rise to transaction costs. A 1996 study found that 70% of the 1,000 largest firms did not use insurance for funding deferred compensation, which suggests that these costs can be quite high. See Christopher Drew & David Cay Johnston, *Special Tax Breaks Enrich Savings of Many in the Ranks of Management*, N.Y. TIMES, Oct. 13, 1996, § 1, at 1.

55. Clark Consulting, *supra* note 21, at 2.

B. Camouflage Benefits

While it is far from clear that deferred-compensation arrangements provide efficiency benefits, their camouflage value is substantial. The compensation being deferred must be reported in the summary compensation table in the year in which it would otherwise have been received. However, the substantial benefits that have been conferred by the deferred-compensation plan—the tax-free (and sometimes above-market) buildup over time—are not evident to outsiders.

Even assuming that the nominal rate of return used by a deferred-compensation arrangement is no higher than the market rate, the effective interest rate earned by executives is higher than it appears because of the substantial tax benefits. Executives must pay taxes on investment income earned outside deferred-compensation arrangements, but investing *within* such plans provides them—at the expense of the firm—with a tax-free buildup. Thus, as long as the rate of return in deferred-compensation arrangements is above the executive's after-tax rate of return, the executive makes substantial gains that do not show up in the compensation tables. The *New York Times* reported, for example, that CEO Roberto Goizueta of Coca-Cola was able to defer taxes on \$1 billion of compensation and investment gains over a seventeen-year period.⁵⁶ Coca-Cola picked up the tab, paying taxes on the earnings needed to cover the returns credited to Goizueta's deferred-compensation account.⁵⁷

Furthermore, while 401(k) plans offer lower-level workers returns equivalent to those available in the bond or stock markets, many deferred-compensation arrangements have provided executives with substantially higher returns. These executives have thus received investment income that was not only tax-free for them (at the expense of the firm) but also above-market. The benefits from these above-market returns have also been hidden to a significant extent.

The SEC requires firms to include in the summary compensation table the above-market interest earned that year by each executive on deferred compensation. In the case of a guaranteed interest rate, "above-market" interest is defined as returns in excess of 120% of the applicable federal rate (AFR) used by the IRS at the time the guaranteed interest rate is set, multiplied by the amount of deferred compensation. By exploiting the SEC's definition of "above-market rate," firms have sometimes been able to provide their executives with rates of return that are higher than those they could get on their own without including this benefit in the compensation tables.

56. *Tax Deferred Pay for Executives*, N.Y. TIMES, Oct. 18, 1996, at A36.

57. According to Coca-Cola's annual reports to shareholders, it paid taxes on its income in every year of Goizueta's tenure except in 1992.

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The threshold used by firms for “market” long-term rates of return is especially generous because boards can reset interest rates whenever doing so benefits executives. If market interest rates and the AFR rise so that the current guaranteed rate is not especially attractive, the firm can simply adopt a new, higher, guaranteed rate. As long as the reset rate is lower than 120% of the new, higher AFR, the additional interest accruals need not be reported in the summary compensation table. If, however, market interest rates and the AFR fall, the firm can continue to pay at the old guaranteed rate, which is now above market. And because the AFR used for the disclosure threshold is that prevailing when the guaranteed interest rate was initially set, no matter how low market rates drop, the above-market interest paid to the executive never appears in the compensation table.

Finally, even benefits that have come from rates of return exceeding the SEC’s threshold are unlikely to be fully reflected in the compensation tables. The reporting requirement ends when the executive retires, but the executive often has the option to continue enjoying the above-market rates after retirement. Such a stream of post-retirement benefits—which could be quite substantial in value—would never appear in the firm’s publicly filed compensation tables.

As in the case of SERPs, deferred-compensation plans could expose executives to the risk of firm bankruptcy. While 401(k) plans must be backed by their assets, which cannot be seized by the firm’s creditors, deferred-compensation arrangements are simply a promise by the firm to pay compensation in the future. The executives owed this compensation are unsecured creditors who may not be paid in full if the firm becomes insolvent. As in the case of SERPs, Congress is considering legislation that would make it difficult for firms to shield executives from this possibility. To date, however, firms have often taken steps to insulate executives from insolvency risk. Many firms have used “security devices,” such as trusts, to ensure that funds will be available to the executives. In addition, firms have usually permitted executives to withdraw deferred compensation at any time—such as when inside information suggests that a firm is about to fail. Shortly before Enron filed for bankruptcy, for example, its executives withdrew millions of dollars of deferred compensation.

For executives and their friends on the board, SERPs and deferred compensation have been very useful. They have provided a means for channeling large amounts of performance-insensitive compensation in a way that, under current disclosure regulations, has not been highly visible to outsiders. As one compensation analyst pointed out: “The disclosure of the myriad executive compensation plans—pension, supplemental executive retirement plans, deferred compensation, split-dollar life insurance—is not adequate in answering a fundamental question: what is the projected value of

these plans to the executive upon his retirement?”⁵⁸

V. POST-RETIREMENT PERKS AND CONSULTING CONTRACTS

We now turn to consider the use of post-retirement perks and consulting contracts to convey a significant amount of performance-decoupled value to executives in a way that is not transparent to shareholders. Part V.A describes some of the perks provided to executives and explains why they are unlikely to result from arm’s-length bargaining between the parties. Part V.B examines the use of post-retirement consulting agreements.

A. Perks

Many compensation contracts promise executives a substantial stream of perks after retirement. For example, many executives receive a certain number of hours of corporate aircraft use annually for themselves, and sometimes for their families and guests as well. Some executives have even received unlimited lifetime use of corporate aircraft.⁵⁹ Other perks that often follow the executive into retirement include chauffeured cars, personal assistants, financial planning, home-security systems, club memberships, sports tickets, office space, secretarial help, and cell phone service.⁶⁰ Outgoing IBM CEO Louis Gerstner, for example, was given access to apartments, planes, cars, home-security services, and financial planning. Terrence Murray, former CEO of FleetBoston, received 150 hours of company aircraft use, a chauffeured car, an office, office assistants, financial planning, and a home-security system.

Another common benefit is giving contributions to charities designated by the retiring executive. FleetBoston gave retiring CEO Murray the ability to direct \$3.5 million of the firm’s charitable contributions to Murray’s favorite institutions.⁶¹ In addition, Ford promised retiring CEO Jacques Nasser to endow a scholarship in his name at the educational institution of his choice (in addition to providing Nasser a new car each year, financial-planning assistance, an office, and an assistant).⁶²

Most of these perks cost the company more than may be apparent at first

58. Gretchen Morgenson, *Executive Pay, Hiding Behind Small Print*, N.Y. TIMES, Feb. 8, 2004, § 3, 1.

59. Nell Minow, CEO Contract Provisions: The Use of Company Aircraft, The Corporate Library (Special Report) (Oct. 2001), at <http://www.thecorporatelibrary.com/special/misc/aircraft.html> (last visited Nov. 14, 2004).

60. See Lublin, *supra* note 34; Gary Strauss, *CEOs Cash In After Tenure*, USA TODAY, Apr. 25, 2002, at 1B.

61. See Agreement, available at <http://contracts.corporate.findlaw.com/agreements/fleetboston/murray.emp.2001.10.10.html> (last visited November 8, 2004).

62. Joann S. Lublin, *How CEOs Retire in Style: Many Former Chief Executives Get Lush Perks and Fat Fees for Limited “Consulting” Work*, WALL ST. J., Sept. 13, 2002, at B1.

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glance. Consider retiree use of corporate jets, now a common perk. Although the marginal cost of allowing a retired executive to use the company jet may appear limited,⁶³ it can run quite high. Consider the use of a company plane for a flight from New York to California and then back several days later. Because the New York-based aircraft and flight crew will return to the East Coast after dropping the retired executive off, the actual charge to the company is two round trips: a total of eight takeoffs and landings and approximately twenty hours of flying time, most likely costing—for fuel, maintenance, landing fees, extra pilot and crew fees, incidentals, and depreciation (an aircraft's operating life is reduced for every hour it flies and, more important, for every takeoff and landing)—at least \$50,000.⁶⁴ Henry R. Silverman, CEO of Cendant, was promised lifetime use of the corporate aircraft or, if the plane was in use, an equivalent chartered plane at a direct cost of thousands of dollars per hour.⁶⁵

Firms usually do not provide post-retirement perks to nonexecutive employees. There is good economic logic to avoiding such in-kind compensation. Promising a retiring employee \$10,000 a year for certain travel expenses is less efficient than providing \$10,000 in cash. The reason is straightforward. If the retiree views travel as the best way to spend \$10,000, the cash and the travel coverage will have identical utility. However, cash is superior if there are any possible circumstances in which the retiree would prefer spending some or all of the money on goods or services other than travel, because the retiree will receive greater utility at the same cost to the firm.

A retiree's needs and preferences are likely to change over time. Thus, economic logic suggests that if in-kind retirement benefits are provided, they should not be provided for long periods. Yet such long-term, in-kind benefits are often provided to retired CEOs: for example, Louis Gerstner of IBM received use of a plane, cars, offices, and financial planning services for ten years.⁶⁶

Although post-retirement perks are unlikely to be an efficient form of compensation, they offer an effective means of camouflaging compensation. The value of post-retirement perks is not reported when they are agreed to, and the firm incurs costs only after the executive has left, at which point any value provided is no longer included in the salient summary compensation table. Post-retirement perks thus offer yet another way of providing additional value to executives without ever having to include the benefits in compensation tables or even place a dollar value on them.

63. This misperception led one compensation consultant, Yale D. Tauber, to label jet use as "an efficient way of delivering something of value to the executive." Lublin, *supra* note 34.

64. We thank Marc Abramowitz and Yitz Applebaum for useful discussions on the cost of operating corporate jets.

65. Minow, *supra* note 59.

66. Strauss, *supra* note 60.

Firms in the past have sometimes grudgingly provided vague descriptions about post-retirement perks, but these descriptions did not generally allow shareholders to form a good picture of the scope and value of these benefits. For example, former General Electric CEO Jack Welch received approximately \$2.5 million in benefits in his first year of retirement, including access to GE aircraft for unlimited personal use and for business travel, exclusive use of a furnished New York City apartment, and unrestricted access to a chauffeured limousine (among other things).⁶⁷ However, GE's proxy statements revealed only that in retirement Welch would be entitled to "continued lifetime access to Company facilities and services comparable to those that are currently made available to him by the Company."⁶⁸ Thus, GE not only failed to put a dollar value on the perks, but did not bother even to describe them.

B. Consulting Contracts

Like perks, consulting contracts provide substantial value to retired executives. They usually offer the retiring CEO an annual fee for "being available" to advise the new CEO for a specified amount of time per year. Approximately 25% of CEOs negotiate a post-retirement "consulting" relationship with their old firm.⁶⁹

For example, AOL Time Warner is paying retired CEO Gerald M. Levin \$1 million a year to serve as an adviser for up to five days a month.⁷⁰ In 2000, retiring Carter-Wallace CEO Henry Hoyt was promised annual payments of \$831,000 for a similar monthly obligation.⁷¹ Verizon co-CEO Charles Lee negotiated a \$6 million consulting contract for the first two years of his retirement. Delta Airlines CEO Ronald Allen's 1997 retirement package provided him with a seven-year, \$3.5 million consulting deal under which, according to Delta's public filings, he was "required to perform his consulting services at such times, and in such places, and for such periods as will result in the least inconvenience to him."⁷² Allen or his heirs will be entitled to the annual fee of \$500,000 even if he is totally disabled or dies.⁷³

These consulting arrangements provide flat, guaranteed fees for the retired executive's "being available" rather than payment for work actually done, and for a good reason: companies generally make little use of the availability for

67. General Electric Settles SEC Action for Disclosure Failures in Connection with Its Former CEO's Benefits Under His Employment and Retirement Agreement, SEC News Digest, Issue No. 2004-184 (Sept. 23, 2004), available at <http://www.sec.gov/news/digest/dig092304.txt> (last visited Nov. 11, 2004).

68. *Id.*

69. Strauss, *supra* note 60 (quoting Ira Kay of consulting firm Watson Wyatt).

70. Lublin, *supra* note 62.

71. Strauss, *supra* note 60.

72. *Id.*

73. Lublin, *supra* note 62.

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which they pay generously. For better or worse, new CEOs are usually not inclined to seek advice from their predecessors.⁷⁴ Allen, for example, reportedly “rarely talks” with the new Delta chief executive, Leo Mullin. Even compensation consultants acknowledge that retired executives add little if any value to the firm under these arrangements. According to Frank Glassner, CEO of Compensation Design Group, most of these consulting contracts are merely a way of increasing the severance payment to the departing executive. According to another executive compensation expert, Alan Johnson, “Most former CEOs are doing very little for what they’re getting paid Usually, the demands [from new management] are miniscule.”

Like post-retirement perks, the consulting payments to retired executives never find their way into the summary compensation tables because they are provided when the executives are no longer officers. However, in contrast to post-retirement benefits, these contracts enable boards to provide retired executives with cash rather than in-kind benefits.⁷⁵ Retirement consulting fees are essentially a cash severance payment, turned over in installments, disguised as compensation for post-retirement work.

If these fees are just a form of cash severance, what is the advantage of packaging them as consulting agreements? Besides ensuring that the payments are kept out of the compensation tables, dressing them up as consulting fees obscures their nature as severance payments that essentially increase the total compensation received by executives for their pre-retirement work. Some observers might believe that the outgoing CEO will in fact provide valuable advice to new management, and therefore view the payments as legitimate consideration for post-retirement services. Needless to say, these consulting agreements do not tie the retired executive’s pay to any personal contribution to shareholder value either before or after retirement.

VI. TRANSPARENCY

A. The Critical Role of Transparency

We turn in this Section to discussing the policy implications of our study. Our study highlights the importance of making compensation arrangements in general, and compensation via retirement benefits in particular, transparent to public investors. Although we argue elsewhere for reforms that would increase

74. *Id.*

75. Of course, there are cases where even these outlays are hidden by the provision of in-kind value rather than cash. For departing CEO Hugh McColl’s continuing “advice and counsel,” Bank of America is providing him or members of his family with 150 hours of flying time on corporate aircraft. *See* Strauss, *supra* note 60. This perk has a value of \$500,000 or more.

shareholder power,⁷⁶ shareholders do already have some power. This power is in part why the outrage constraint matters. The greater outsiders' understanding of compensation arrangements, the tighter the outrage constraint. Improving the transparency of compensation arrangements is therefore desirable.

Financial economists have paid insufficient attention to transparency because they often focus on the role of disclosure in getting information incorporated into market pricing. It is widely believed that information can be reflected in stock prices as long as it is known and fully understood by even a limited number of market professionals.

In the case of executive compensation, there is already significant disclosure. As we have discussed, SEC regulations require detailed disclosure of the compensation of a company's CEO and of the four most highly compensated executives other than the CEO. In our view, however, it is important to recognize the difference between disclosure and transparency, and it is transparency that should receive more attention.

The main aim of requiring disclosure of executive compensation is not to enable accurate pricing of the firm's securities. Rather, this disclosure is primarily intended to provide some check on arrangements that are too favorable to executives. This goal is not well served by disseminating information in a way that makes the information understandable to a small number of market professionals but opaque to others.

The ability of plan designers to favor managers depends on how compensation arrangements are perceived by a wide group of investors and other outsiders. Because of market forces and social dynamics, managers and directors are concerned about disapproval (threatened or actual) from institutional investors or other reference groups, such as the business press or popular media. We have seen that compensation designers often seek to make the amount of pay, or the extent to which pay is decoupled from performance, less transparent. For disclosure to constrain compensation effectively, the disclosed information must reach more than just a select group of market professionals and arbitrageurs. Raw facts buried in a mountain of technical disclosure probably will not suffice. The salience of disclosure and degree of transparency are important.

B. Putting Retirement Benefits on the Radar Screen

Public officials and governance reformers, therefore, should work to ensure that compensation arrangements are and remain transparent. Having shown that pensions, deferred compensation, and post-retirement perks and consulting contracts have been used to camouflage a significant amount of performance-

76. See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE*, *supra* note 1, at ch. 16.

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decoupled compensation, we now put forward several proposals designed to put these forms of compensation on investors' radar screens.

As we explain in more detail below, firms should be required to report each year the (present) dollar value of the future benefits to which executives become entitled during the year in connection with SERPs, deferred compensation, and post-retirement perks and consulting arrangements. These monetary values should be included in the firm's annual summary compensation table. The SEC should also require firms to provide a separate table disclosing the present value of all the retirement benefits—SERP payments, deferred compensation balances, and post-retirement perks and consulting arrangements—to which the CEO and other high ranking executives would be entitled were they to separate at year end (under each of the various termination scenarios contemplated in their employment contracts). Before proceeding, it is worth noting that SERPs, deferred compensation, and post-retirement perks and consulting contracts are not necessarily the only forms of stealth compensation. Firms have provided—and will continue to look for ways to provide—other forms of stealth compensation. Thus, while our proposals will substantially reduce the ability of firms to provide stealth compensation, they will not eliminate it completely.

Disclosing the Full Details of Executive Compensation Contracts. Firms should be required to disclose in their annual proxy filing the full text of the most recent versions of the employment contracts that the firm has entered into with high-level executives. Firms often file such agreements with forms other than the annual proxy statement that are not as closely followed. Requiring firms to attach executive compensation contracts to their most important SEC filing, which contains the summary compensation table and other key details about compensation, will make executive compensation agreements more accessible and salient.

However, requiring firms to disclose in an accessible and salient way the text of executive compensation contracts is far from enough. While experts who take the time to do so may be able to calculate the monetary value of the various forms of stealth compensation provided in these contracts, these values are not as transparent to investors as the dollar values reported for many other forms of executive compensation. To make the information contained in these compensation contracts more transparent and accessible, firms should be required to attach monetary values to each of the types of compensation we have discussed. That is, the SEC should require firms to report compensation via retirement payments, deferred compensation, and post-retirement perks and consulting contracts in the same manner as other forms of compensation: by putting a dollar value on these amounts and including them in the compensation tables accompanying firms' proxy filings. We explain below, for each type of retirement benefit we have discussed, how this can be accomplished.

SERPs. As we explained, SERP payouts are generally based on years of service and historic compensation levels. The actuarial value of SERPs therefore usually increases each year. The annual buildup in value of an executive's SERP is not, under current rules, reported in firms' annual summary compensation tables. Nor are the payments themselves, which are made after the executive retires.

We propose requiring firms to add a column in the annual summary compensation table for SERPs. This column would indicate, for each of the firm's highest-paid executives, the amount by which the actuarial value of the executive's SERPs increases each year. Firms should also provide an accompanying explanation of the reasons for the increases in actuarial value reported in the compensation tables.

Deferred Compensation. Recall that firms currently must report in the publicly filed summary compensation tables only "above-market" returns credited to executives' deferred compensation accounts. As we explained, however, firms have been able to exploit the SEC's definition of "above-market" to provide above-market returns without disclosing them in the compensation tables. Moreover, firms have not been required to report the tax benefit to the executive—which comes at the expense of the firm—provided by deferred compensation arrangements.

We propose adding disclosure requirements that would provide outsiders with a clear and full picture of the gains to executives from deferred compensation programs. Firms should be required to disclose each year the value of an executive's deferred compensation account at the beginning of the year, the amount of earnings credited to this account by the end of the year, and the basis on which these earnings were determined. This information will enable outsiders to decide for themselves whether and to what extent executives enjoy above-market returns.

Firms should also report to investors the tax cost to the firm of covering the earnings. For example, if a firm in the 33% tax bracket credits \$600,000 to an executive's deferred compensation account, the firm should disclose not only the \$600,000 credited to the account, but also the \$300,000 in taxes that the firm must pay on the \$900,000 in pre-tax income needed to cover the \$600,000 earnings credited to the executive's account.

Finally, it is necessary to ensure that summary compensation tables include the full monetary value executives derive from deferred compensation. We propose that compensation tables include a column reporting this monetary value. In calculating this value, firms should be required to regard as "above-market" any returns exceeding the AFR—not only returns exceeding 120% of this rate. For this purpose, firms should be required to use the AFR for short-term loans in effect at the beginning of the firm's fiscal year. Furthermore, and perhaps more importantly, the monetary value included in the compensation

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tables should include any gains to the executive that come from having returns accumulate tax-free at the company's expense.

Post-retirement Perks and Consulting Contracts. Post-retirement perks and consulting contracts never appear in the summary compensation tables because the value is provided to the executive after she retires. This is the case even when such arrangements are promised in the executive's contract long before the executive retires—either when she is initially hired or later when she negotiates a new contract.

The SEC should modify the compensation tables to include a column for post-retirement perks and consulting contracts. Firms should be required to report, in this column, the actuarial present value of post-retirement perks and consulting contracts promised to executives. Critically, these amounts should be disclosed as soon as the executive is promised these payments—not when the payments are made and the executive is already out the door. Thus, for example, if an incoming CEO negotiates a package that includes the use of a corporate jet for ten years after he retires, the firm should place a dollar amount on the value of this arrangement and include that amount in the entry for non-SERP retirement payments.

Disclosing the Retirement Kitty. The proposals we have just offered would require firms to report the compensation executives receive each year in the form of buildup in pension value, earnings, and tax benefits associated with deferred compensation, and promises of post-retirement perks and consulting contracts. In addition, firms should be required to put all this information together to provide a complete picture of how much the executive would receive from the firm if she were to separate at the end of the year, under each of the termination scenarios described in her employment contract.

In particular, the SEC should require firms to publish a table showing the actuarial value of each high ranking executive's SERP at the end of the year, the balances in any deferred compensation accounts, and the value of any post-retirement perks and consulting contract to which the executive would be entitled if she were to resign, retire, or otherwise separate from the firm at year's end. This picture will better enable shareholders to form a judgment as to whether it is necessary for the firm to continue spending money to ensure that the executive has a comfortable retirement. The table will also enable shareholders to easily see whether executives will enjoy a "soft landing" even if they are pushed out for failure.

We should emphasize that a retirement-payout table is not a substitute for our proposals to expand the annual summary compensation tables to include the yearly monetary value associated with SERP buildup, deferred compensation programs, and promises of post-retirement perks and consulting contracts. These measures are necessary to make transparent to investors how much executives have been paid during the past year, as well as to help

investors estimate the relationship between annual pay and the executives' own performance. In contrast, the retirement-payout table is necessary to make transparent to investors the extent, if any, to which it would be necessary for subsequent pay packages to provide executives with additional retirement benefits.

Transparency and Improved Compensation Arrangements. The measures above would provide shareholders with a more accurate picture of total executive compensation. They will thereby reduce the total amount of compensation executives could get below the radar screen. These measures could thus help constrain total compensation levels. More importantly, these measures also would reduce the distortions that arise when companies choose particular forms of compensation for their camouflage value rather than for their efficiency. Improving transparency in this area could thus substantially increase shareholder value.

Our analysis has focused on the most important forms of stealth compensation via retirement benefits that have been used by firms to date. Of course, designers of compensation plans may find and use new ways to make compensation, or its insensitivity to performance, more opaque. As new practices (and new means of camouflage) develop, disclosure arrangements should be updated to ensure transparency. Regulators adopting the measures we propose should continue to monitor compensation arrangements and to refine disclosure requirements as new ways of making pay less salient are developed.

VII. CONCLUSION

This Article has explained how retirement benefits and payments have been used to camouflage the payment of large amounts of performance-insensitive compensation to executives of public companies. Our study has highlighted the significant role that camouflage and stealth compensation play in the design of compensation arrangements, as well as the importance of ensuring that information about compensation arrangements be communicated in a way that is transparent and accessible to outsiders.

We have also proposed several measures aimed at putting retirement benefits on investors' radar screens. Among other things, firms should make transparent, on a timely basis, both the monetary benefits to executives and the cost to firms of the various arrangements we have described. In particular, the summary compensation table firms must publicly file should include entries that indicate: (1) the amount by which the actuarial value of executives' SERP plans increases each year; (2) the monetary value executives derive that year from the firm's deferred compensation plans, including the value of a tax-free buildup at the firm's expense; and (3) the present value of post-retirement perks and consulting contracts promised to the executives during the year. Firms should also be required to include a separate table showing how much of each

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form of retirement compensation a high ranking executive would receive if she were to separate at the end of the year under each of the termination scenarios contemplated by her contract. By making it more difficult to camouflage pay through retirement benefits, the proposed requirements would contribute to improving compensation arrangements.