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Heads I Win, Tails I Win

By ROGER LOWENSTEIN

Every year, in an annual rite of spring, SBC Communications discloses the principles that it follows in setting pay for its top executives.

As with all companies, this information is contained in the annual proxy statement, and as is also common, SBC purports to follow some basic credos of American business.

A sprawling Baby Bell with headquarters in San Antonio, SBC says its aim is to attract and retain high-quality executives, those who will "enhance the profitability" of SBC. And its foremost principle in achieving this goal is to "align the financial interests of SBC's executives with those of SBC and its shareholders."

This is an all-American notion, just as SBC is an all-American company. Though not as well known as AT&T and MCI, SBC provides the dial tone in the Southwest, California, the Midwest and Connecticut -- that is, to one in three Americans. SBC is typically American in one other respect: somewhere along the way, its stated compensation principles became little more than platitudes.

For the purpose of examining a single C.E.O.'s compensation, I picked SBC for its unspectacular qualities. It is profitable and professionally managed, and its C.E.O. is well regarded in his industry. Like many C.E.O.'s, he pursued a bold growth strategy for much of the 90's, had some good early years and more recently gave back much of his gains. In the last three years, his stock has fallen 27 percent -- more than either the Standard & Poor's 500 or the stocks of his Baby Bell peers. But the rate at which the boss was compensated kept growing.

SBC's chief executive is Edward E. Whitacre Jr. A 60-year-old, 6-foot-4 lifer in the Bell system, he was hired by the old Southwestern Bell back in 1963 for a job that included hammering fences. He has been the boss since 1990 and now rakes in an annual sum that salaried executives a generation ago could scarcely dream of. Last year, the third year in a row in which SBC's share price declined, Whitacre received the largest pay package of his career -- one with a present value of $82 million.

SBC is not, by present standards, a compensation horror story. Ed Whitacre's record bears little resemblance to the catastrophes overseen by others in his industry, like the lavishly paid C.E.O.'s employed by Lucent, AT&T and WorldCom. Nor did Whitacre preside over an Enron-style scandal or pocket tens of millions before

taking his company into bankruptcy, as Linda Wachner did at Warnaco.

Whitacre exemplifies how the system itself is shot through with hypocrisy. And because his tenure is long, his collected proxies offer a view of the system's gradual corruption. Over his 12 years as C.E.O., while Whitacre reaped a fortune, his stockholders have done precisely average. Their return from appreciation and dividends is 11.5 percent a year -- a notch below the S&P 500, at 12.8 percent, and a sliver higher than its peer companies.

Executive pay has been soaring for two decades, but over the last couple of years, as many big companies have seen their stock pummeled, the pay-for-performance rationale that was supposedly driving these packages has been exposed as a fraud. Moreover, as executive pay has grown ever more dependent on share prices, the incentive to manipulate earning reports and thereby boost shares has also increased.

The superinflation of executive wages began in the 1980's. Following a dismal decade for stocks, corporate boards began focusing more on their share prices. This was largely defensive: low stock prices spawned a takeover wave. The best defense against a T. Boone Pickens or a Carl Icahn was to get your stock out of their reach.

"Promoting shareholder value" became watchwords of corporate America, as if that hadn't been the duty of management all along. Boards wanted to make executives think like entrepreneurs. The model became Silicon Valley, where companies motivated the troops by liberally dispensing options (and where many entrepreneurs became fabulously wealthy). The beauty of options, to corporate boards, is that they don't count against the income statement. They are like Monopoly money. Of course, the more you issue options, the more you dilute the value of existing shares, but in the bull market of the 1990s, this was neatly obscured.

Ed Whitacre's cash take, at first, was relatively stable -- in 1992, he got $3.1 million; two years later, $4.4 million. But as SBC grew, Whitacre was rewarded with options that gave him the chance to earn a small fortune over many years. For instance, in 1994 Whitacre received options entitling him to buy 161,739 shares, at the price prevailing in 1994, over the next decade. So if, for instance, the stock doubled, Whitacre stood to make $6.6 million; if it tripled, he would make $13 million.

That didn't completely align his interests with those of cash-paying shareholders, because Whitacre had nothing to lose if the stock went down. Also, a 10-year fixed-priced option -- the standard variety in corporate suites -- entails something of a freebie, because even if Whitacre did only a mediocre job, the stock was likely to rise somewhat. (Even a portfolio of Treasury bonds, vintage '94, would have nearly doubled.)

So Whitacre's options would reward him not just for the part of the stock's rise that reflected superior performance, but also for the part that reflected what might be termed normal business progress, or progress at the rate of risk-free Treasury bonds.

Meanwhile, in industry circles, Whitacre was winning a name as a tough and effective leader with an L.B.J.-like aptitude for cajoling regulators. He was especially renowned for his skill at lobbying to keep long-distance companies out of local services, a monopoly. He also pushed SBC into sexy new terrain, like wireless, long distance and the Internet.

Profiles described Whitacre as hard-working, not given to publicity and uninterested in corporate frills. While he maintained a ranch near Marble Falls, Whitacre wore business pinstripes to work, not cowboy boots.

He also developed a strong interest in stock options. In 1994, SBC's stock price was virtually flat. But the following year, Whitacre got a fresh -- and substantially larger -- batch of options. Though the shareholders received a poor return, Whitacre was granted a fresh start.

Now that he was getting huge annual grants, the arithmetic subtly changed. To become rich, Whitacre merely had to raise the stock above its level of any particular year. Since stocks fluctuate, some of his grants would tend to be at depressed prices, meaning that his "option" to get wealthy became a virtual certainty. The frequency of the awards thus undermined the principle of pay for sustained long-term performance. By turns, a system designed to motivate became one to simply enrich.

In 1995, SBC shares rose sharply; in 1996, they fell. And in the following year, Whitacre got what was then his biggest option grant ever, 345,000 shares. Those 1997 options didn't merely give Whitacre a fresh start; they handed him a golden carrot for getting the stock back to where it had been. They were paying him for treading water.

The other way his pay changed was that his board began to grant significant compensation aside from options. In 1995, Whitacre got $4.9 million. In 1996, an off year for SBC, he got $6.6 million. In 1997, the total rocketed to $15.7 million. Including options, the total for that year was $21 million. These sums were distributed over seven different categories: salary, bonus, "other," restricted stock, options, long-term incentive plan and "all other." This seven-pocket approach served two purposes. First, the dollars that Whitacre received in any one category were only a fraction of the total, minimizing the appearance. Secondly, the board determined the total for each category by different yardsticks, as if each were independent of the other. He would get millions out of one pocket for overall leadership, millions out of another for directing some special event like a merger and still more to "retain" his future services.

In 1997, for instance, Whitacre got $8.7 million as a "special retention grant." The most curious aspect of that award was that in 1998 Whitacre received another retention grant, this time of $12.5 million. He has received comparable awards in every year since, as if he were somehow both an indispensable captain and a notorious flight risk.

Whitacre also benefited from a permissive redundancy. Every year, he got a

"long-term incentive" -- in 1997 it was $2.2 million -- rewarding him for the rise in the stock over a three-year stretch. This just duplicated the effect of his options.

In 1997 as well, the board awarded Whitacre a $3.3 million "bonus," largely for his "excellent leadership" in fashioning a merger with Pacific Telesis Group. This mimicked a national trend of awarding bonus pay for work once considered to be part of the job. After all, if the Telesis merger turned out to be a success, Whitacre would presumably benefit via his stock options. And if the merger was too new to bear fruit for stockholders, why was the board rewarding Whitacre ahead of the people whose returns his were supposed to reflect?

His total package, including the present value of options, soared to $29 million in 1998 and $25 million the following year. But in 2000, the board was forced to admit that various officers, including Whitacre, had failed to meet their yearly targets. Accordingly, his bonus was cut by 25 percent to a mere $4.5 million.

Nonetheless, Whitacre got a 32 percent hike in salary. The multipocket approach, a staple of the consultants who design packages for SBC and most other big corporations, thus put the lie to the appearance of risk; if Whitacre was punished from one pocket, he was promptly redeemed from another. Indeed, the board doubled his options award, raising the total compensation for 2000 to a present value of $29 million. The total kept on rising.

Increasingly, the board's human resources committee, which deals with compensation, cited metrics related to SBC's size or general reputation but not necessarily to its profitability or long-term stockholder returns. Though SBC's returns had outpaced those of other Baby Bells in Whitacre's early years, in the last five years they were 20 percentage points lower. And that is the period when Whitacre has gotten the bulk of his pay. Boards typically take longevity into account, and SBC is no exception-almost as if the board felt it had to make up for some suddenly felt neglect when Whitacre was just cutting his teeth.

In any case, the proxy has found plenty on which to commend the C.E.O. -- for "transforming SBC from a regional carrier to a national and global competitor," for meeting "extraordinary challenges," for becoming "one of the leading chief executive officers in the United States."

The directors, who earn $60,000 a year, no doubt believe this; they have been close to Whitacre and have been endorsing his pay for a long time. He has also been endorsing theirs. Two of SBC's nominally independent directors -- August A. Busch III, chairman of Anheuser-Busch, and Charles Knight of Emerson Electric -- run companies for which Whitacre is a director. Most of the other 18 directors have either served with Whitacre for at least 10 years or were directors of companies that Whitacre acquired.

Certainly there was much to admire in Whitacre's bold management. With the world of telecommunications rocked by technological change and regulatory upheaval, Whitacre reckoned that to sit still was to invite slow decimation. He followed the Telesis merger by acquiring Southern New England Telecommunications

Corporation in 1998 and Ameritech, a giant rival, in 1999 -- a blockbuster $62 billion combination.

It is not clear that the merger strategy was wrong or that a better strategy was at hand. But the telecom industry was increasingly unattractive. Technology was reducing the cost of service, and rivals were snapping up slices of SBC's former monopoly. While SBC's revenues grew to $40 billion, the empire ranging from Capetown to Hartford with nearly 200,000 employees, most of its cash flow was being consumed by reinvestment, and its growth was starting to sputter.

For the last four years, SBC's net income growth has been anemic. On closer examination, the picture was worse. Corporations with overfunded pension plans are allowed to book some of the excess as profit, even though the money never reaches the shareholders. In the late 1990's, as the stock market boomed, SBC's plan, like many, became overfunded, allowing SBC to pad its net income. In 2000, this contributed $1.1 billion, 14 percent of its total. Then, in 2001, SBC's green eyeshades raised the rate at which they assumed that the pension plan would appreciate in the future -- by a full percentage point. Since the market was then in meltdown, this was a curious decision. In fact, according to a study of 50 big pension plans by Milliman USA, SBC raised its rate by more than any other company (most didn't raise it at all). In real dollars, SBC's plan lost money last year. But since its assumed rate of appreciation was higher, so was the contribution to income. Last year it equaled $1.45 billion -- 20 percent of SBC's so-called bottom line. In setting pay levels, SBC says the board distinguished between telephone revenue and pension plans. The stock market presumably did not.

SBC's proxies have repeatedly cited 1996, the year of the Telecommunications Act, as the start of Whitacre's transformation. In 1996, SBC earned $1.73 a share (split-adjusted). Even if you accept SBC's reported profit for 2001 at face value, its per-share earnings, adjusting for a stock split, have grown by only 4 percent per annum over that entire span.

So how did SBC's board justify an $82 million package for 2001? The proxy cited Whitacre's "solid financial results," as well as SBC's strong balance sheet, the "extraordinarily challenging" market conditions and Whitacre's status as a "leading" C.E.O., deserving of a salary and bonus in the 75th percentile of his peers.

There is nothing unusual in this. Most companies justify their pay levels according to peer groups; all believe their own C.E.O. deserves to be in the upper echelon; and each thus helps to ratchet up the scale for all. Until recently, Verizon, a rival Baby Bell, had two C.E.O.'s, each of whom received $14 million last year in addition to at least $14 million apiece in options value. Whether SBC or Verizon got more for the C.E.O. buck becomes a senseless debate; indeed, at such levels, all attempts to rationalize pay become meaningless.

After reporting this article from public filings, I called SBC for comment. Jim Ellis, the general counsel, took strong exception to the idea that his boss is overpaid. "If he's a poster boy, it isn't for abusing the system or being off the reservation," Ellis

maintained. SBC's performance, he said, ranked in the top third of a group of 20 companies examined by the board, yet his pay was less than the median of that group. Ellis added that Whitacre "has done exceedingly well in positioning the company not just for growth periods but for down periods."

The C.E.O.'s most recent package included a Bunyan-size options grant of 3.6 million shares. That was partly "to assure his continued presence," Ellis said. The present value of these options, according to the compensation consultant Pearl Meyer & Partners, is $61 million. In effect, the board turned the stock's decline to Whitacre's advantage, since it chose a time when the stock was down (and options were cheap) to give him four times as many shares as when the stock was at its peak. Of course, Whitacre will have to turn the stock around to cash in on the award. But if he does, he will reap an immense fortune -- tens of millions of dollars -- merely for recapturing the ground that his shareholders had already lost.

Roger Lowenstein, the author of "When Genius Failed," writes frequently for the magazine and is working on a book about the dot-com bubble.

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