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PAGE ONE

Hidden Burden As Workers' Pensions Wither, Those for Executives Flourish

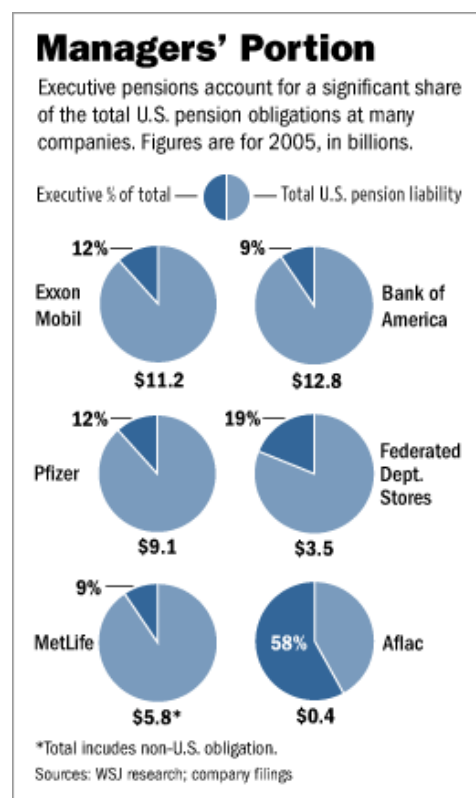
Companies Run Up Big IOUs,
Mostly Obscured, to Grant
Bosses a Lucrative Benefit

The Billion-Dollar Liability

By ELLEN E. SCHULTZ and THEO FRANCIS
 June 23, 2006; Page A1

To help explain its deep slump, **General Motors Corp.** often cites "legacy costs," including pensions for its giant U.S. work force. In its latest annual report, GM wrote: "Our extensive pension and [post-employment] obligations to retirees are a competitive disadvantage for us." Early this year, GM announced it was ending pensions for 42,000 workers.

But there's a twist to the auto maker's pension situation: The pension plans for its rank-and-file U.S. workers are overstuffed with cash, containing about \$9 billion more than is needed to meet their obligations for years to come.



Another of GM's pension programs, however, saddles the company with a liability of \$1.4 billion. These pensions are for its executives.

This is the pension squeeze companies aren't talking about: Even as many reduce, freeze or eliminate pensions for workers -- complaining of the costs -- their executives are building up ever-bigger pensions, causing the companies' financial obligations for them to balloon.


Companies disclose little about any of this. But a Wall Street Journal analysis of corporate filings reveals that executive benefits are playing a large and hidden role in the declining health of America's pensions. Among the findings:

- Boosted by surging pay and rich formulas, executive pension obligations exceed \$1 billion at some companies. Besides GM, they include **General Electric Co.** (a \$3.5 billion liability); **AT&T Inc.** (\$1.8 billion); **Exxon Mobil Corp.** and **International Business Machines Corp.** (about \$1.3 billion each); and **Bank of America Corp.** and **Pfizer Inc.** (about \$1.1 billion apiece).
- Benefits for executives now account for a significant share of pension obligations in the U.S., an average of 8% at the companies above. Sometimes a company's obligation for a single executive's pension approaches \$100 million.

• These liabilities are largely hidden, because corporations don't distinguish them from overall pension obligations in their federal financial filings.

• As a result, the savings that companies make by curtailing pensions for regular retirees -- which have totaled billions of dollars in recent years -- can mask a rising cost of benefits for executives.

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- Executive pensions, even when they won't be paid till years from now, drag down earnings today. And they do so in a way that's disproportionate to their size, because they aren't funded with dedicated assets.

One reason executive pensions have grown so large is that they are linked to ballooning overall executive compensation. Companies often design retirement payouts to replace a percentage of what a person earns while active.

WALL STREET JOURNAL VIDEO



1

WSJ's Alan Murray discusses² executive pensions and whether working stiff's are picking up the tab for posh executive retirement benefits.

But for executives, the percentage of pay replaced is itself higher. Compensation committees often aim for a pension that replaces 60% to 100% of a top executive's compensation. It's 20% to 35% for lower-level employees.

David Dorman was chief executive of AT&T Corp. from 2002 until its merger with SBC Communications in November. He left in January. His total of five years at AT&T earned him a yearly pension of \$2.1 million. That will replace 60% of his annual salary and bonus in his final three years.

By contrast, former AT&T accountant Ralph Colotti's \$28,800 annual pension replaces 33% of his final pay. He was at the company for 33 years.

Mr. Colotti's pension was held down by a change AT&T made in 1998 in the formula used to calculate pensions. The switch had the effect of freezing pension growth for older workers like him. The 55-year-old now works at another company with a pension plan. "Working here another 10 years won't make up for what my old pension would have been" without AT&T's change in formula, he said.

AT&T described its retirement benefits as excellent and said a pension on the scale of Mr. Colotti's is good in the telecommunications industry. Mr. Dorman's richer deal is "reasonable, customary and comparable to what similarly sized companies offer," AT&T said. A spokeswoman noted that "in any industry, senior executives are almost always provided with enhanced levels of benefits as a way to recruit and retain the best talent and the best leadership possible to lead the company."

In percentage of pay replaced, Pfizer's chairman and CEO, Henry McKinnell, does best of all. His future \$6.5 million-a-year pension will replace 100% of his current salary and bonus.

Cutting Back

Even as executives' pensions grow, many companies are curtailing those for the rank and file. In one move, hundreds of employers, including **Boeing Co.**, **Xerox Corp.** and **Electronic Data Systems Corp.**, have switched to pension formulas known as "cash balance" plans. One effect is to slow the growth of older workers' pensions or halt it altogether. That's what happened to Mr. Colotti at AT&T.

Other companies, including **Verizon Communications Inc.**, **Unisys Corp.** and **Sears Holdings Corp.**, are freezing their pension plans for some workers. A freeze leaves intact pensions already earned but prevents any further growth during a worker's career.

Some employers have added pensions for executives at about the same time as they limited those for others. **McKesson Corp.** established a special pension plan for its executives in 1995 and froze those of other workers two years later. McKesson didn't respond to requests for comment.

Allied Waste Industries Inc. froze pensions for certain salaried workers in 1999. Among those affected was Brad Green, then a safety official at a business Allied Waste had acquired. Although he never expected his pension to be big, said Mr. Green, 45, the freeze meant any future growth "was basically just wiped out with the stroke of a pen."

Four years later, Allied adopted a pension plan that covers 10 executives. It did so "to provide a competitive recruitment and retention benefit," said Allied's treasurer, Michael Burnett. He noted that the plan that was frozen had come from a company Allied acquired.

Mr. Burnett added that all employees have a 401(k), a savings plan to which they can contribute from their own earnings. Many companies, including Allied, match part of employee contributions.

Companies that restrict regular pension plans often point to the 401(k), some noting that they've enhanced their match of contributions. Unlike pension plans, 401(k) plans don't create a corporate debt or liability, since employees provide most of the assets and firms are typically free to halt any contributions of their own.

Companies generally are also free to alter, freeze or end regular employees' pension plans, unless a union contract is involved. But executive pensions often are protected from management interference by employment or other contracts.

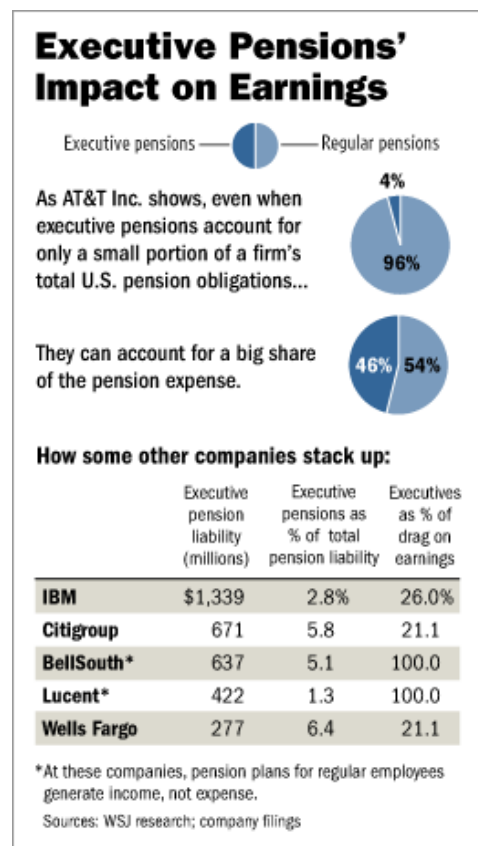
By curtailing pensions for regular workers, large companies have reduced pension obligations to them by billions of dollars in recent years. So pension obligations to regular workers are stable or shrinking at many companies while those for executives rise. At **BellSouth Corp.**, for example, the obligations for pensions for ordinary workers have edged down 3% since 2000. The liability for pensions for executives is up 89% over the same period. A BellSouth spokesman noted that, like many executive pensions, the benefit could be lost in the event the company becomes insolvent.

The promise of any pension becomes a corporate obligation. Although the payments are in the future, the promise means the company has a liability now. And a number can be put on it.

Figuring the Bill

Pfizer's promise to pay Mr. McKinnell \$6.5 million a year for life in retirement equals an \$83 million liability for Pfizer today, federal filings by the drug maker show. Pfizer defends Mr. McKinnell's pension as fair.

When Edward Whitacre, chairman and CEO of AT&T Inc., turns 65 in November, he'll be entitled to a pension of \$5.4 million a year for life, plus an \$18.8 million lump sum. For this, AT&T's liability today is \$84.4 million, according to an actuarial estimate done for the Journal by Katt & Co. of Mattawan, Mich. AT&T said Mr. Whitacre's pension reflects four decades of service and 15 years of "very, very strong and visionary management" as chief of the company, which was called SBC much of that time.



UnitedHealth Group Inc. Chairman and CEO William McGuire will get a \$5.1 million annual pension after he retires, plus a further \$6.4 million at retirement. The result is a UnitedHealth liability of about \$90 million, according to two actuaries. UnitedHealth declined to comment on their estimate. In the wake of recent criticism of Dr. McGuire's pay -- which includes \$1.6 billion in unrealized stock-option gains as of the end of last year -- the managed-care company has capped his pension benefit, a spokeswoman said.

Pension Pyramid

Companies sometimes offer several tiers of pensions for the highly paid. The structure at IBM illustrates this.

Its chairman and CEO, Samuel Palmisano, is due a yearly pension of about \$4.7 million in retirement after age 60. He's now 54. IBM's liability today for this is about \$50.3 million, according to an estimate by Katt & Co.

Another IBM pension plan, which last year covered eligible executives earning \$351,000 or more, had a \$204 million liability at year-end, company filings show. And for a third plan covering a broader group of the well-paid, IBM had obligations totaling \$1.1 billion. IBM declined to say how many are covered by these plans, saying only that it is "thousands."

To put the figures in perspective: The liability for IBM's regular U.S. pension plan, covering 254,000 workers and retirees, was \$46.4 billion at the end of

2005.

An IBM spokesman described the estimate of its liability for Mr. Palmisano's pension as high but declined to provide another figure. He said Mr. Palmisano's pension from 32 years at the company will replace about 45% of his

compensation, which the spokesman called below average for heads of major companies.

MORE ON EXECUTIVE PAY

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A result of these trends is that executive pensions make up a significant portion of total pension liabilities at many companies: 12% at Exxon Mobil and Pfizer; 9% at **Metlife Inc.** and Bank of America; 19% at **Federated Department Stores Inc.**; 58% at insurer **Aflac Inc.**

At some companies, the only people who have pensions at all are executives. At **Nordstrom Inc.**, the nearly 30,000 ordinary employees don't get pensions. But 45 executives do. Another retailer, **Dillard's Inc.**, also provides pensions only to certain officers. Neither had any comment.

Companies' retirement liabilities for their executives have also grown through another little-noticed trend: Over recent years, an increasing portion of executives' pay has been postponed, via pension and deferred-compensation plans, rather than given in current paychecks. ([See adjoining article](#)⁴.)

Out of Sight

Even if a company's liability for executives' pensions totals hundreds of millions of dollars, its employees and shareholders may never know. Companies don't have to report this obligation separately in federal financial filings. A few specify it in a footnote, and some provide clues that make it possible to derive the figure.

The minimal disclosure dates from the late 1980s, when companies first were required to report pension liabilities but were allowed to aggregate all of them. At the time, distinguishing executive pensions was less of an issue because they were smaller. When they ballooned along with executive pay in the 1990s and 2000s, the rules didn't change. Most employers have continued to blend pension figures together. Wall Street Journal publisher **Dow Jones & Co.** said it hasn't broken out executive-pension figures but will "re-examine whether to do so going forward."

When they do mention executive pensions in filings, companies often use terms that only pension-industry insiders would recognize. **Time Warner Inc.**'s filings include -- as part of a category called "other, primarily general and administrative obligations" -- a footnote reference to "unfunded defined benefit pension plans." Those are executive pensions.

Lumping pensions together can also give a false impression of the security of ordinary workers' plan. Someone browsing Time Warner's filings might think its pensions for regular employees were underfunded by 7%. This impression would be illusory. The pension plan for regular Time Warner employees has more assets set aside in it than the plan needs to pay benefits well into the future. The shortfall is due entirely to a plan for highly paid employees. That one has a \$305 million unfunded liability.

A spokeswoman for Time Warner said the company's elite pensions cover more than just a small number of top executives but declined to say how many. She said Time Warner goes "to great lengths to make complex information accessible to the average investor."

A Debt and Its Cost

Perhaps the most significant effect of the limited disclosure is to make it difficult, or impossible, to evaluate company statements about their retirement burdens and the need to cut benefits. To see this, it's necessary to understand a bit about how pensions are accounted for.

Pension plans, whether for executives or for others, are obligations to pay. In other words, they're debts. And like any debt, they have what amounts to a carrying cost. That carrying cost is part of a company's pension expense.

In the case of pensions for regular employees, the expense is partly or wholly offset by investment returns on money the company set aside in the pension plan when it "funded" it.

Executive pension plans are different. They're normally left unfunded. They have no assets set aside in them. That means there is no investment income to blunt the expense. The result is that obligations for executive pensions create far more expense for an employer, dollar-for-dollar, than pensions for regular workers.

A company's pension expense is something it has to subtract from its earnings each quarter. The cost of executive pensions, having no investment income to cushion it, hits the bottom line with full force.

An Outsize Impact

In Pfizer's overall U.S. pension obligation of about \$9 billion, executive pensions account for about one dollar in eight. Yet the pension expense they generate is proportionately far larger -- equal to more than half as much as that from pensions for regular employees and retirees, who are much more numerous. The executive plans cover 4,200 people. The regular plans cover more than 100,000. Pfizer had no comment on this.

At AT&T Inc., the pension liability for executives was a modest 3.8% of the company's total pension obligation at the end of last year. Yet these promises to 1,000 or so highly paid people generated more than 45% of AT&T's pension expense. The expense for them came to \$113 million last year, and reduced AT&T's 2005 earnings by that amount.

The other 55% of pension expense? It covered 189,000 regular employees.

AT&T's controller, John Stephens, confirmed that executive pensions cause a bigger drag on earnings, per dollar of liability, than pensions for others. He added that AT&T, like some other companies, has informally earmarked an undisclosed amount of assets for paying executive pensions in the future. But while these assets earn investment returns, they don't lower pension expense, because the assets aren't irrevocably dedicated to this purpose. The executive pension plan, in other words, isn't funded.

Why don't companies just fund executive pensions? Chalk it up to taxes. Contributions that companies make to regular pension plans are tax-deductible and grow tax-free. Congress set that rule to encourage employers to provide pensions for the rank and file. But a company that contributes assets to an executive pension plan gets no tax break. In fact, there's a tax penalty: Money contributed to such a plan is considered current compensation to the executives, and they owe personal taxes for it.

There's often another reason executive pensions are more costly. The expense of regular pensions can be offset not just by investment returns on the assets but also by gains that result when companies cut benefits.

Cutting a benefit naturally cancels part of an employer's liability. Under accounting rules, a canceled liability equates to a gain. That gain reduces pension expense from the regular workers' plan. So thanks both to investment returns and to gains from cutting benefits, regular pension plans are less costly than those for executives.

Whose Expense?

These accounting effects may sound technical but they matter, because companies that curtail ordinary workers' benefits often cite their pension "costs" or "expense" as the reason.

In January, IBM said it will freeze the pensions of all U.S. employees and executives. The move reduced its pension liability by \$775 million. IBM cited pension costs, volatility, and unpredictability. It didn't mention that a quarter of its U.S. pension expense last year resulted from pensions for several thousand of its highest-paid people.

The numbers: \$134 million of pension expense was for the well-paid; \$381 million was for all active and retired employees, more than a quarter of a million people. An IBM spokesman confirmed the numbers but said the expense for its executive plans came to only about 1% of pretax earnings from continuing operations.

Lucent Technologies Inc. has pointed to retiree benefits as a burden and has cut benefits in a number of ways. For instance, for various retirees in recent years, Lucent has used a less-generous pension formula; eliminated dental and spousal medical coverage and death benefits; and raised retiree health-insurance premiums. In a recent filing, the Murray Hill, N.J., telecom-equipment firm said, "Lucent's pension and postretirement benefits plans are large...and also costly."

Yet the pension plans for regular Lucent employees and retirees, who number about 230,000, are overfunded. In fact, they're so full of cash that the investment return on their assets not only erases the pension plan's expense -- it adds to earnings. In the fiscal year ended last Sept. 30, these pension-plan assets pumped \$973 million into Lucent's bottom line, accounting for about 82% of the company's profit.

They would have pumped in still more, save for an unfunded pension plan for Lucent's highest-paid people, which had a liability of approximately \$422 million last year. Lucent confirmed that pensions for its executives and those earning more than \$210,000 in 2005 reduced net income. It declined to say by how much. A spokeswoman said Lucent follows U.S. pension accounting and disclosure rules and that if the expense for retiree medical plans were subtracted, its overall retirement benefits contributed \$718 million to income.

GM's Retirees

When General Motors cites retiree costs, the giant auto maker has a point: It owed nearly 700,000 U.S. workers and retirees pensions that totaled \$87.8 billion at the end of last year.

But \$95.3 billion had already been set aside to pay those benefits when due.

All of these assets are earning investment returns, which offset the pensions' expense. GM lost \$10.6 billion in 2005. But deep as its losses have been, they would have been far worse without the more than \$10 billion per year in investment income that the GM pension plan for the rank and file generates.

The pension plan for GM executives is another matter. Unfunded to the tune of \$1.4 billion, it detracts from GM's bottom line each year.

Just how much is a mystery, because GM doesn't break out the figure. It said executive pensions are "a very small portion of our overall expense" but declined to give the figure.

Earlier this year, GM announced it would freeze the pensions of its 42,000 salaried workers starting next January, as well as of those 5,200 highly paid employees. The freeze of the executive pensions will cut GM's pension liability by \$60 million, while its freeze of salaried workers will yield a far bigger reduction, \$1.6 billion.

A spokeswoman for GM said its concerns about its pension plans have eased, though the company remains concerned about retiree health-care costs. With the pension freeze and improved returns on its pension assets, including billions of dollars GM has contributed to the plans in recent years, "I would say pension really is not a problem any more," the spokeswoman said. She said that GM has no fixed obligation to pay the executive benefits and could renege at any time, although she called such a move unlikely.

GM has often said its U.S. pension plans added about \$800 to the cost of each car made in the U.S. in 2004. It declines to say how much was due to executive pensions.

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