Crime pays: CEOs rake it in as stocks and jobs evaporate

By Jeremy Johnson
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New charges of fraud against the ex-CEO of Tyco International, Dennis Kozlowski, have revealed a level of decadence amongst today's ruling circles that would put the court of France's King Louis XIV to shame. According to a report commissioned by current Tyco management and released last month, personal items that Kozlowski billed to the company included a $2,200 wastebasket, $5,960 for two sets of sheets, a $6,000 gold and burgundy shower curtain, a $6,300 sewing basket, a $15,000 poodle-shaped umbrella stand, a $17,100 traveling toilet box, all the way down to a $445 pincushion.

These incidentals were part of the $11 million worth of furnishings for his Fifth Avenue apartment in New York City, which he bought for $16.8 million (plus $3 million in renovations) with money borrowed from Tyco, most of which he never paid back. Earlier loans, also forgiven, paid for his $29.8 million Boca Raton, Florida mansion and for a $7 million New York City co-op apartment for his ex-wife as part of a divorce settlement. The report alleges that, in total, Kozlowski improperly authorized the company to lend him $61.7 million for real estate and other purchases.

Kozlowski shared the loot among his top lieutenants. Former chief financial officer Mark Swartz was able to "borrow" $33.1 million; and former general counsel Mark Belnick, $14.6 million. Bonuses to offset loans were then granted to 51 Tyco executives totaling $96 million—$56 million to pay off the loans, and $40 million more to pay the taxes on the bonuses.

Many of the loans were entered on the company's books as relocation assistance, even though some of the recipients never moved. Belnick spent most of his money on a $10 million vacation home in Utah.

Among other items Kozlowski passed off as a business expense was half the cost of a $2.1 million fortieth birthday party for his second wife on the Mediterranean island of Sardinia.

The revelations from Tyco's internal investigation follow on the heels of a New York grand jury handing down new criminal indictments against Kozlowski and Swartz on September 12. The indictments charge the two with "enterprise corruption" that netted them $600 million since 1995 through stock fraud, unauthorized bonuses and false expense accounts. Besides $170 million in outright theft, the two men are alleged to have made $430 million more by selling company stock after using accounting gimmickry to inflate the price, which has since plummeted by 70 percent.

In the wake of scandals at Enron, Worldcom and Global Crossing, in which tens of thousands of workers have lost their jobs and many more their life savings, government prosecutors are making an example of Kozlowski's particularly flagrant abuse in an attempt to restore confidence in corporate America. Rampant corruption and greed, however, are not merely the result of a few bad apples, but endemic to the capitalist system in its current state of decay.

According to the annual *BusinessWeek* survey of executive pay, first at the corporate trough during 2001 was Lawrence Ellison of the high-tech firm Oracle Corporation. While receiving neither salary nor bonuses, he cashed in stock options worth $706 million in January 2001, just before Oracle stock took a dive.

Eight other executives earned over $100 million in 2001, while another 16 received over $50 million. Sixth on the list at $127 million was Louis Gerstner of IBM Corp, who exercised $115 million in stock options. The price of IBM stock has dropped 50 percent so far in 2002.

The IBM CEO retired in March with a multimillion-dollar regular pension, a $2 million annual "Supplemental Executive" pension, a $2 million annual consulting contract, plus 10 years' entitlement to use IBM aircraft, cars, offices, a luxury apartment and financial planning and home security services. In addition, he retains unexercised stock options valued at $382 million as of earlier this year.

Gerstner's retirement package stands in stark contrast with the treatment he meted out to IBM's regular employees in 1999, when he introduced a defined contribution pension plan to replace the defined benefit plan, saving the company an estimated $200 million a year at its workers' expense.

In a study released in August entitled "Executive Excess 2002: CEOs Cook the Books, Skewer the Rest of Us", [www.ufenet.org/press/2002/EE2002_pr.html] the Institute for Policy Studies and United for a Fair Economy examine CEO compensation at 23 major companies that are under investigation by the Securities and Exchange Commission, the US Justice Department or other authorities. These include such well-known corporate names as AOL Time Warner, Bristol-Myers Squibb, Kmart, Lucent Technologies and Xerox.

The researchers found that the 23 companies' CEOs were paid a combined total of over $1.4 billion from 1999 through 2001, or an average of $62.2 million apiece over the three years. By comparison, CEOs at the top 500 US corporations earned an average of $36.5 million over the same period. At least for corporate executives, it seems, crime pays.

While the CEOs at the 23 companies were raking it in, since January 2001 their shareholders have lost $530 billion in stock value—more than 73 percent—and 162,000 of their workers have lost their jobs.

Besides the most highly publicized case of Kozlowski, who took in $331.8 million in on-the-books compensation in the last three years, and Enron's Kenneth Lay, who collected $250.8 million, the report cites Joseph Naccio for being paid $266.3 million as CEO of Qwest Communications, which is now undergoing four separate investigations for illegally inflating reported revenue. Gerald Levin of AOL Time Warner, another company charged with manipulating revenue figures, earned $178.4 million over three years.

In 2001 the average CEO received 411 times the wages of the average worker, or ten times the 42 to 1 ratio that prevailed 20 years ago. If production workers' wages had risen at the same rate as CEO pay in that period, their average annual earnings would be $101,156, and the minimum wage would be $21.41 per hour.

These numbers are actually down from last year's report, due to the decline in average CEO compensation from $13 million in 2000 to $11

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million in 2001. However, another report, by the compensation consulting firm Pearl Meyer & Partners, shows that the median pay—the level at which 50 percent receive more money and 50 percent receive less, and which is generally considered a more meaningful statistic—for top CEOs increased 7 percent in 2001. Thus, the general trend in executive pay continues upward in spite of the slumping economy.

Both reports point to the explosion in the use of stock options as the primary vehicle to boost executive pay levels. In 1992, long-term incentives—stock options primarily—accounted for 27 percent of median CEO compensation, while by 2000 they had ballooned to 60 percent of pay.

An option represents a commitment to sell a share of stock at a fixed price—usually the market price on the day the option is granted—at some time in the future. If the stock price rises, the option holder can buy the stock at the pre-agreed price, then turn around and sell it, pocketing the difference. The market bubble of the 1990s made executives holding options fabulously wealthy.

The abundant use of stock options and outright grants was justified in the name of aligning the interests of management with the shareholders. As the rising number of corporate scandals has shown, the exact opposite turned out to be the case. Huge stock holdings gave insiders the incentive to manipulate the share price in ways both legal and illegal in order to cash out at the inflated price, leaving ordinary investors—not to mention workers and retirees—holding the bag when the bubble burst.

Larry Ellison of Oracle sold 29 million shares at the end of January 2001, only five weeks after issuing an optimistic earnings forecast, in spite of the high-tech downturn already under way. The impact of flooding the market with such a large sale in itself started a downward trend in the price, which then dropped 21 percent in one day five weeks later when the company acknowledged that profits would be down after all.

In spite of the billions of dollars doled out through stock options, none of the money spent showed up on company books as an expense, in accordance with Generally Accepted Accounting Principles (GAAP), which are used for preparing financial statements for the public. However, the use of different rules for tax accounting allow corporations to take a deduction for the difference between the option price and the market price at the time the option is exercised. Estimates are that these deductions cost the government $28 billion in 1998, $42 billion in 1999, and $56 billion in 2000. These tax deductions gave companies further incentives to hand out stock options.

Tax benefits also accrue to the executive receiving the options. If the stock acquired when the option is exercised is held for at least a year, the entire profit is taxed at the capital gains rate of 20 percent, rather than at the top rate for ordinary income of 38.6 percent.

While the drop in the stock market has reduced or even wiped out the value of options previously granted, many companies are making up the difference by making even larger grants. CEO John Chambers of Cisco Systems, whose stock fell 72 percent in a year, reduced his base salary to $1 for 2001 in exchange for an award of 6,000,000 options, an increase over the 4,000,000 he was awarded in 2000. The estimated value of his overall pay package increased by 32 percent at a time when his company posted a billion-dollar loss.

Another technique used by companies to cushion their executives from the impact of falling share prices is to go back and re-price options retroactively at a low enough level to put the executive back "in the money."

According to the Pearl Meyer study, the use of stock options and grants reached record levels in 2001. Among the top 200 US corporations, 16.3 percent of total shares outstanding are the product of such employee compensation programs. Over half of the companies made mega grants to their CEOs, averaging 1.4 million shares each.

The leading business magazine *Fortune* recently surveyed 1,035 large companies whose market value has dropped at least 75 percent, finding that insiders have cashed out to the tune of $66 billion since January 1999. As the authors of the survey put it, "The not-so-secret dirty secret of the crash is that even as investors were losing 70 percent, 90 percent, even in some cases all of their holdings, top officials of many of the companies that have crashed the hardest were getting immensely, extraordinarily, obscenely wealthy."

The increasing public attention focused on this appalling waste of social resources—amid the slashing of needed funds for jobs, housing, education and medical care—has led to expressions of concern from within the business community itself. In a speech on the occasion of the September 11 anniversary, the president of the Federal Reserve Bank of New York William McDonough called for corporate boards of directors to reduce today's "excessive" executive pay to unspecified "reasonable and justifiable levels."

A few days later, a "blue-ribbon" panel of business leaders called the "The Conference Board Commission on Public Trust and Private Enterprise," which includes former US Federal Reserve Chairman Paul Volcker and former SEC chairman Arthur Levitt Jr., released a report (with one dissent) calling for companies to expense stock options, along with other reforms.

Both McDonough and the Conference Board urged corporations to carry out reforms voluntarily, and discouraged further legislative action. The true purpose of this hand-wringing over corporate governance is to attempt to defuse public anger at big business in the face of what the board's report called "an unprecedented loss of confidence in the stock market and in corporate America."

Such calls for reform ignore the fact that the subordination of production to the extraction of private profit by a wealthy elite is the essence of capitalism. It is a symptom of this system's crisis—not its cause—that fraud and criminality have become standard business procedures.

The fate of earlier reform proposals is instructive. A measure passed in the early years of the Clinton administration took away the tax deduction for any "non-incentive based" pay over $1,000,000. In fact, this so-called reform only contributed to the upward pay spiral, as corporations shifted compensation away from base salary to bonuses and, even more, stock options, both of which are considered "incentive based," and therefore not subject to any limit on deductibility.

Similarly, the highly touted corporate reform bill passed by Congress this July does not even address executive pay, only putting limits on corporate lending to top executives.

One reporter expressed a justified cynicism by citing a 1991 recession-year headline in the *Wall Street Journal*, reading: "Firms Rethink Lucrative Severance Pacts for Top Executives as Criticism Mounts." Severance packages, along with other forms of wealth transfer, became richer and richer over the subsequent decade.

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