

## *PAY WITHOUT PERFORMANCE*



**COMPENSATION PACKAGES WHICH ARE INAPPROPRIATELY DESIGNED SUGGEST A FAILURE IN THE BOARDROOM, SINCE A PRIMARY RESPONSIBILITY OF THE BOARD OF DIRECTORS, PARTICULARLY THE COMPENSATION COMMITTEE, IS TO ENSURE THAT EXECUTIVE COMPENSATION PROGRAMS ARE EFFECTIVELY DESIGNED AND LINKED TO A COMPANY'S PERFORMANCE.**

**CURRENT COMPENSATION ARRANGEMENTS CAN DILUTE EXECUTIVES' INCENTIVES TO SERVE SHAREOWNER INTERESTS AND CAN CREATE PERVERSE INCENTIVES TO DESTROY, RATHER THAN CREATE, LONG-TERM VALUE. IF SHAREOWNERS CAN REDUCE OUTSIZED COMPENSATION LEVELS WHILE AT THE SAME TIME IMPROVE THE ALIGNMENT OF LONG-TERM INCENTIVES, THE EFFECT ON FIRM VALUE CAN BE MATERIAL.**

At the beginning of the 2006 proxy season, The Corporate Library (TCL) released an analysis of U.S. companies identifying those with the worst relationship between compensation levels and the company's performance. This section of the governance report summarizes the TCL study and adds SBA voting and other related information. TCL notes these companies paid their top executives some of the highest salaries while long-term shareholder value substantially decreased. TCL screened companies in the S&P 500 index that had: 1) TCL *Board Effectiveness* ratings of 'D' or 'F'; 2) negative five-year total stockholder return (TSR); 3) CEO total compensation for the last two reported fiscal years was greater than \$15 million; 4) underperformed their industry peer group; and 5) high revenues placing them in the Fortune 250.

**"PAY FOR FAILURE" COMPANIES**

- AT&T
- BellSouth
- Hewlett-Packard
- Home Depot
- Lucent Technologies
- Merck & Co.
- Pfizer
- Safeway
- Time Warner
- Verizon Communications
- Wal-Mart Stores

SOURCE: THE CORPORATE LIBRARY

ultimately reflecting increased shareholder value. TCL's study also showed that six of the ten companies whose CEOs received the highest increases in total compensation underperformed their peers in stock price appreciation over the previous five years. All ten of these companies' total annual compensation increases appear justified by short-term achievements.

Unsatisfactory compensation agreements suffer from a lack of comparative performance, as well as poor design and calibration of performance objectives. True measures of value increase are needed, including those that measure the direct delivery of value to shareowners (e.g. total stockholder return) as well as those that measure absolute value creation (e.g. return on capital that exceeds the company's cost of capital). The appropriate performance metrics for incentive plans can and should vary by company, but we believe these general principles should be adopted by all.

**/// AT&T, Inc. ///**

Edward E. Whitacre, Jr. is currently the CEO and Chairman. We believe AT&T's choice to incorporate several important elements of executive compensation into formal components of its executive's employment contract weakened its incentive structure. Executive

Long-term value growth is hampered when poorly designed and/or implemented incentive plans encourage executives to focus exclusively on achieving short-term operational targets or short-term gains in stock price. This focus on the short-term comes at the expense of growth derived over through strategies focused on longer time periods.

Studies show that the largest percentage increases in total compensation have very little connection to long-term value creation for companies within the S&P 500 index, whereas moderate percentage increases in total annual compensation generally reflect positive changes in year-over-year company performance,

**THE SBA PERSPECTIVES ON EXECUTIVE COMPENSATION DOCUMENT HAS ADDITIONAL BACKGROUND AND ANALYSIS OF UNDERPERFORMING COMPANIES IN THE RUSSELL 3000 INDEX EXHIBITING OUTSIZED COMPENSATION.**

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compensation should be dependent upon performance. In other words, superior performance should be rewarded with superior pay, not embedded in a contract. Moreover, too much of the current and future compensation at AT&T is either fixed, or based on the wrong performance metrics, or the wrong performance metrics measured over too short a time period. While these performance metrics are achievable, they do not necessarily translate into long-term growth in shareholder value. The CEO's total annual compensation is among the very highest for a company of this size.

account, the committee is comparing compensation levels of companies with widely differing levels of performance, ignoring the possibility that high performance will lead to higher levels of incentive compensation.

At the 2006 annual meeting, two compensation-related stockholder resolutions were scheduled. The first resolution requested the board undertake a special executive compensation review and provide a summary report to investors by the middle of 2006. The second requested for management to seek shareowner ratification

### SBA VOTING RECORD FOR AT&T (APRIL, 28, 2006)

- SBA withheld votes from 6 of the 17 directors, this list includes Aldinger, Busch, Madonna, Metz, Richey and Roche
- SBA voted in favor of the adoption of the simple majority vote requirement
- SBA voted in favor of putting the severance agreement (change in control) up for shareholder ratification
- SBA voted in favor of the separation of Chairman and CEO positions

Aldinger and Madonna are members of the audit committee and together sit on more than three public company audit committees, negatively impacting the time and attention required to fulfill their duties. Aldinger attended less than 75 percent of the board meetings since his appointment in November of 2005.

Busch, Metz, Richey and Roche served on the corporate governance and nominating committee during the 2005 fiscal year. During this time, a shareholder proposal, which received majority support, requested that the board take steps to apply a simple majority vote on issues subject to shareholder vote. As far as determinable, no actions were taken to comply with the request. The committee failed to fulfill its obligations to the shareowners of the company. Additionally, directors Busch, Metz and Roche are affiliated with the company, creating conflicts of interest for these directors when making board decisions.

The compensation committee reported that a regression analysis is performed based on the size of companies within AT&T's Comparator Group so as to eliminate the differences in compensation that arise due to size. There is no indication that a similar exercise is conducted to eliminate the effects of performance from such a comparative study. Without taking performance into

of any severance agreement with any officer that provides severance benefits with a total present value exceeding 2.99 times the sum of the officer's base salary plus target bonus. Both resolutions were opposed by the board.

In spite of these setbacks, there have been two small achievements for the shareowners of the company. The first victory consists of future severance benefits which

*[continued on page 48]*

**THE BELL SOUTH BOARD REPRESENTS AN AWKWARD COMBINATION OF THREE FACTORS: 1) THE ABSENCE OF ANY VESTED SHAREHOLDERS - THE FIRM IS AN INDEXED STOCK WITH NO SINGLE OWNER HOLDING ABOVE ONE PERCENT; 2) THE PRESENCE OF TOO MANY ACTIVE AND FORMER CEOs; AND 3) "OVERBOARDED" DIRECTORS WHO SIT ON TOO MANY BOARDS SIMULTANEOUSLY.**

**WHILE SUCH BOARDS ARE OFTEN FULLY COMPLIANT WITH MOST BEST PRACTICE STANDARDS, OUR RESEARCH SUGGESTS THAT THEY ARE SIGNIFICANTLY MORE LIKELY TO ENCOUNTER SERIOUS GOVERNANCE-RELATED PROBLEMS THAN MOST OTHER BOARDS.**

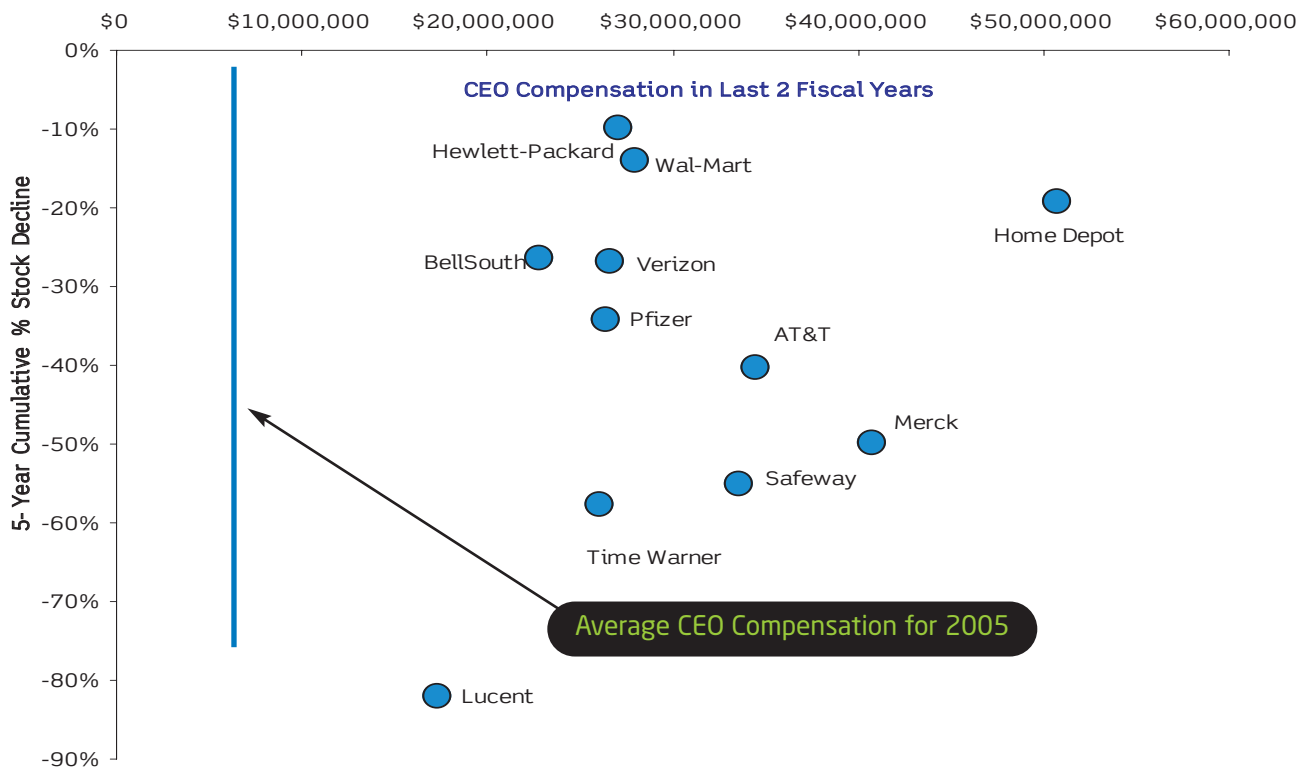
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### PAY FOR FAILURE COMPANIES

Company Name	Name of Current CEO	Total CEO compensation (last 2 Fiscal Years)	TCL Rating	5-year Total Stock Return (TSR)	Performance vs. Peers
AT&T, Inc.	Edward E. Whitacre	\$34,435,596	D	-40.32%	Underperformed
BellSouth Corporation	F. Duane Ackerman	\$22,747,700	D	-26.33%	Underperformed
Hewlett-Packard Company	Mark V. Hurd	\$27,056,129	D	-9.88%	Underperformed
Home Depot, Inc. (The)	Robert L. Nardelli	\$50,717,002	F	-19.05%	Underperformed
Lucent Technologies, Inc.	Patricia F. Russo	\$17,317,113	F	-82.05%	Underperformed
Merck & Co., Inc.	Richard T. Clark	\$40,754,311	D	-49.80%	Underperformed
Pfizer, Inc.	Henry A. McKinnell	\$26,365,439	D	-34.11%	Underperformed
Safeway, Inc.	Steven A. Burd	\$33,510,855	D	-54.99%	Underperformed
Time Warner, Inc.	Richard D. Parsons	\$26,058,130	D	-57.71%	Underperformed
Verizon Communications, Inc.	Ivan G. Seidenburg	\$26,580,200	D	-26.83%	Underperformed
Wal-Mart Stores, Inc.	H. Lee Scott	\$27,961,065	D	-13.90%	Underperformed

SOURCE: THE CORPORATE LIBRARY

TOTAL COMPENSATION VS STOCK RETURNS FOR PAY FOR FAILURE FIRMS (as of 2/16/06)



SOURCE: THE CORPORATE LIBRARY

### SBA VOTING RECORD FOR BELL SOUTH (APRIL, 24, 2006)

☐ SBA withheld votes from 5 of the 11 directors, including directors Anderson, Blanchard, Brown, Codina and Mullin

Anderson, Blanchard and Codina - are all involved in professional relationships with BellSouth, creating conflicts for directors. Additionally, Form 4 disclosures were not filed in a timely manner for director Blanchard regarding purchases of shares made in fiscal year 2005, creating the opportunity for backdating of stock option grants.

Brown serves on five other public company boards, including Brown & Brown, of which he is the chairman and CEO.

Mullin - serves as a non-independent chairman of the nominating & corporate governance committee and as non-independent member of the compensation committee, the board had no independent lead director during fiscal 2005.

must exclude target performance share awards from the calculation, and future pension benefits which must be limited to 50 percent of annual compensation – except for the CEO, whose pension will continue to be calculated based on 75 percent of annual compensation. Secondly, while net income was the metric used for the performance share plan at the former SBC, in 2004 this was changed to a return on invested capital (ROIC) measure, which is a definite improvement.

### /// BellSouth Corporation ///

The metrics used to determine the annual incentive bonus for BellSouth executives makes it impossible to understand exactly what the compensation committee is rewarding. The reason for this is that the metrics used are not disclosed in the company's proxy, nor are the results or the expectations. In addition to this ambiguity, the maximum pool for such awards is set as the, "higher of a percentage of net income or a percentage of operating cash flow." The committee then exercises, "negative discretion," to make awards based on, "financial and operating results, the Company's performance relative to other large regional telecommunications companies, the performance of each executive's business unit for the year and the executive's individual achievement of personal commitments."

Furthermore, half of the metrics used to determine performance shares are based on net income and operating cash flow. These are the same targets which have been used to determine the annual incentive bonus, having the effect of rewarding the same achievement twice. The other half of the metrics were based on the company's relative TSR compared to the S&P 500 Integrated Telecommunication Services Index over three years. In the 2006 proxy, it was reported that the payout for fiscal year 2005 was based on BellSouth's annualized TSR for the performance period of 4.9 percent as compared to the peer group annualized TSR of 3.7

### HP'S NON-PERFORMANCE COMPENSATION

(fiscal year 2005)

- ~ No bonuses were earned in first half of year due to poor performance, except for CEO Mark Hurd, who received \$233,333 under the "Executive Pay for Results Plan" as a guaranteed pro-rated bonus payment (paid at target);
- ~ Guaranteed on target bonus for latter half of fiscal 2005 and first half of fiscal 2006 for CEO Hurd, including \$2,000,000 signing bonus; as well, \$1,000,000 signing bonus for EVP R. Todd Bradley; \$2,200,000 signing bonus for CIO Randall D. Mott; \$1,082,500 retention bonus for EVP Michael J. Winkler (who has since left);
- ~ \$25,337,700 worth of restricted stock, including \$8,684,000 for CEO Hurd;
- ~ \$2,750,000 relocation bonus to CEO Hurd and \$300,000 relocation bonus to CIO Mott;
- ~ \$5,000,421 to Hurd pursuant to the price protection provisions of his employment contract related to stock options held at his former employer: reimbursement for up to 20% for declines in the per share fair market value of NCR's stock as covered by vested options;
- ~ Severance payment of \$21,627,300 for former CEO Carleton Fiorina;
- ~ Guaranteed long-term performance cash plan payments of a minimum of \$4,200,000 for Hurd and \$5,000,000 to Mott, as part of so-called "make-whole" payments.

**HP STOCK-BASED INCENTIVE PLANS,  
WHICH ARE NOT PERFORMANCE  
RELATED, HAVE BEEN ADOPTED  
WITHOUT SHAREOWNER APPROVAL.**

SOURCE: THE CORPORATE LIBRARY

**SBA VOTING RECORD FOR HEWLETT-PACKARD**

**(MARCH 15, 2006)**

- SBA withheld support from only 1 (Wayman) of the 11 directors up for election.
- SBA voted in favor of requiring a majority vote for the election of directors.
- SBA voted in favor of the claw-back of payments when financial restatements occur.

**Wayman - currently sits on the board while serving as the company's executive vice president and CFO - we believe such senior executives should report to, not serve on, a company's board of directors.**

percent. The LTIP paid out part of its award because BellSouth outperformed its peers. Based on this measurement, it would seem that the LTIP is functioning correctly. However, when referring to the 2005 proxy, the payment of an award in fiscal 2004 demonstrates that the plan is not functioning correctly and that there is no real understanding of how an incentive pay plan should work at the company. In the 2005 proxy, the compensation committee says, "BellSouth's annualized TSR for the performance period was -8.1 percent as compared to the peer group TSR of -6.4 percent, resulting in actual shares earned of 80 percent of the performance shares awarded in 2002." Simply stated, even though BellSouth's

performance was noticeably worse than its peers, the LTIP paid out 80 percent of an award that was allegedly meant to be based on performance. In our view, this practice symbolizes a compensation framework that is disconnected with the company's performance and does not appear to be in shareowners' best interest.

**/// Hewlett-Packard Company ///**

This year has been a tumultuous one for Hewlett-Packard, going through an internal investigation regarding boardroom leaks which consisted of illegal tactics, including hiring private investigators that impersonated board members to obtain personal phone records and media contacts. From the degree of the investigations, it seems that HP's corporate governance structures failed during a critical time for the company.

It is presently unclear how much former board chairwoman Patricia Dunn, outside counsel Larry Sonsini and CEO and new board chairman Mark Hurd knew and when they knew it. However, testimony from a September 28, 2006, congressional hearing, as well as recently released evidence, suggested no board members or senior executives are willing to admit any explicit knowledge or involvement in the "pretexting" activities. In early December, HP was required to pay a \$14.5 million fine to the State of California to settle civil charges related to the company's practices.

**HOME DEPOT'S LACKLUSTER GOVERNANCE**

Seven active CEOs on the board.

More than two directors sit on more than four public boards, a clear example of "overboarded" directors.

The positions of Chairman and CEO are combined.

There are directors on the board with more than one year of service that do not own any stock in the company.

**OVER 30% OF THE COMPANY'S SHAREOWNERS WITHHELD THEIR VOTES DURING THE 2006 MEETING FOR ALL BUT ONE MEMBER OF THE HOME DEPOT BOARD, INCLUDING CEO/CHAIRMAN NARDELLI.**

**AFTER THESE RESULTS WERE RELEASED, THE BOARD IMMEDIATELY ANNOUNCED A REVERSAL OF ITS PREVIOUS POSITION ON HAVING BOARD MEMBERS PRESENT AT ANNUAL MEETINGS, AMONG OTHER CHANGES IT HOPES WILL IMPROVE ITS CORPORATE GOVERNANCE IMAGE.**

**2006 BOARD ELECTIONS  
% OF VOTES WITHHELD**

Gregory D. Brenneman	30.76%
Milledge A. Hart III	31.24%
Robert L. Nardelli (CEO)	31.82%
Claudio X. Gonzalez	35.89%
Bonnie Guiton Hill	32.12%
Lawrence R. Johnston	31.65%
Laban P. Jackson Jr.	30.48%
Thomas J. Ridge	31.34%
Angelo R. Mozilo	7.82%
John L. Clendenin	31.27%
Kenneth G. Langone	32.05%

Regarding the company's compensation, there are two welcome signs. The first company statement says that one must forfeit bonus entitlements upon termination. The second indicates that there will be a recoupment of bonuses if there has been a significant financial misstatement. These may be insufficient though, since

Historically, a front-loaded, non-performance related package was given to former CEO Carly Fiorina. Excess compensation was delivered to Ms. Fiorina in the beginning, proper pay systems were not established for her while she was in place, and, when the board announced her termination, she received an excessively generous termination package. Instead of learning from this, the board and the compensation committee chose to compensate the new CEO Mark Hurd in much the same way. In addition, executive compensation is being determined by some non-GAAP measures of performance (e.g. non-GAAP net profit). The compensation committee has also adopted an approach of making adjustments for any, "extraordinary or non-operational items," in these non-GAAP measures. Making such adjustments can further cloud accounting measures which are made opaque through the use of non-GAAP methodologies.

**THE SBA WAS 50% MORE LIKELY TO WITHHOLD SUPPORT FROM DIRECTORS SITTING ON PAY FOR FAILURE COMPANIES THAN THOSE AT OTHER FIRMS.**

under the proposed arrangements it is only the recipients whose, "fraud or misconduct resulted in such restatement", who will have their bonuses repossessed. For example, if the earnings were wrongly represented, they were wrongly represented whether an officer was directly responsible for the misrepresentation or not. If and when this occurs, all bonuses should be reduced to the level that would have been paid out had results not been misstated; bonuses for those not responsible should be entirely recovered as well as the bonuses for those directly responsible for the inappropriate payout.

During the 2006 annual meeting there were two proposals that concerned executive compensation. The first sought approval of the 2005 annual incentive plan. While there are some improvements to this plan, one negative element involves the potential absolute maximum of \$10,000,000 – which is an extremely high level for annual achievements.

**/// Home Depot, Inc. ///**

Company shareowners may be astounded by the tremendous generosity of Home Depot regarding a loan to

*[continued on page 52]*

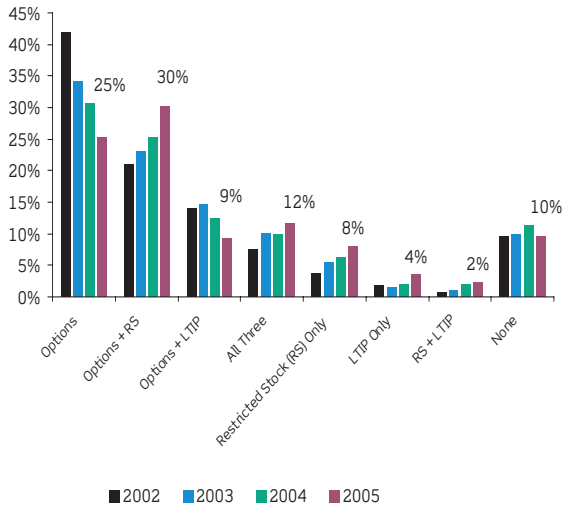
**SBA VOTING RECORD FOR HOME DEPOT (MAY 25, 2006)**

- SBA withheld votes from 10 of the 11 directors, including directors Brenneman, Clendenin, Gonzalez, Hart, Hill, Jackson, Johnston, Langone, Nardelli and Ridge.
- SBA voted in favor of increasing the disclosure of executive compensation.
- SBA voted in favor of the report on EEOC-related activities.
- SBA voted in favor of separating the Chairman and CEO positions.
- SBA voted in favor of requiring a majority vote for the election of directors.
- SBA voted in favor of submitting executive retirement plans for shareholder vote.

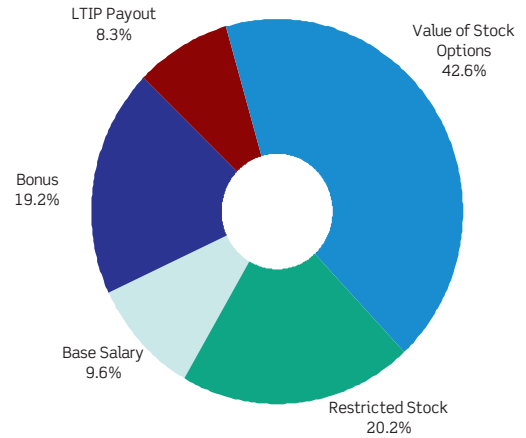
Clendenin, Gonzalez, Hill and Johnston serve on the board's compensation committee which has allowed CEO Nardelli to be one of the highest paid CEOs in corporate America despite the company's poor total shareholder returns. Gonzalez - serves as the chairman and CEO of Kimberly-Clark de Mexico as well as serving on the boards of nine other public companies. Due to these extreme time commitments, there may be little time left to devote on behalf of Home Depot's shareholders. During the 2004 and 2005 annual meeting, Gonzalez received a 22 percent and 24.3 percent withhold vote, respectively. It should also be noted that CEO Nardelli received his most excessive pay during the time Gonzalez served as chairman of the compensation committee. Nardelli, Langone, Hart, Gonzalez, Clendenin, Johnston, Jackson, Brenneman and Ridge are directors that failed to implement a shareholder proposal supported by a majority of the company's shareowners for two consecutive years. The proposal requested that the board seek shareholder approval of future severance agreements in which executives are to be provided benefits in amounts that exceed 2.99 times the sum of the executives' base salary plus bonus.

## EXECUTIVE COMPENSATION TRENDS OF LARGE U.S. COMPANIES

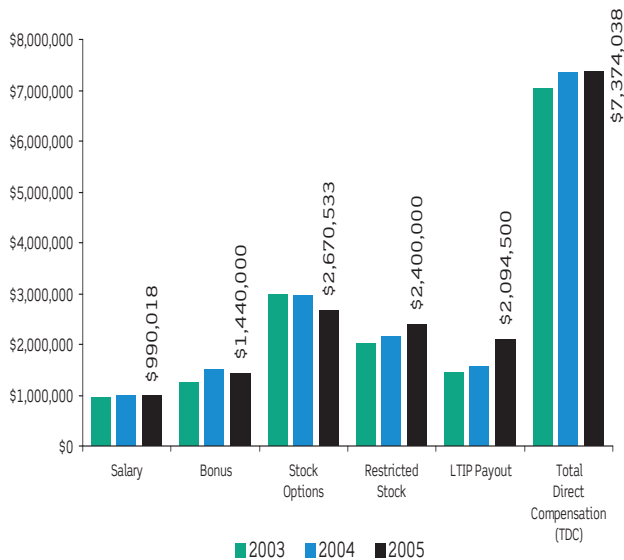
LONG TERM INCENTIVE PLAN ("LTIPs") TRENDS (BY COMPONENT)



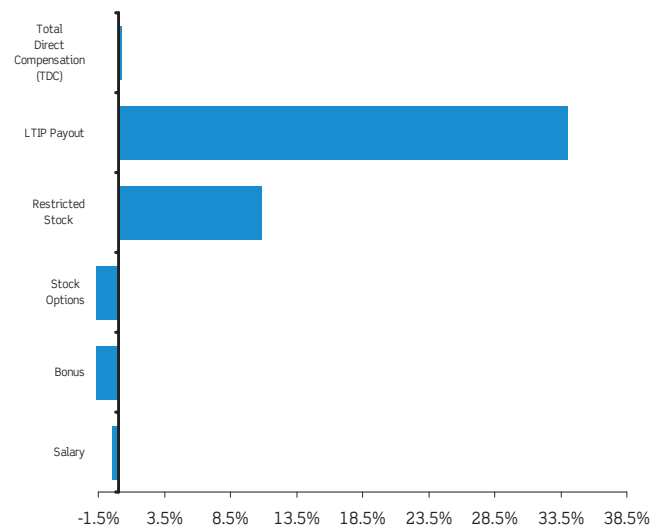
PAY COMPONENTS AS % OF TOTAL DIRECT COMPENSATION (TDC)



MEDIAN CEO COMPENSATION (BY COMPONENT)



YOY % CHANGE IN MEDIAN PAY (BY COMPONENT)



SOURCE FOR EACH GRAPH: EQUILAR, INC. [BASED ON 403 CEOS AT S&P 500 INDEX COMPANIES WITH TENURE DURING THE LAST 4 YEARS, ONLY INCLUDING PROXIES FILED WITH COMPANIES WITH FISCAL YEAR END AS OF JUNE 2006.]

the CEO. Robert Nardelli received a loan from the Company in the amount of \$10,000,000, which accrued interest at the rate of 5.87 percent per year, compounded annually. The loan was treated as a long-term employment incentive and the obligation to repay the loan was fully forgiven (including accrued interest and tax), and the company's obligations with respect thereto were completed, as of the end of fiscal year 2005.

In addition, Mr. Nardelli was awarded a cash bonus of \$7,000,000 and received 380,000 shares of restricted

**THE PRACTICE OF TIME BASED VESTING IS A SIGNIFICANT PROBLEM FOR MANY U.S. COMPANIES – IF THE COMPANY'S PERFORMANCE IS LACKLUSTER, SUBSTANTIAL COMPENSATION IS STILL ASSURED AS LONG AS THE EXECUTIVES CAN HANG ON LONG ENOUGH TO VEST**

**THESE NON-PERFORMANCE VESTING SCENARIOS HAVE BEEN APPROPRIATELY DUBBED, "PAY FOR PULSE."**

Mr. Nardelli was also the recipient of a very generous compensation package. When the board determined Nardelli's compensation, it was decided that his base salary was set at \$1,500,000, then subsequently increased to \$2,225,000 in 2005. Moreover, his annual bonus would not be less than \$3,000,000 (paid out at \$7,000,000 in 2005). Nardelli also received two stock option awards following his employment agreement. The two stock option awards entitled him to purchase 3,500,000 shares of common stock at \$40.75 per share. Both awards were fully vested as of the end of fiscal 2005. Beginning in 2002, Nardelli received additional annual option awards to purchase no less than 450,000 shares of common stock. He was also granted deferred stock units totaling 750,000 shares of common stock. This stock was also fully vested

stock, 175,000 deferred shares and 90,000 nonqualified stock options for fiscal year 2005. His total compensation for fiscal 2005 was valued at more than \$31 million. In contrast to this sum, total shareholder return (over his tenure as CEO) decreased by 20.88 percent.

Between 2003 and 2004, the performance metric for the long-term incentive plan (one of the few elements of CEO Nardelli's pay that was dependent on a performance metric) was changed from total shareholder return versus a peer group (a metric against which the company is performing badly) to average diluted earnings per share. It so happens that the company's record in regards to EPS growth by its own assessment is very good, ensuring that this change of metric would lead to a payout, rather than

incentivize enhanced performance. Precise data is not offered by the company regarding which metrics are in use for the annual bonus, though EPS is again given distinction in the record of the CEO's achievements. From this information, it appears that the CEO and the other officers will be rewarded not once, but twice, for the same set of achievements.

**VIACOM: THOMAS E. FRESTON SERVED AS PRESIDENT AND CEO OF VIACOM FOR LESS THAN A YEAR.**

**ON OCTOBER 16, 2006, THE BOARD OF DIRECTORS ENTERED INTO A SEPARATION PAYMENT WITH MR. FRESTON, WHICH CONFIRMED HIS RESIGNATION FOR "GOOD REASON" AND QUANTIFIES HIS ENTITLEMENTS UNDER HIS EMPLOYMENT AGREEMENT.**

**UNDER THE TERMS OF THE EMPLOYMENT AGREEMENT, VIACOM WILL PAY MR. FRESTON APPROXIMATELY \$84.7 MILLION IN CONNECTION WITH HIS TERMINATION OF EMPLOYMENT.**

**THE CORPORATE LIBRARY**

as of the end of fiscal 2005. Also, severance provisions entitle Mr. Nardelli to receive \$20,000,000 and immediate vesting of deferred compensation and unvested equity-based awards that remain exercisable through the end of their original term.

During 2006, two compensation-related shareowner proposals were submitted to the board of directors. The first proposal recommended that stockholders be given the opportunity at each annual meeting to vote on an

advisory resolution to approve the report of the compensation committee set forth in the proxy statement. The second proposal advocated that the board seek shareholder approval of any future extraordinary retirement benefits for senior executives so long as existing employment agreements or vested pension benefits are not violated. The first proposal received support of more than 37 percent of all votes, and the second received support of more than 43 percent of all votes. Despite shareowner efforts, the board of directors recommended voting against both proposals.

On January 3, 2007, within a few weeks of activist investing fund Relational Investors taking a position in Home Depot stock, Mr. Nardelli resigned as CEO, with an estimated \$210 million severance package. The departing CEO had received over \$240 million in salary, bonus and stock grants during his tenure, while the market capitalization of the company actually declined.

### /// Lucent Technologies ///

Of the 11 “pay-for-failure” companies, Lucent Technologies’ (now known as “Alcatel-Lucent” post merger) negative shareholder return for the past five years was the highest at an astounding 82.05 percent. During the past two years, CEO Patricia Russo was compensated \$17,317,113. Shortly after being hired, Russo was awarded 550,000 stock units, and 1,220,000 options, inducement awards of 500,000 stock units and 1,515,000 stock options, and a guaranteed bonus of \$1,800,000 for her first year of employment. This compensation bore no relation to performance

*“Poor design of compensation plans, and questionable judgment in administering plans, coupled with a lack of disclosure on stealth compensation have created a sea change in the executive compensation landscape.*

*Compensation committees are being held to higher standards and are challenged to draw not a dotted line, but a solid line, from pay to performance.”*

Institutional Shareholder Services (ISS)  
Proxy Advisory for Pfizer Inc. (4/27/06)

### SBA VOTING RECORD FOR MERCK (APRIL 26, 2006)

- SBA withheld votes from 2 of the 12 directors, including directors Cole and Lazarus
- SBA voted in favor of adopting a simple majority vote

*Cole - serves on the compensation committee as a non-independent director, creating the potential for conflicts of interest. Moreover, during 2005 the United Negro College Fund, of which Cole is a President of its member college, received approximately \$1 million in charitable contributions from the company, with the actual amount not being disclosed to shareowners.*

*Lazarus - Merck received advertising services in 2005 from Ogilvy & Mather, the company for which Lazarus is chairman and CEO. The dollar amount for these services was not disclosed to shareowners. In addition, Lazarus serves as a non-independent member of the audit committee.*

whatsoever. Insisting that future compensation be tied to performance in the future would be utterly inconsistent with the way in which Russo was compensated shortly after employment. In 2003 Lucent’s long-term incentive plan (“LTIP”) was implemented. The LTIP does not appear to have reduced the number of stock options awarded. TCL found that Russo’s total annual compensation exceeded the median for a company of its size by more than 20 percent.

The SBA withheld support for 3 of the 10 directors up for election, including directors Goldin, Hagenlocker and Thomas because of their performance on the company’s compensation committee during a time when the company paid significantly more to its top executives than its peers and were not justified in doing so based on the company’s performance. On other shareowner proposals, the SBA voted in favor of using performance-based/indexed options and excluding pension credit from the calculation of incentive compensation.

### /// Merck ///

During 2005, former CEO Gilmartin received an assortment of long-term incentive awards despite the nearness of his retirement. Moreover, there is unacceptably poor disclosure of retirement benefits Mr. Gilmartin will receive. The only performance conditions in place for incentives, apart from stock price, are EPS, sales revenue, and return on operating assets (ROA), whereas annual incentive plans use EPS for performance shares. Here is yet another compensation committee

attempting to reward executives twice for the same achievements.

**/// Pfizer, Inc. ///**

During 2006 a stockholder proposal (which was originally scheduled for the annual meeting, but later dropped from the proxy) proposed limiting pension benefits for executives to a "ceiling of 100 percent of the senior executive's final average salary, as calculated at the Board's discretion." In response, a limit was placed on the provision of pension benefits in excess of 100 percent of "final average salary" without shareowner approval. Unfortunately, the board chose to define "final average salary" as the "average of the highest five calendar years' earnings, where earnings includes salary earned during the year and annual cash incentives (or bonus) earned for the year." It is obvious the stockholders are requesting that a limit be placed using a percentage of salary, not earnings, and the fact that the board would play a game of semantics is unflattering. In our view, the shareowner proposal was not appropriately

**SBA VOTING RECORD FOR PFIZER (APRIL 27, 2006)**

- SBA withheld votes from 3 of the 13 directors, including directors Burns, Lorch and Mead.
- SBA voted in favor of restoring or providing for cumulative voting.
- SBA voted in favor of the separation of Chairman and CEO positions

Lorch and Mead are long-tenured members of the compensation committee and Mead serves as the chairman of this committee. These two directors were key players in the sizeable awards granted and embedded in the ever increasing pension for CEO McKinnell. This pension has resulted in one of the largest payouts in U.S. corporate history, totaling \$83 million. Burns - was a board member and Chair of the compensation committee in the late 1990s during the creation of extremely large pension benefits for former CEO McKinnell. Mead - served as a member and Chair of the compensation committee during several years of poorly structured and implemented compensation practices. Mead joined during 1998 in the latter part of the creation of the large pension liabilities.

A prime example of this is the retirement package for former CEO, Dr. McKinnell. It is one of the largest payouts in history, totaling \$83 million. While it should be expected that Dr. McKinnell's pension would be significant due to his over 35 years of service with the company, the estimated \$83 million payout tops the charts. In late December of 2006, the company disclosed additional severance compensation tied to Mr. McKinnell's departure. When added to the previously disclosed pension benefit, Mr. McKinnell was removed from the board at a cost of approximately \$200 million. For this sizable sum, shareowners should have received stronger performance than they did over the last five years.

**WHEN COMPARED TO AN APPROPRIATELY DESIGNED PEER GROUP, WE PREFER TO SEE INCENTIVE AWARDS ELIMINATED ENTIRELY WHEN COMPANY PERFORMANCE IS BELOW THE 50<sup>TH</sup> PERCENTILE.**

implemented as the board claims.

In addition to this, the compensation committee has allowed employment contracts to include excessive severance provisions, excessive supplemental executive retirement plan (SERP) payouts, huge bonus payouts without any justifiable performance linkage, and other excessive compensation payouts or poor pay practices at the company.

After McKinnell became CEO in January 2001 and chairman of the board in May 2001, the value of Pfizer stock dropped from approximately \$46 to \$25, a decline of almost 45 percent. Contributing to the increase in the retirement package is the fact that the pension plan defined earnings using any and all forms of compensation. Although this was recognized in 2000, the compensation committee ceased embedding performance awards in the pension calculation, but let the tail (later years) of the program run out, which cost the shareholders an additional \$17 million.

Lastly, Pfizer's 2005 proxy statement did not disclose the actuarial value of Dr. McKinnell's pension benefits nor the amount of the annual payment. Therefore, to value this pension, a reader would have to carefully review Pfizer's disclosures to determine how the firm calculates the annual payment – and then make an actuarial assessment of the cost of these payments. There is also no information

on the amounts held in deferred compensation accounts. The former CEO earned over 85 percent of his more than \$18 million in 2005 compensation as incentive compensation in a year when total stock returns were negative.

**/// Safeway, Inc. ///**

Currently, there are two annual bonus plans in place at Safeway. The first bonus rewards store sales, operating profit and working capital, contributing to the majority of the potential annual incentive compensation. The second bonus is a capital performance-based compensation, which is based on new capital investments achieving targeted rates of return and is typically measured for the first and third years following completion of a particular

a pay-for-performance style of compensation, it is significant to note that the most of the CEO's compensation during 2004 was derived from the exercise of stock options. These stock options netted approximately \$17 million in profit after a five-year period during which the company's stock price nearly halved.

Furthermore, the compensation committee stated in the 2005 proxy statement that compensation levels and incentives were below those of the median for comparable companies, and that the CEO's benefits were much less than those of his peers. To remedy this situation the compensation committee increased both grants of stock options as well as Burd's retirement benefits, which have, subsequently, been doubled. This increase, and a further

**5-YEAR TOTAL COMPENSATION OF PAY FOR FAILURE FIRMS (2001/02 THRU 2004/5)**

Company Name	2001 fiscal year CEO compensation	2002 fiscal year CEO compensation	2003 fiscal year CEO compensation	2004 fiscal year CEO compensation	2005 fiscal year CEO compensation	Total five year CEO compensation
AT&T, Inc.	\$25,048,376	\$8,643,475	\$19,534,875	\$14,900,721	\$17,101,304	\$85,228,751
BellSouth Corporation	\$3,275,700	\$5,592,400	\$11,511,400	\$11,236,300	\$15,072,300	\$46,688,100
Hewlett-Packard Company	\$1,248,073	\$4,120,049	\$3,518,460	\$3,811,294	\$23,244,835	\$35,942,711
Home Depot, Inc. (The)	\$22,839,424	\$20,030,158	\$22,217,160	\$28,499,842	---	\$124,402,015
Lucent Technologies, Inc.	\$14,275,895	\$14,275,895	\$4,486,542	\$9,037,273	\$8,279,840	\$50,355,445
Merck & Co., Inc.	\$2,890,988	\$2,992,334	\$2,967,340	\$37,786,981	\$4,160,106	\$50,797,749
Pfizer, Inc.	\$23,759,405	\$10,536,281	\$9,706,002	\$16,659,437	\$18,127,684	\$78,788,809
Safeway, Inc.	\$2,209,000	\$12,226,122	\$14,041,080	\$19,469,775	---	\$50,472,977
Time Warner, Inc.	\$1,284,633	\$1,264,163	\$11,881,965	\$14,176,165	---	\$192,994,823
Verizon Communications, Inc.	\$13,489,300	\$15,598,200	\$12,842,000	\$13,738,200	\$19,425,000	\$75,092,700
Wal-Mart Stores, Inc.	\$15,555,798	\$17,813,746	\$15,367,572	\$12,593,493	\$12,593,493	\$73,924,102

SOURCE: THE CORPORATE LIBRARY

project. This performance metric, which is helpful in building long-term value, cannot allow for compensation exceeding 30 percent of the CEO's bonus and has a maximum bonus award of \$375,000. For other executive officers, the bonus can be between 15 and 30 percent of salary and has a maximum bonus award of \$300,000.

As stated by the company, the overall level of the annual incentive was, "established based on a review of competitive compensation levels with a view to allowing for higher than average incentive compensation to supplement lower than average base compensation." While this sounds as if Safeway is moving toward more of

increase in Burd's other non-performance related pay (i.e. pension and base salary), does not correlate with the committee's expressed desire to place greater emphasis on variable pay. Raising target long-term incentive payments, regardless of performance, separates compensation levels even further from actual achievements.

Despite this disappointing information, Safeway has noticeably improved its performance over the past two years and has recently moved from a 'D' to a 'C' letter grade rating by The Corporate Library. Moreover, all of the nine directors on the board had less than 2.5 percent

**SBA VOTING RECORD FOR TIME WARNER (MAY 19, 2006)**

- ☐ SBA withheld votes from 5 of the 11 directors, including directors Caufield, Miles, Novack, Vincent and Wright.
- ☐ SBA voted in favor of the adoption of a simple majority vote requirement.
- ☐ SBA voted in favor of the separation of Chairman and CEO positions.
- ☐ SBA voted in favor of developing a vendor code of conduct.

Caufield, Miles, Vincent and Wright - all serve on the compensation committee (Miles as Chair). In 2005, Time Warner paid more to its top executives even though the company performed worse than its peers. In addition to this, certain reserves from company EBITDA figures were excluded so that higher bonuses would be paid to executives.

Novack - during 2005, Time Warner engaged in a legal service relationship with a law firm in which Novack is senior counsel, creating a conflict-of-interest. Novack is a former executive of America Online, Inc. which was the subject of several accounting scandals (due primarily to accounting 'errors' and 'misstatements') under his leadership.

votes withheld by shareholders. This is a vast improvement from previous years. The SBA supported all nine directors during the 2006 annual meeting and also supported shareholder proposals calling for cumulative voting, elimination or restriction of the company's severance agreements, and the issuance of sustainability reports to investors.

**/// Time Warner, Inc. ///**

Reviewing Time Warner's compensation structure reveals that incentives based on long-term performance are lacking. The compensation committee recently began to use a mix of restricted stock, as well as traditional stock options. Unfortunately, both the restricted stock and stock option awards become vested not through the

achievement of performance objectives, but rather through the mere passage of time. This practice is clearly anathema to a performance based compensation framework and does little to incentivize senior executives to achieve performance objectives. Simply put, the company doesn't use any performance objectives.

The company's high levels of compensation to executives are primarily the result of the compensation committee targeting pay in the upper quartile of the company's peer group. The compensation committee is quoted as saying that it, "generally targets total direct compensation...at approximately the 75th percentile," but, "may range between the 50th and 90th percentiles." Over the past five years, Time Warner has produced a negative TSR of 57.71 percent, underperforming its peer group by a wide margin. We believe in such situations, executive pay should be well below the median of its peers, regardless of whether it is a "targeted" amount or the actual compensation awarded.

Furthermore, the compensation committee can liberally apply its discretion in determining whether bonuses should be paid even when performance standards have not been met. For example, in 2004, the original threshold metric used for the annual incentive plan was earnings-before-interest-taxes-depreciation-and amortization, or 'EBITDA'. However, after having already paid the maximum

**SBA VOTING RECORD FOR VERIZON (MAY 4, 2006)**

- ☐ SBA withheld votes from 5 of the 13 directors, including directors Carrion, Lane, Neubauer, Shipley and Stafford.
- ☐ SBA voted in favor of restoring or providing for cumulative voting.
- ☐ SBA voted in favor of requiring a majority vote for the election of directors.
- ☐ SBA voted in favor of company-specific-directors on common boards.

Lane, Shipley and Stafford serve on the compensation committee which has allowed for outsized compensation to CEO Seidenberg during a time of poor stock performance.

Carrion - is the Chairman, President and CEO of Popular, Inc. and Banco Popular de Puerto Rico, its subsidiary, while Verizon owns a majority interest in Puerto Rico Telephone, in which Popular is an investor, creating a conflict-of-interest. As well, director Carrion serves as a non-independent member of the human resources and compensation committees.

Neubauer - serves as chairman and CEO of ARAMARK. Lawrence Babbio, the vice chairman and president of Verizon, serves as a director of ARAMARK. Due to these interlocking board relationships, conflicts of interest can be magnified.

permissible bonuses according to the incentive plan, the compensation committee used its discretion to reward executives even further—giving an additional bonus of \$8 million to CEO Richard Parsons, placing his cash compensation in the upper quartile of the peer group.

### /// Verizon Communications, Inc. ///

In an attempt to move away from a non-performance compensation framework, Verizon no longer offers stock options, instead awarding only performance stock units (or “PSU”) and restricted stock units (or “RSU”). Unfortunately, similar to Time Warner and many other companies, Verizon’s RSU awards utilize only time-vesting requirements, are paid out in cash, and vest immediately for retirees if more than six months have passed since receipt. Such non-performance award criteria clearly represent a compensation philosophy that is risk-averse when it comes to applying performance hurdles to senior executives.

In 2005, the compensation committee made use of PSU awards, measuring performance at the end of a three-year performance cycle. Verizon measures performance by comparing its TSR to the TSR of the Standard & Poor’s 500 index as well as the TSR of its own peer group. While most investors would applaud the use of TSR as a performance

objective, especially over a relatively long time period, Verizon’s long-term incentive plan pays out even when stock performance is below median. In fact, it awards senior executives even when the company’s performance is in the bottom quartile.

While the amount of LTIP awards are scaled back for lower levels of stock returns, which on the surface may appear to indicate a pay-for-performance relationship, the fact that awards are given to the CEO and other senior executives when the company’s stock price performs well below its peers is problematic. We believe such plans should not payout for poor relative performance, regardless of the individual metrics used by the compensation committee to gauge management’s performance.

Another example of the ineffectual performance objectives used by Verizon is the annual incentive plan, which is based on earnings-per-share (or “EPS”) and revenue targets, measured against industry peers. As noted by Paul Hodgson, a Senior Researcher at The Corporate Library, almost a quarter of the RSU target award is paid out when the company is in the bottom quartile (bottom 25 percent) when compared to broad market and industry specific peer group indices. Although a shareowner return objective is

## TOP 12 HIGHEST PAID CEOs IN 2005

Company Name	CEO Name	Base Salary	Annual Bonus	Total Annual Compensation	LTIP Payout	Option Value (Realized)	Restricted Stock	Total Compensation
IAC InteractiveCorp	Barry Diller	\$726,115	\$3,250,000	\$4,770,153		\$290,204,537		\$295,136,421
Capital One Financial Corporation	Richard D. Fairbank	\$0	\$0	\$136,725		\$249,267,658		\$249,420,163
Nabors Industries Ltd.	Eugene M. Isenberg	\$825,000	\$3,000,000	\$4,112,661		\$193,308,763	\$5,765,000	\$203,431,397
Yahoo! Inc.	Terry S. Sernel	\$600,000	\$0	\$600,000		\$173,599,602	\$8,687,500	\$182,889,082
KB Home	Bruce E. Karatz	\$1,091,667	\$5,000,000	\$6,387,744	\$3,527,250	\$118,370,799	\$27,913,496	\$156,301,690
Countrywide Financial Corporation	Angelo R. Mozilo	\$2,666,667	\$19,557,361	\$22,570,546		\$119,024,772		\$141,975,114
Cendant Corporation	Henry R. Silverman	\$3,300,000	\$12,316,600	\$15,716,974		\$117,644,547		\$139,962,017
Abercrombie & Fitch Co.	Michael S. Jeffries	\$1,200,000	\$2,880,000	\$4,399,101		\$108,463,724		\$113,517,877
Lehman Brothers Holdings Inc.	Richard S. Fuld	\$750,000	\$13,750,000	\$14,500,000		\$74,958,627	\$14,942,021	\$104,418,439
Valero Energy Corporation	William E. Greehey (former)	\$1,400,000	\$3,500,000	\$4,900,000	\$29,280,638	\$55,269,605		\$95,319,257
Occidental Petroleum Corporation	Ray R. Irani	\$1,300,000	\$3,640,000	\$6,045,365	\$10,561,324	\$37,562,444	\$30,900,180	\$86,563,740
Autodesk, Inc.	Carol A. Bartz (former)	\$941,667	\$1,700,000	\$2,641,667		\$80,451,795		\$83,151,643

SOURCE: THE CORPORATE LIBRARY'S BOARD ANALYST

utilized by the plan to gauge the company's relative performance, because the LTIP is not calibrated well, the plan allocates sizeable compensation when the company severely underperforms its peers. For this and other reasons, Verizon's compensation practices clearly represent pay without performance.

### /// Wal-Mart Stores, Inc. ///

Most of Wal-Mart's executive long-term compensation is delivered in the form of time-vesting restricted stock and stock options. The total long-term package is made up of only a third of shares which are based upon performance, and only a quarter of the total long and short-term incentive

profit measure (assessing how well a firm uses its capital to generate profits) which is already being rewarded by net profits through the company's annual bonus plan. In addition to this, the company does not utilize performance-based equity awards with specific performance criteria and hurdle rates disclosed. Nor are we ensured that the executive compensation process is sufficiently performance-related due to the amount of the CEO's 'Other Annual Compensation' and "All Other Compensation."

At Wal-Mart's annual shareholder meeting on June 2, 2006, the SBA withheld support from board member Hernandez, who serves on the audit committee. For the last two years

he has sat on more than three public company audit committees, detracting from the time and energy required to fulfill his duty to Wal-Mart's shareholders. Of all the individual board committees, the audit committee is perhaps the most demanding. Several shareholder

proposals were also supported including requiring a majority vote for the election of directors, preparing a sustainability report and reporting on stock option awards.⊙

*"Corruption, democracy, and accountable governments both reflect and shape corporate governance patterns. In some countries, blockholding mingles with authoritarianism to mask structures and events. Transparency in politics is needed to sustain transparency in the economy, and each can stimulate the other."*

Peter A. Gourevitch & James Shinn

*"Political Power & Corporate Control - The New Global Politics of Corporate Governance"*

plan payments. The performance shares of this long-term compensation is determined by measuring achievement based on return on investment and average revenue growth. This time-vesting restricted stock raises the issue of double dipping, as return on investment is fundamentally a

## OWNERSHIP AND RETENTION GUIDELINES

Although the prevalence of executive stock ownership guidelines is far below the SBA's standards, they have increased considerably over the past several years. Ownership and retention guidelines foster a long-term horizon and represent a meaningful compensation policy that goes beyond the point at which pay is awarded. Corporate governance research firms, such as ISS and Glass Lewis, encourage the use of executive and director stock ownership guidelines and ISS assigns positive ratings for companies that do so. The largest companies - as seen in the Fortune 100 - most frequently have stock ownership guidelines and retention requirements. (Note: the SBA's "Perspectives on Executive Compensation" contains a model ownership/retention guideline)

Executives are usually allowed five years to achieve their required ownership guidelines, but the time period can vary widely among individual firms. For most companies with stock ownership requirements (73.2 percent) executives are given five years after being hired or promoted to meet the level of stock ownership and only 57.4 percent require executives to retain a particular amount of acquired equity until having met pre-set ownership levels. However, if an investor evaluates the entire equity market, including many of the smaller capitalization firms, a staggering 84.8 percent of senior executives and 81.7 percent of directors are not subject to any stock ownership requirements.

**EVEN AT THE LARGE END OF THE MARKET CAP SPECTRUM, ONLY 17.7 PERCENT OF FORTUNE 100 COMPANIES HAVE BOTH OWNERSHIP AND RETENTION GUIDELINES IN PLACE.**