February 2005

Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage

Lucian Bebchuk
Harvard Law School

Jesse Fried

ISSN 1045-6333

HARVARD

JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS

EXECUTIVE COMPENSATION AT FANNIE MAE: A CASE STUDY OF PERVERSE INCENTIVES, NONPERFORMANCE PAY, AND CAMOUFLAGE

Lucian Bebchuk and Jesse Fried

Discussion Paper No. 505

02/2005

Harvard Law School
Cambridge, MA 02138

This paper is also a discussion paper of the
John M. Olin Center's Program on Corporate Governance

February 2005

Executive Compensation at Fannie Mae:

A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage

Lucian Bebchuk* and Jesse Fried**

This paper examines Fannie Mae's executive compensation arrangements during the period 2000-2004. We identify and analyze four problems with these arrangements. First, by richly rewarding executives for reporting higher earnings, without requiring return of the compensation if earnings turned out to be misstated, Fannie Mae's arrangements provided perverse incentives to inflate earnings. Second, Fannie Mae's arrangements provided soft landings to executives who were pushed out by the board for failure; expectation of such outcome adversely affected ex ante incentives. Third, even if the executives had retired after years of unblemished service, the value of their retirement packages would have been largely unrelated to their own performance while in office, weakening the link between pay and performance. Fourth, both when promising retirement payments to executives and when making these payments, Fannie Mae's disclosures obscured rather than made transparent the total values of the executives' retirement packages. Because many other companies have practices similar to Fannie Mae's, our study highlights some general problems with existing pay practices and the need for reform.

JEL Classification: D23, G32, G34, G38, J33, J44, K22, M14

Keywords: Executive compensation, agency problems, pay for performance, nonperformance pay, performance pay, soft landing, golden goodbyes, camouflage, misreporting, restatement, earning manipulation, incentives.

---

* Professor of Law, Economics, and Finance, and Director of the Program on Corporate Governance, Harvard Law School.

** Professor of Law, University of California at Berkeley. We would like to thank Brian Foley of the compensation consulting firm Brian Foley & Co. for very helpful discussions, and Laura Knoll for excellent research assistance. This paper applies the framework put forward in our recent book, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard University Press 2004), to Fannie Mae's executive compensation practices during the period 2000-2004. For financial support, we wish to thank the Nathan Cummins Foundation, the Guggenheim Foundation, the Harvard John M. Olin Center for Law, Economics, and Business, the Berkeley Committee on Research, and the Boalt Hall Fund.

In December 2004, the board of the Federal National Mortgage Association ("Fannie Mae"), a financial company of great importance in the US economy, asked CEO Franklin Raines and CFO Timothy Howard to step down. The departure of the two executives followed a determination by the SEC that Fannie Mae had inflated its earnings over the last several years. The company may be required to restate its earnings by as much as $9 billion, which would wipe out more than half of the company's total reported profits from 2001-2003. The departures of the two executives were classified as "retirements," and Fannie Mae revealed in an SEC filing the terms of the generous retirement packages with which they are leaving.[1]

This paper examines Fannie Mae's executive compensation arrangements during the period 2000-2004. We consider the compensation paid to the executives while they served as well as their retirement packages. We identify and analyze four problems with Fannie Mae's executive pay arrangements:

(1) Perverse Incentives: Fannie Mae's compensation arrangements richly rewarded its executives for reporting higher earnings without requiring them to return the compensation if the earnings turned out to be misstated, thus providing incentives to inflate earnings.

(2) Soft Landing: Fannie Mae's arrangements provided a soft and generous landing to executives who were pushed out by the board for failure; expectation of such an outcome adversely affects ex ante incentives.

(3) Pay Decoupled from Performance: Most of the executives' retirement payouts were totally unrelated to firm performance, thus greatly increasing the fraction of their total compensation that was decoupled from the managers' own contribution to firm value.

(4) Camouflage: Fannie Mae obscured rather than made transparent the total values of the executives' retirement packages.

[1] Form 8-K filed December 19, 2004.

We do not know, nor do we want to speculate as to, whether the dilution and perversion of incentives produced by Fannie Mae's compensation arrangements in fact affected the executives' decisions – about accounting or anything else – prior to their departures. Raines and Howard may have acted throughout their service with the utmost dedication to Fannie Mae and its shareholders. Our claim is merely that Fannie Mae's pay arrangements, which are typical of pay arrangements given to public company executives, did not strengthen the managers' incentives to enhance shareholder value but rather weakened and distorted them. As we discuss below, there is empirical evidence that, in the aggregate, pay arrangements at public companies have influenced executives to inflate earnings.

We also should stress at the outset that, even though Fannie Mae's story has received significant attention due to the prominence of the company and its CEO, the importance of this case for our purposes is that it reflects current practices rather than presents an exceptional aberration. As we document in a recently published book,[2] the types of problems found at Fannie Mae have long been endemic among public firms.

To begin, firms often base bonuses and other forms of incentive compensation on earnings figures that can be manipulated, and commonly give managers broad freedom to choose when they sell shares. Thus, the structure of both equity and non-equity compensation provides executives with incentives to inflate short-term earnings at the expense of long-term shareholder value. In addition, executive pay arrangements commonly provide soft landings – even when executives are pushed out by the board for failure. The generous treatment of managers who have performed poorly weakens their incentives, thereby imposing costs on shareholders both ex ante and ex post. Directors also often alleviate their personal discomfort, at shareholders' expense, by authorizing large gratuitous benefits beyond those to which executives are contractually entitled.

[2] LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) [hereinafter PAY WITHOUT PERFORMANCE].

Furthermore, after executives leave – whether as a result of retirement, resignation, or being forced out – they often receive substantial retirement payouts that are unrelated to firm performance, greatly increasing the fraction of total compensation that is performance-decoupled. And firms commonly take steps to obscure rather than make transparent the total value of executives' retirement packages.

The case of Fannie Mae thus highlights how important it is to reform current compensation practices. Given most companies' failure to make pay any more transparent than is required by law, the SEC should adopt tighter disclosure requirements that, among other things, require companies to put a dollar figure on any retirement benefits that companies promise their executives. Institutional investors should press companies to improve the link between pay and long-term shareholder value by, among other things, not tying compensation to short-term earnings figures and stock price movements and adopting contractual provisions that reduce termination payoffs to failing executives. Most importantly, we must adopt reforms that make boards more accountable to shareholders and more attentive to the costs imposed on them by flawed pay arrangements.

Before proceeding, we should emphasize that, consistent with our general approach, we do not question the absolute levels of compensation provided to Fannie Mae's executives.[3] We do not know whether Raines was worth the dozes of millions of dollars he was paid for several years of service as a CEO. Rather, our concern is with both the structure and disclosure of the executives' compensation. Even if Raines were worth the amount he was paid, it is far from clear that Fannie Mae's board should have (i) structured the compensation package in a way that rewards higher reported annual earning figures, regardless of later restatements; (ii) included as a major element of Raines' compensation package retirement payments whose value was unrelated either to the performance of the company during Raines' service or to the reasons for Raines'

[3] *See id.* at ch. 1.

departure; or (iii) not made transparent the value of Raines' retirement package either when it was contractually promised or when it was actually paid.

The remainder of this paper proceeds as follows. Section I shows how Fannie Mae's compensation arrangements – like those of many other public companies – provided its executives with an incentive to manipulate earnings. Section II describes the soft landings enjoyed by Fannie Mae's executives even though they were forced out, as is typical for managers departing in such circumstances. Section III explains that, because of the amount and structure of the executives' retirement packages, much more of their compensation was decoupled from their own performance than appears at first glance. Section IV considers what Fannie Mae did – and chose not to do – to camouflage the amount of the executives' retirement packages. Section V concludes.

I. INCENTIVES TO INFLATE EARNINGS

Executive compensation is reported in firms' annual proxy statements filed with the SEC. Most salient for investors and researchers is the information reported in the "summary compensation table." That table divides the compensation of each of the top-five executives into a number of categories. The four main categories are: (1) salary; (2) annual bonus; (3) option/restricted stock grants; and (4) long-term incentive plan (LTIP) payouts. Both current-year and prior-year amounts for each category are included. A simplified version of Fannie Mae's summary compensation tables filed in 2003 and 2003 – showing entries for Raines – appears below.[4]

[4] We rounded the amounts to the nearest thousand dollars.

TABLE 1: FRANKLIN RAINES' COMPENSATION DURING HIS SERVICE AS CEO

Year	Salary	Bonus	Options/Stock[5]	LTIP
2003	$992,000	$4,180,00	$3,007,000	$11,621,000
2002	$992,000	$3,300,000	$6,680,000	$7,234,000
2001	$992,000	$3,125,000	$7,946,000	$6,803,000
2000	$992,000	$2,481,00	$5,829,000	$4,589,000

As this table makes clear, during the period 2000-2003, more than 50% of Raines' reported pay came from the annual bonus and LTIP payouts. The same was true for Howard. We will now explain how the structure of the yearly bonus and the LTIP program, as well as other elements of the compensation arrangements, provided the executives with affirmative incentives to inflate earnings.

Fannie Mae tied the amount of the executives' yearly bonus to the firm meeting a particular earnings goal. According to the company's proxy statements from recent years, Fannie Mae "exceeded that goal" each year. For meeting these targets, both CEO Raines and CFO Howard received an annual bonus in each of the four years during the period 2000-2003, adding up to a total of $13 million for Raines and $3 million for Howard.

Under the LTIP, Fannie Mae gave executives company stock. But, the number of shares given each year depended to a substantial extent on prior years' earnings. According to the company's annual proxy filings, the weight given to earnings in determining how many shares to award was fifty percent. During 2000-2003, Fannie Mae's climbing earnings helped Raines amass almost $30 million worth of Fannie Mae shares under this compensation program. Howard raked in almost $10 million worth of

[5] The summary compensation table reports only the number of options or restricted stock granted. Elsewhere in the proxy filing, the firm indicates the Black-Scholes value of the granted securities. We report these dollar values rather than the number of securities granted.

shares. Thus, more than half of the executives' total compensation depended on declared earnings.

Seeking to turbo-charge executives' incentives to increase reported earnings, in 2000 Fannie Mae's board adopted a special option grant program – "Earnings Per Share Challenge Option Grants." Under their terms, these options would become vested and exercisable in January 2004 if reported EPS equaled or exceeded $6.46 by December 31, 2003. Raines and Howard were awarded 213,000 and 57,000 such options, respectively. Rising to the challenge, Fannie Mae's executives delivered this result – EPS reached $7.91 by the end of 2003 – and enjoyed immediate vesting of the options.

Interestingly, Fannie Mae's recent announcements do not indicate that the board plans to try to recover any of the bonuses, options, and shares given to Raines and Howard on the basis of earning figures that will have to be restated. Whether or not the executives were at fault, it would make sense to adjust earnings-based compensation whenever actual earnings turn out to be different from those originally declared. Unfortunately, however, like most other companies forced to restate earnings, Fannie Mae does not seem to contemplate such an adjustment. [6]

Another feature of Fannie Mae's arrangements that provided adverse incentives was the broad freedom granted to executives to unload vested options and shares. Howard, for example, was a frequent seller of Fannie Mae shares. During the six month period leading up to the SEC's announcement that Fannie Mae had grossly misstated earnings, Howard realized approximately $6 million selling Fannie Mae shares – presumably more than he could have made had investors known that the company's prior-year profits were in fact significantly lower.

---

[6] The language in Fannie Mae's annual proxy statements suggests that much of Raines' and Howard's compensation was based on EPS. However, defending itself against a recent shareholder lawsuit seeking to block earnings-based payments to the executives , Fannie Mae's board now claims that much of the executives' earnings-related payouts were not based on EPS but rather on a different measure, "core business earnings" per share, most of which, Fannie Mae claims, are not affected by the $9 billion restatement. It is worth noting that there is no mention of "core business earnings" in the sections discussing the executives' annual bonus and LTIP payments in the annual proxy statements. In any event, the EPS challenge option grants were clearly based on reported EPS, and not "core business earnings."

As we noted at the outset, we do not know whether Raines and Howard were in any way influenced by the incentives to inflate earnings created by their compensation packages. There is a growing body of evidence, however, that in the aggregate, the structure of executive pay affects the incentive to inflate earnings. For example, pay arrangements that enable executives to time the unwinding of equity incentives have been correlated with attempts to increase short-term stock prices by inflating earnings.[7] Thus, the problem of rewards for short-term results is of general concern.

While a large executive pay package might be acceptable when it serves the goal of providing incentives to enhance long-term shareholder value, it is unacceptable when it produces perverse incentives to overstate earnings and artificially boost short-term stock returns. Such packages use shareholders' money to create incentives to take actions that do not increase, and may well decrease, shareholder value. Investors should press boards to overhaul all compensation arrangements and to adopt only those incentive plans that are based on long-term earnings or stock price results. These schemes should include mechanisms that adjust payouts – and if necessary recover payments already made to executives – when earnings are subsequently restated.

To be sure, Section 304 of the Sarbanes-Oxley Act of 2002 may require the CEO and CFO of a firm forced to restate earnings to repay the company. In particular, such an executive must return to the firm any bonus or other incentive or equity-based compensation received within 12 months of the misleading financial statement, or any profits realized from the sale of stock during that period. This giveback rule would operate regardless of the firm's contractual arrangements with its executives.

Unfortunately, Section 304 – the only provision of the Sarbanes-Oxley Act requiring the return of compensation based on misleading financials -- applies only in special circumstances involving "misconduct." And, there is good reason to adjust compensation based on misstated earnings even when there is no misconduct. If it

[7] *See, e.g.*, Scott L. Summers & John T. Sweeney, *Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis*, 73 ACCT. REV. 131 (1998). For further discussion of this problem, *see* PAY WITHOUT PERFORMANCE, *supra* note 2, at 183-85.

were desirable to base an executive's pay on earnings calculated under a given set of accounting rules, and those earnings are miscalculated under that set of rules in a way that artificially increases reported earnings, it makes no sense to tie the executive's compensation to the miscalculated earnings rather than to the properly calculated figures. Yet, strangely, executive compensation contracts require no such adjustment.[8]

Some companies may be contemplating adding such adjustment provisions to future executive compensation contracts. The issue, however, is relatively straightforward – executives should not be paid based on improperly calculated earnings. Furthermore, the idea of making executives return compensation based on inflated earnings has been on the table since before the passage of the Sarbanes-Oxley Act in 2002. The process of adopting give-back provisions thus seems to be taking longer than necessary.

II. SOFT LANDING

Thus far we have discussed key elements of the compensation received by Raines and Howard before they departed from Fannie Mae. We now turn to the retirement packages they got upon departure. As we shall discuss later, there are aspects of these packages that would raise concerns even if the executives were retiring with an impeccable record of performance. For now, however, we would like to focus on the fact that the executives' retirement packages were not different than the ones they would get if they were retiring after years of unblemished service. The executives were asked to leave because of the accounting problems for which they were held responsible. But this fact was in no way reflected in their retirement payoffs.

The executives enjoyed the same "soft landing" they would have received under

[8] In one recent episode, executives "volunteered" to give back $12 million of bonuses that they received as a result of inflated earnings. Nonetheless, compensation specialists say that such an event is very rare. *See* Mark Heinzl & Ken Brown, *Nortel Unveils New Accounting Flubs Company Details Mistakes, Says Executives Will Return Millions in Bonus Payments*, WALL ST. J., Jan. 12, 2005, at A3.

ordinary circumstances, as did many other executives who were forced to leave following accounting irregularities. Soft landings in the event of failure are problematic from an incentive standpoint. From the perspective of ex ante incentives, it is desirable to provide executives with less when they leave as a result of failure than when they retire under normal circumstances.

The unreduced retirement packages received by the executives were quite large. The two largest elements of Raines' retirement package were the automatic vesting of 360,000 options to purchase shares of Fannie Mae (worth about $7 million) and a monthly pension of $114,000 during his and his wife's lives (worth about $25 million).[9] Howard (and his wife, if any) received a monthly pension of $36,000, which is worth at least $6 million. [10]

Pushed-out executives like Raines and Howard are able to enjoy soft landings because of the employment contracts which boards give executives and because of how boards choose to interpret those contracts when executives leave. Boards give executives contracts that usually guarantee large severance or retirement benefits as long as executives are not terminated "for cause," which is defined very narrowly. (However, as we will see in Howard's case, even a "for cause" termination would not have materially reduced his retirement package). In the absence of a for-cause termination, the standard executive employment does not reduce the level of benefits if the executive's performance has been poor.

Consider Raines' and Howard's employment contracts. Each could be terminated "for cause" only if he had (A) been convicted of a felony; (B) participated personally in act of fraud as an executive that demonstrably discredits Fannie Mae and cannot be cured; or (C) continued for 20 days following written notice from Fannie Mae to (1) engage in activities that constituted a material conflict of interest with Fannie Mae,

---

[9] Raines claims that he is entitled to – and may eventually receive – over $1 million in additional options.

[10] Like Raines, Howard claims that he is owed even more – an additional $1.7 million in cash – and may end up getting that amount as well.

(2) fail substantially to perform material duties (other than as a result of incapacity or illness), or (3) fail to cure a material breach of his employment contract. Note that poor operating performance, deception, or earnings manipulation that falls short of the legal definition of fraud, are not grounds for "for cause" termination. Such a narrow definition of "for cause" is standard in executive employment contracts. As Stewart Schwab and Randall Thomas found in their recent study of CEO contracts, incompetence was listed as a ground for firing in less than 3.5% of such contracts.[11]

As long as the termination does not fall within the remarkably narrow definition of "for cause," the contracts of the two executives guarantee them a retirement package whose value cannot be reduced under any circumstances. Indeed, under these contracts, even a "for cause" termination would still have given the two executives sizable retirement packages: Howard would have essentially received the full amount of his package even if he had been fired "for cause:" a pension worth about $6 million. Raines, on the other hand, would not have received the $7 million worth of options that automatically vested (as well as some other benefits), reducing the value of his retirement package from about $30-35 million to approximately $25 million. Thus, under the contracts, even if the executives had been terminated for cause following, say, a felony conviction, they still would have received substantial downside payoffs on the way out.

Interestingly, the $5-$10 million penalty imposed on Raines under a "for cause" termination would have been approximately $6 million higher had the board not amended his employment agreement shortly before he was fired. According to Raines' employment agreement of June 30, 2004, Raines' pension payouts were to be cut by 25% if he were fired for cause. This 25% penalty would have reduced the value of his pension from approximately $25 million to approximately $19 million. [12]

---

[11] *See* Stewart J. Schwab & Randall S. Thomas, What Do CEOs Bargain For? An Empirical Study of Key Legal Components of CEO Contracts 24 (Mar. 1, 2004) (working paper, on file with authors).

[12] According to Raines' employment contract, his pension payout is based on his deemed base salary (which is in excess of his actual base salary of $992,250) plus his other

However, as the government began investigating Fannie Mae's accounting problems, the board made a series of changes to Raines' employment agreement, including changes to the "for cause" termination provisions. One of these changes eliminated the 25% pension penalty. While many of these changes to Raines' contract were apparently made at the request of government regulators, it is unlikely that the government demanded Raines be paid his retirement benefits in full even if he were fired "for cause." Rather, it appears that Fannie Mae's board, on its own initiative, exploited the opportunity to eliminate the penalty for "for cause" termination even as the possibility of such an outcome was increasing. Even if this 25% penalty had not been eliminated, however, the terms of Raines' compensation contract would have guaranteed him a soft landing even if he had been fired for cause.

The other reason pushed-out executives enjoy soft landings is that boards tend to interpret compensation contracts in a manner favorable to executives.[13] If circumstances give a board the choice between firing an executive "for cause" and firing the executive "without cause", the board will typically prefer to go the latter route, which will tend to provide a larger payoff to the executive. For example, Fannie Mae's board did not indicate in its filing or otherwise that it had given any consideration to the possibility of terminating the executives for cause, even though there may have been grounds for such a termination and such a move could have saved Fannie Mae shareholders $5-10 million.[14] In fact, the board, by eliminating the 25% pension penalty under a "for cause"

---

taxable compensation, up to 100% of his deemed base salary. According to the June 30, 2004 version of the contract, if Raines were terminated "for cause," his pension would be based on his deemed base salary, plus his taxable compensation up to 50% (rather than 100%) of his deemed base salary. Because Raines' other taxable compensation always far exceeded his deemed base salary, the effect of a "for cause" termination would have been to reduce Raines' annual pension payout by 25%.

[13] *See* PAY WITHOUT PERFORMANCE, *supra* note 2, ch. 7.

[14] The board's decisions -- both to define "for cause" narrowly in the compensation contract and then to treat the termination as other than for "for cause," -- are generally protected by the business judgment rule if certain process requirements are met. Thus, even if the decisions fail to serve shareholders' interests they are all but impossible to successfully attack through derivative litigation. *See* PAY WITHOUT PERFORMANCE, *supra* note 2, at 45-48.

termination shortly before Raines stepped down, essentially tied Fannie Mae's hands so that such a termination could not be used to deny Raines an extra $6 million of pension benefits. Indeed, the board is now using the September amendment to Raines' employment contract to prevent shareholders from recovering any of Raines' payout, arguing that even if Raines had been fired for cause he would have received the same pension.

The last minute change to Raines' contract boosting his payout in the event of a "for cause' termination by $6 million can be seen as an example of what we call "gratuitous goodbye" benefit – essentially a gift given to executives on the way out. Boards often freely provide departing executives benefits not required by the executive's contract. Such gratuitous goodbye benefits take a number of forms, including forgiveness of loans, accelerated vesting of options and restricted stock, increases in pension benefits (for example, by "crediting" CEOs with additional years of service), awards of lump-sum cash payments, and promises of consulting contracts that will provide the departing CEO with generous annual compensation for little or no work.[15]

To be sure, Raines' gratuitous goodbye contract change will benefit Raines only if shareholders can convince a court that Raines' should have been fired for cause and should be required to return the difference between what he received and what he

---

15 For example, when CEO Jill Barad was forced out by Mattel's board in 2000, she had a $4.2 million loan forgiven and received an additional $3.3 million in cash to cover the tax liability arising from the forgiveness of another loan. In addition, her unvested options were allowed to vest automatically and to remain exercisable until the end of their original terms. These gratuitous benefits accompanied the severance package already guaranteed under her contract, which included a termination payment of $26.4 million, annual retirement benefits of more than $700,000, and other benefits.

Likewise, when Bank One CEO John McCoy was pushed out in 1999 for poor performance, he met with his friends on the board to hammer out a separation agreement. The package included a $10.3 million cash payment (in addition to $7.5 million in "special recognition" awards for 1997 and 1998), plus a pension of $3 million annually beginning in 2001. *See* PAY WITHOUT PERFORMANCE, *supra* note 2, at 88.

would have received had he been fired for cause. If Raines' termination without cause is upheld, the elimination of the 25% pension penalty will have no effect on his payout. The point, however, is that the board sought to benefit Raines at the expense of shareholders by fully protecting his pension payout even if he were fired for cause, and this protection was not required by the terms of his pre-existing contract.

Providing fired executives with a lavish soft landing is problematic. The cost of a soft landing goes far beyond the money given to the departing executive. This practice dilutes and weakens the incentives of executives to perform well. Executives are paid large amounts in order to provide them with incentives to generate value for shareholders. Providing failing executives with soft landings reduces the difference in financial payoff for performing poorly and for performing well – the very difference that shareholders spend a lot of money to create. Investors thus should press boards to introduce, and apply, compensation arrangements that reduce or even sometimes eliminate the value of retirement packages given to failing executives.

It is worth noting that soft landings also weaken the incentive effect of Section 304 of the Sarbanes Oxley Act. As noted earlier, Section 304 requires executives engaged in accounting-related "misconduct" to return to the firm bonuses or other incentive or equity-based compensation received within 12 months of a misleading financial statement." But Section 304 does not force executives to return any part of their substantial pension and other post-retirement payouts -- even if these payouts are based, in part, on earnings inflated by the executives in prior years. Thus boards can ensure that even an executive who has committed "misconduct" under Section 304 will enjoy a soft landing. The practice of soft landings thus undermines not only firms' incentive compensation arrangements, but also Congress' effort to deter executives from engaging in financial improprieties.

It might be argued that giving failing executives full retirement benefits and other post-retirement payouts is necessary – and justified – to provide risk-averse executives with insurance against the possibility that they will be forced out for poor performance. However, this insurance rationale seems unpersuasive. The insurance rationale is, if anything, more applicable to other employees. Other employees are commonly far more likely to be terminated than executives, but rarely receive a large stream of lifetime payments exceeding their salary. Given executives' accumulated wealth, they are likely to be less risk-averse and better able to insure themselves than most other employees. In addition, executives' large compensation packages are commonly premised on the need to provide them with incentives; incentive considerations might thus be even more important in their case than in the case of the average employee. Accordingly, relative to other workers, the termination packages of executives should be more sensitive to performance and reasons for departure – not less – and executives should therefore receive less protection, not more, in the event of failure.

To be sure, one could argue that failing executives' ability to receive full retirement payout is intended to protect them if they are forced out for reasons other than their own poor performance. However, given boards' reluctance to dismiss even mediocre CEOs, it is highly unlikely that a board will dump a CEO who is performing satisfactorily.

A related justification for soft landings is the difficulty of defining poor performance and failure by departing executives. But, at a minimum, boards could require provisions imposing a penalty under certain objective conditions that reflect a high likelihood of extremely poor performance. For example, departing executives could receive a lower termination payoff when their departure follows an accounting restatement or considerably lower stock performance relative to the company's industry peers over a sufficiently long period.

III. PAY DECOUPLED FROM PERFORMANCE

In discussing the retirement packages of Fannie Mae's executives, we have thus far focused on the fact that the reason for the executives' departure was not reflected in, and in particular did not reduce, the value of their retirement packages. We now turn to the fact that most retirement benefits are in no way linked to the performance of the company during the executives' years of service. The decoupling from performance of such a major component of executives' total compensation would be problematic even if the executives were retiring under normal circumstances. In discussing this issue below, we will focus on the details of Raines' retirement package, but the same problem afflicts Howard's package, albeit on a smaller scale.

The main justification given for large executive pay packages is the need to provide strong incentives to enhance shareholder value. During the 1990s, the large and ever-increasing levels of compensation received by executives were widely believed to be based on performance. The passage of Section 162(m) of the Internal Revenue Code in 1992 reinforced this general perception. Section 162(m) prevents firms from deducting more than $1 million annually of nonperformance compensation (e.g., salary) paid to any given executive. Because of the $1 million deductibility limit established by Section 162(m), and because most firms keep executives' salaries from exceeding this cap, it is commonly believed that nonperformance pay is limited to $1 million and that compensation in excess of that amount must therefore be linked to performance. The compensation schemes adopted by Fannie Mae illustrate why this has actually not been the case.

Fannie Mae, like many other firms, paid its executives salaries below $1 million. For example, as we saw in the summary compensation table presented in Section I, Raines (who was paid the highest salary at Fannie Mae) received an annual salary of $992,000 during the period 2000-2003.[16] However, Congress left a big loophole in Section 162(m). It neglected to apply Section 162(m) to payments that companies promise to make to executives after they retire. Thus, like most other companies, Fannie Mae was able to circumvent the limits Congress sought to impose on nonperformance pay by providing such pay through retirement benefits. Although Raines got a salary

[16] Raines' salary for 2004 has not yet been reported, but it presumably is also $992,000.

not exceeding $1 million for each year of service, his retirement package provided him with several millions of dollars of nonperformance pay for each year of CEO service.

The different elements of Raines' retirement package will be discussed in detail in the next section. Most of the value of the package comes from benefits promised to Raines in his employment agreement whose value is in no way linked to the performance of the firm. Raines (and his surviving spouse) will get a pension whose present value is about $25 million. In addition, he will get additional benefits, which could add up to several million dollars, from a deferred compensation plan, life insurance, and medical insurance for the remainder of his and his spouse's lives.

Thus, by channeling nonperformance pay through post-retirement benefits, Fannie Mae provided Raines with an additional $5-6 million for each year of his five-year service as CEO. As a result, Raines' nonperformance pay was several times larger than his reported salary and constituted a substantial fraction of his total compensation from Fannie Mae. The case of Fannie Mae suggests that in public companies salaries might be only the tip of a larger iceberg of nonperformance pay.

While we provide in this paper a dollar value estimate of the nonperformance pay Raines will receive from retirement benefits, such estimates are generally not reported by firms or otherwise easily available to investors. Although we have good reasons to believe that retirement benefits add substantially to the reported amounts of total executive pay, firms currently are not required to, and do not, include these amounts in the compensation tables on which media reporting and standard datasets are based. This brings us to the issue of camouflage.

V. CAMOUFLAGE

How far directors are willing to go in providing favorable compensation arrangements to executives, and executives' willingness to ask for them, depend on how the arrangements will be perceived by outsiders. Arrangements viewed as "egregious" will impose market penalties and social costs on the executives and directors. Because outsiders' perceptions are important, managers and boards have an incentive to adopt pay arrangements that will not elicit strong negative reactions by outsiders whose views the insiders care about. Thus, designers of pay arrangements will have an incentive to hide and obscure – that is, camouflage – the total amount of pay as well as the extent to which pay is decoupled from performance.

As we have explained in detail elsewhere,[17] firms have been using post-retirement payments to obscure large amounts of performance-decoupled compensation. Retirement benefits are a convenient form of "stealth compensation" because firms need not put a dollar figure on them and include them in the salient summary compensation tables contained in the firms' annual proxy filings. Firms are not required to include the dollar amount of these benefits either in the year in which such benefits vest or in the year in which they are actually paid to the executive.

Executive compensation at Fannie Mae is a case in point. Fannie Mae was not required to, and chose not to make easily accessible to investors, the monetary value given the departing executives. Fannie Mae did not make the amounts salient when the executives initially vested in these retirement benefits, and did not take the opportunity to do so later on when the executives left. Below we will focus on Raines' package, but similar points can be made about Howard's.

Upon Raines' departure, Fannie Mae disclosed that Raines' "retirement" triggered the immediate vesting and exercisability of 360,000 previously unvested and unexercisable options to purchase company shares. The company noted meekly that, because the options' exercise price was close to Fannie Mae's current stock price, the profit that Raines could make from immediate exercise of the option was about $215,000, less than $1 per option. The company declined to say anything more about the actual value of the options. However, these options, which will be exercisable for a long period, have a Black-Scholes value of approximately $7 million.

---

[17] *See* Lucian Bebchuk & Jesse Fried, *Stealth Compensation via Retirement Benefits*, 2 BERKELEY BUS. L.J. (2004) (forthcoming Nov. 2004) [hereinafter *Stealth Compensation*]; PAY WITHOUT PERFORMANCE, *supra* note 2, ch. 8.

According to the company's filing, it also will pay Raines a monthly pension of $114,000 for life (and for the rest of his wife's life, if she survives him). Fannie Mae chose not to put any dollar figure on this benefit, as it is free to do under SEC rules. To estimate the value of this annuity-like benefit we had to do obtain Raines' age (55) from the firm's proxy filings and search the web for information about the age of his wife (which we estimate to be approximately 47, based on her year of college graduation). With this information, and a bit of additional work, we came up with an estimate of $25 million for the Raines' joint annuity.[18]

Fannie Mae also disclosed that Raines has a balance of $8.7 million in his deferred compensation "account." Because Fannie Mae's disclosure indicated that the growth of this balance over time will be tied to the returns of mutual funds available on the market, one might think this arrangement does not financially benefit Raines at Fannie Mae's expense (relative to a scenario in which Raines takes the balance when he leaves and invests it himself in mutual funds). As we explain in detail elsewhere, however, this is not the case – the deferred compensation arrangement provides Raines with a tax-free buildup at a cost to the company.[19] Estimating the tax savings to Raines requires knowing, among other things, the funds to which Raines chose to link the returns on his deferred compensation balances. Thus, we are unable to provide an estimate of this value. Under some circumstances, however, it could be as high as $3-4 million.

In addition, Fannie Mae disclosed that Raines will get lifetime medical coverage

---

[18] We located a website that calculates the price of different types of annuities, including joint life annuities, based on the age and gender of the beneficiary or beneficiaries, and the monthly payment desired. (http://www.totalreturnannuities.com/information/annuity-calculator.html). Raines' pension pays $114,000 per month. The website calculated that an annuity paying $114,000 for the life of a 55-year old male (and for the life of a 47-year old female, if she survives him) would cost over $25 million. We received a similar estimate of the value of such an annuity from an actuary working with compensation consulting firm Brian Foley & Co. Incidentally, we were not able to obtain information about Howard's spouse (if any), and thus could not do a similar calculation for the value of his pension payout.

[19] *See Stealth Compensation*, *supra* note 15, at xx; PAY WITHOUT PERFORMANCE, *supra* note 2, ch. 8.

for himself, his surviving spouse, and his children, as long they qualify as dependents, and in any event until the age of 21. Fannie Mae will also pay the premiums on \$5 million of life insurance until Raines reaches 60, and on \$2.5 million of coverage thereafter, for the rest of his life. We have not made the effort necessary to estimate with any precision the value of these benefits, so we assigned a ballpark estimate of \$2 million.

We put together in Table 2 below the value of the different elements of Raines' retirement package as well as we could estimate them.

TABLE 2: THE RETIREMENT PACKAGE OF CEO FRANKLIN RAINES

Form of Compensation	Description	Company-Provided Value	Our Estimate of the Value
Immediate Option Vesting	370,000 options	$215,000	$7 million
Retirement Payments	$114,000 per month for Raines' and wife's lives	None	$25 million
Tax-Free Buildup on Deferred Compensation	Balance of $8.7 million, earning market return, with at least partial deferral through 2014	None	Difficult to estimate. $1-4 million.
Medical Coverage	Lifetime for Raines and Spouse	None	Difficult to estimate. Our guess: $1 million
Life Insurance	$5 million, declining to $2.5 million at age 60	None	Difficult to estimate. Our guess: $1 Million.
Total Post-Retirement Compensation		None	Difficult to estimate. At Least $33 million.

The discussion above indicates that estimating the dollar value of each of the components of Raines' retirement package requires some time and effort as well as certain information that is not readily available to investors. Even for those accustomed to reading SEC filings, coming up with these estimates requires a bit of work. The Black-Scholes value of the options must be calculated. The ages of Raines and his spouse must be determined. The annuity value must be estimated. The medical coverage for Raines and his family, as well as the life insurance, must be valued. It certainly would have made more sense for Fannie Mae to provide dollar figures for the components of the retirement packages rather than leave it for investors to try to do the task themselves based on incomplete information. But, Fannie Mae, like other companies, chose not to make the value of the retirement package transparent.

While the value of the retirement package was not transparent to investors even after Fannie Mae provided details of this package upon the executives' departure, it would have been even more difficult for investors to determine at earlier points in time what these executives would receive upon termination. It is important for investors to know the value of retirement packages as soon as executives vest in them, not only when they actually retire – which might be much later and too late for investors to react or apply pressure on the board.

Suppose, for example, investors had attempted to determine, one month before Raines "retired," the amount of options that would automatically vest upon Raines' retirement. One would need to locate in the SEC database Raines' employment contract, check for any subsequent modifications, and read and interpret the provisions relating to option vesting upon termination. Whether particular options vest depends on the retirement date and the date the options were granted. The dates of prior year option grants can be determined by scouring previous years' annual proxy statements (which are released in the spring of the following year). Other forms can be searched to determine the date of any options granted in the current year (and the previous year, if the proxy statement for that year has not yet been released). Once the options have been identified, we would know what ended up being reported in the post-retirement disclosure of the company: that, if Raines were to retire in December 2004, he would enjoy automatic vesting of 360,000 previously unvested options. Of course, the Black

Scholes value would still need to be calculated. It goes without saying that most shareholders and outside observers are unlikely to attempt to figure out which of Raines' options would automatically vest should he retire at the end of 2004, and the value of those options.

Determining the amount of Raines' pension payments one month before he retired would also have taken a significant amount of work. An investor reading only the part on retirement plans in the annual proxy statement could have well received the impression that – based on Raines reported salary of $992,00 and the formula generally used to calculate executives' pension payouts – Raines' pension would start only when he reached the age of sixty and would amount to approximately $900,000 a year.[20] But a discussion of Raines' compensation in another part of the proxy statement indicated that, for purposes of pension calculations, his salary would be deemed to be approximately $1,140,000. And, his compensation contract, which was not filed with the annual proxy but rather with another form at another time, indicated that Raines' pension would be calculated under a more generous formula.[21] Thus, the actual annual retirement payment is almost $1.4 million per year. Moreover, a close reading of Raines' employment contract indicates that Raines, unlike other employees, could begin receiving full retirement payments even if he retired at age 55.

As we highlight in our book, the practice of providing executives large amounts of compensation through retirement packages whose value is not transparent is widespread. Most firms provide executives with generous supplemental retirement

---

[20] The description of executives' pension plans in the annual proxy statements seemed to suggest that Raines was entitled to receive, at age 60, 60% of the sum of (a) his salary and (b) other compensation, up to 50% of his salary (where (a) and (b) are averaged over the three years in which his compensation was highest). It also indicated that executives retiring before age 60 generally receive a reduced benefit. In each year, Raines' other compensation exceeded his salary. The compensation table reports Raines' salary as $992,000. One might think that Raines, who retired at age 55, was to receive, starting five years later, a retirement payment of 60% of approximately $1.5 million, or about $900,000.

[21] Raines compensation contract indicated that he would be entitled to receive 60% of the sum of (a) his deemed salary ($1,140,000) plus (b) other compensation, up to 100% of his salary.

plans.[22] And, almost all firms have deferred compensation arrangements that can, at potentially significant expense to the firm, provide substantial tax-savings benefits to executives after they retire – benefits that are unrelated to the executives' own performance while they worked at the firm.[23] These amounts never show up in firms' annual compensation tables. As a result, they are not reflected in most media coverage of executive compensation or in the standard datasets of executive compensation levels. Indeed, the camouflage consequences of retirement benefits might well explain their large use even though most of the retirement benefits given to executives do not enjoy the tax subsidy the government provides to company-sponsored retirement plans for other employees.

Firms' ability to camouflage post-retirement compensation to executives could be reduced by improving the transparency of disclosure. While experts who take the time to do so may be able to calculate the monetary value of the various forms of retirement compensation provided to executives, these values are not as accessible to investors as the dollar values reported for many other forms of executive compensation, such as salary and bonus, which appear in firms' summary compensation tables. Firms should be required to attach monetary values to retirement payments as they vest and include these amounts in the annual summary compensation tables accompanying firms' proxy filings. In addition, firms should be required to provide a separate table indicating how much compensation and severance each highly paid executive would receive under the various termination scenarios contemplated in the employment contract (e.g., retirement, termination for cause).

---

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

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

A detailed description of our proposal can be found elsewhere.[24] However, it is worth providing an example of how disclosure of one important type of payout – pensions – can be better disclosed. Pension payments are generally based on years of service and historic compensation levels. The actuarial value therefore usually increases each year. The annual buildup in value of an executive's retirement plan is not, under current rules, reported in firms' annually filed summary compensation table. The payments themselves, which are made after the executive retires, are similarly not reported in this table.

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

In addition, firms should be required to put all the information about post-retirement payouts together to provide a complete picture of how much the executive would receive from the firm if she were to retire, be terminated for cause, or separate under other conditions at the end of the year. In particular, the SEC should require firms to publish a table showing the actuarial value of each high ranking executive's retirement package at the end of the year, the balances in any deferred compensation accounts, and the value of any post-retirement perks and consulting contract to which the executive would be entitled under each termination scenario described in the employment contract if she were to separate at year's end. This picture will better enable shareholders to form a judgment as to whether it is necessary for the firm to continue spending money to ensure that the executive has a comfortable retirement.

---

[24] *See Stealth Compensation*, *supra* note 16.

As we discuss elsewhere,[25] the measures above would provide shareholders with a more accurate picture of total executive compensation. They will thereby reduce the total amount of compensation executives could get below the radar screen. These measures could thus help constrain total compensation levels. More importantly, these measures also would reduce the distortions that arise when companies choose particular forms of compensation for their camouflage value rather than for their efficiency. Improving transparency in this area could thus substantially increase shareholder value.

V. CONCLUSION

A close look at Fannie Mae's executive pay arrangements and practices reveals serious flaws. These arrangements provided executives with large amounts of camouflaged pay unrelated to performance, diluted and even distorted the executives' incentives, and failed to make transparent the value of the retirement packages promised and given to executives. Fannie Mae's practices, however, are not unique to that company. They are unfortunately representative of prevailing compensation practices in public companies. The case of Fannie Mae thus provides us with a powerful reminder of the need to reform our systems of executive pay and corporate governance.

[25] *See Stealth Compensation*, *supra* note 16; PAY WITHOUT PERFORMANCE, *supra* note 2, ch. 15.