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Economic, Moral, and Motivational Criteria of Executive Compensation: Recent Developments

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Abstract: Recent economic developments have renewed societal debate about executive compensation practices in business organizations. This study explores economic, moral, and motivational criteria in decisions about how to best compensate executives in organizations. The essay devotes particular attention to new developments in this controversial debate. The authors propose that managerial work implies a kind of fiduciary trust necessary for the proper functioning of business activity and argue that executive compensation decisions and levels should be based on objective criteria.

Key Words: Business ethics, CEO pay, Clawbacks, Executive compensation, Economy and Society, Organizational ethics, Organizations and motivation, Say on Pay.

I. INTRODUCTION

The serious economic and financial market problems of recent years and especially the past few months have renewed and raised to a fever pitch a variety of economic and moral debates about executive compensation. U.S. Government bailout plans and other recent actions have brought new economic, legal, and ethical questions to an already complex and important discussion. How much executives are compensated and in what ways matters a great deal to the general functioning of organizations and to the overall health of the economy. Recent corporate scandals, financial market instability, the banking crisis, and ongoing real estate market weakness have moved many financial regulators and ordinary citizens to raise urgent questions about executive compensation, including whether and to what extent these problems have been made worse and perhaps even partly caused by irresponsible levels of executive compensation. The present economic environment has magnified and heightened concerns about the importance of properly compensating executives.

Compensation policies are highly significant to firms for a variety of basic reasons. Recently, new questions have been raised about how such policies may have contributed to serious problems faced by some organizations, particularly those in the financial sector. For example, in 2007, employees at Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers, and Bear Stearns received a combined \$39 Billion in bonuses; in 2006 bonuses for these firms totaled \$36 Billion [1]. Payouts of this magnitude have caused economists and mortgage market analysts to question how such compensation has contributed to some parts of the financial crisis. Recent attention in popular

media, business press, and academic literature has highlighted and examined a variety of current cases of potential compensation conflicts and market issues. A number of controversial highlights include: AIG paid \$13.9 million to Martin Sullivan in 2007 and then lost \$37.6 Billion; Bear Stearns compensated James Cayne \$290.4 million; Lehman Brothers paid Richard Fuld \$47.7 million in 2007 and folded; E. Stanley O'Neal as Merrill Lynch CEO earned \$157.7 million over 6 years and then his successor John Thain was awarded \$ 83.1 million in 2007 [2]. According to a study prepared for the New York Times, "executives at seven major financial institutions that have collapsed, were sold at distressed prices or are in debt to the taxpayer received \$ 464 million in performance pay since 2005" (p.1) [2].

Efforts to reclaim some of these financial rewards, termed *clawbacks*, seek to challenge excessive executive compensation plans. Of course, there are many ways that top executives can reward themselves and others, such as replacing past bonuses with higher base salaries. Both shareholders and taxpayers are motivated to find some level of justice through legal actions to redistribute the wealth that found its way into a few pockets while so many other people are suffering or out of work. Also, why have some segments of executive compensation been so out of line with other areas of society such as academics, primary care medicine, science, engineering—all of which are also necessary to the basic functioning of society but command much lower levels of recompense? What constitutes a just and reasonable level of compensation? The issue at hand is how best to determine just and fair criteria.

II. HYPOTHESIS

Corporate scandals involving questions of improper executive conduct and unjustifiable compensation have negatively influenced the current economic crisis and the general support of costly taxpayer bailout programs. If

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executive performance were to be measured by objective economic criteria in a moral and practical framework, then much fairer levels of compensation could be determined. In the present environment this has not occurred.

Executive compensation decisions and levels should be based on objective criteria. These criteria could be carefully established by the board of directors and monitored by an independent review board. The emphasis here is on having measurable and agreed upon criteria. It is not acceptable to say that because of past performance, executives deserve excessive compensation while their companies falter.

III. ECONOMIC CRITERIA

Many past economic arguments for high compensation no longer seem relevant in the current market. While one can make a strong case for keeping talent by rewarding them, it no longer holds true that executives will jump ship as soon as they feel under-compensated. There aren't that many other ships to sail on. In the present economic environment, real questions arise about whether or not the retention argument is still as valid as it was in the past. The recent uproar over executive bonus payments by the insurance giant A.I.G. illustrates all too well the complex systemic problems and failures in compensation decisions inside many organizations. Now nearly 80% government-owned as part of federal bailout actions, A.I.G. had planned 2009 bonus payments to employees even after receiving billions of dollars of taxpayer funds. While previous salary contracts may legally require such payments, in this case it seems clear a significant break exists in the link between performance and compensation. Many of the employees slated to receive these bonuses performed poorly and made serious errors related to A.I.G.'s near financial collapse. From the economic and moral points of view, the present public outcry is understandable and further points to the apparent conflicts in linking firm economic performance with compensation practices. Since mid-2007 banks worldwide have lost more than \$1 trillion and some experts have predicted that total losses could eventually reach three times this figure [3]. During this period tens of thousands of bankers and traders have lost their jobs, so leaving for another higher-paying organization seems a much less likely option in the present business climate. Recently proposed pay caps may enable firms much more flexibility and selectivity in choosing and retaining executive talent.

Performance and its measurement has for some time been a central focus in debates about executive compensation. Critics of high levels of CEO and other executive compensation often have argued that pay levels have only been loosely linked to actual performance [4]. There has been debate about how to effectively measure executive performance. Should measurement be directed primarily toward the objective of maximization of shareholder value? If so, how exactly should a group of executives be measured in line with this performance objective? Some approaches set target objectives and make comparisons to a peer group of other executives from similar competitor firms. While a basic justification for the use of stock option compensation is to encourage effective performance, this form of compensation

can often complicate measurement and assessment. Performance measurement problems (and also basic questions in calculating overall total executive compensation) are often related to the kind of stock option plan adopted in organizations (e.g. fixed value, fixed number, or mega grant plans). It is also not easy to measure the particular contributions of individual executives to an organization's overall goals. Some researchers have suggested that empirical evidence that examines the correlation between pay and firm performance is generally mixed and inconclusive [5]. Measurement of stock option grants especially as these relate to pay over particular time periods is complex and difficult. This basic problem can often lead to a blurring of the important link between compensation and performance.

IV. MORAL CRITERIA

It is important to distinguish between ethics and morality and to indicate how these terms are used in this article. Ethics is primarily concerned with theory, foundational justifications, and methods of judgment. Ethics as a discipline examines questions about why and on what theoretical basis are we to act morally. Morality is mostly concerned with practical application and considers questions of moral judgment and decision making. Morality deals with the how of applying practical judgments about what we are to do as moral agents. These two constructs are both necessary and interdependent. There has been a vacuum on Wall Street and in many organizations both moral theory and proper behavior have been lacking.

At the most fundamental level executives manage the wealth and assets of others and also the wealth and economic livelihood of society. Managers are entrusted to direct the use of scarce organizational resources to meet a firm's objectives. The nature of managerial work implies a kind of trust that is necessary for the proper functioning of business activity. In a sense executives and employees are stewards entrusted with the wealth, assets, and often the knowledge developed by others. Responsible compensation systems seem to be a central part of the trust necessary for the proper functioning of organizations both internally and externally. When compensation is not ethically (in theory) or morally (in practice) justified, this important relationship of trust can become dysfunctional and disordered bringing harm to organizations, society, and also to individual executives.

Executives provide important and necessary skills to organizations and markets, and they clearly deserve just and fair compensation for their efforts. Yet executives and all employees are members of organizations and, as such, clearly have economic and moral obligations to these social bodies. This association implies that executive compensation decisions acknowledge fundamental obligations of stewardship and fiduciary duty. Executives and employees have serious agency obligations to serve the best interests of their organizations. In many firms executive compensation levels have become unbalanced and are not based on objective performance criteria. Boards of directors have essential responsibilities and important duties to manage accountability. In recent years it seems that many boards have been unable or unwilling to do this adequately.

Conflicts of interest on various levels represent a fundamental part of many internal problems with compensation practices. Executives and their boards each have duties to minimize these conflicts as much as possible and to develop workable systems and practices to address these problems.

Stewardship means that executives “work for others” and this relationship imposes obligations like that of fiduciary obligation. The important idea of “stewardship duty” for executives and all employees may provide an ethical basis on which to guide practical moral decisions about executive compensation.

V. MOTIVATIONAL CRITERIA

Many of the specific justifications for high levels of executive compensation are based upon the need to encourage and motivate superior performance by executives who have significant and difficult management responsibilities. Since CEOs and other top executives carry out complex duties of leadership, function in highly competitive markets, and work long hours with heavy travel commitments and great pressure to achieve short term financial results, it has been widely accepted that they deserve excessive salaries and other non-cash compensations. Since high-level managerial talent is usually seen as a scarce resource with the potential to bring about future profits (sometimes at very high levels), corporate boards have argued that it is necessary to pay executives at exceedingly high levels in order to positively motivate their activities.

Recent news reports about large executive bonuses even under conditions of a massive government bailout program in the financial industry point to a fundamental denial of the problem in many organizations. Often justifications for lavish executive bonuses note that these are necessary to encourage superior performance which is tied to profitability goals. At the same time it seems evident that serious greed is also a central part of the problem. Many executives seem to simply think, “I deserve it, I made the company what it is, and so on.” Some of the basic questions here include: How can or should such a culture of greed be dealt with? Is cash as big a motivator as we think it is? Are there margins or levels of compensation at high levels where there is a kind of diminishing returns? Is greed acceptable just because it is born out of habit? What about quality of life issues for executives, such as family concerns, time with family, overwork?

It may be that excessive salaries represent some other measure of success rather than the monies alone; could it be winning the competition and being at the top of the leadership profile race? That is, “I make more money than you, so I am better than you. I win.” This train of thought would suggest that other measures of success could be employed to sustain and retain executive talent such as peer review and business rankings. It may be that the most successful executive could become the one whose company wins in the market place, has the most satisfied employees or does the most good for society (similar to a non-profit model). It seems clear that motivation and morale inside firms could be improved by adopting more coherent, rational, and fair compensation practices.

VI. CLAWBACKS, VOLUNTARY GIVEBACKS AND PAY REDUCTIONS, AND RECENT LEGAL DEVELOPMENTS

The “say on pay” movement has gained new momentum in the deepening financial crisis, recent government financial bailout efforts, and the new initiatives of the Obama administration. There has emerged new urgency in debates about executive compensation due to a variety of recently enacted laws and regulations. While the Sarbanes-Oxley Act of 2002 enacted important provisions affecting executive compensation, new rules have dramatically changed the legal landscape in executive compensation practices.

Under Sarbanes-Oxley the CEO and CFO of a publicly traded firm may be required to forfeit bonuses or performance incentive compensation received in the previous 12 months if company financial reports required restatement under SEC reporting requirements [6]. Sarbanes-Oxley also regulates personal loans to executives and gives the SEC powers to remove or temporarily freeze payments to executives and directors [6]. The rules continue to develop and change and have generally become more restrictive.

The new rules as part of federal bailout efforts recently announced by the Obama administration and the U.S. Treasury in early February 2009 set up two categories: (1) companies needing “exceptional assistance” (e.g. Bank of America, Citigroup, and AIG), and (2) firms seeking assistance through already available government programs such as the Troubled Asset Relief Program (TARP) [7]. The pay restrictions for firms needing exceptional help are more demanding and include provisions such as maximum annual pay of \$500,000 except for restricted stock, pay disclosures to shareholders for a nonbinding vote, clawback procedures in cases of misleading information, and restrictions on severance packages and on luxuries such as private jets and entertainment. Since these rules are so recent the practical effects on compensation procedures are not yet fully clear. Yet this new regulation changes compensation practices in significant ways. Some executives have recently volunteered to accept pay cuts and in some cases have agreed to return compensation. Various organizations seem to be handling these new restrictions differently. What is clear is that new government bailout efforts that make use of taxpayer funds are dramatically affecting the executive compensation practices in organizations throughout many industries.

VII. CONCLUSIONS AND FUTURE DIRECTIONS

In the present economic environment, organizations would do well not only to follow the law in questions of executive compensation. They must do much more than just the minimum in this arena. There is much to be gained by firms internally and externally with respect to actual economic impacts and public moral perceptions. In this volatile economic climate, society is now demanding that business organizations behave more responsibly in this area. It seems clear that past failures have been part of the problem. There will likely be more regulations proposed, but if business is able to deal more appropriately and effectively on its own initiative with the problem, the terms in the end may be less restrictive. If business responds voluntarily and works creatively to find practical and workable solutions,

organizations may legally be granted more flexibility rather than being forced to adopt even more stringent executive compensation regulations.

We recommend that, in addition to already existing compensation committees, firms work to develop a new panel inside their organizations with the responsibility of assessing and monitoring executive performance and assigning fair compensation levels. While this should already be happening through the work of board compensation committees, the process at present seems not to be working adequately. The board compensation committees in many organizations most likely focus on CEO and top executive pay and less on the compensation packages for other high-level executives. Better methods of measurement are needed to make timely and fair evaluations. The link between pay and performance must be further strengthened in all executive compensation decisions and practices.

The current economic climate seems by common sense and sound ethical principle to demand a certain level of “virtuous frugality” in compensation decisions. It could also

be argued that executives who accept lower compensation packages could in the end better understand the market itself and other citizens who are also dealing with such reductions in the present economic environment.

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