

# CORNELL HR REVIEW

## THE EXECUTIVE PAY DRAMA: FROM COMEDY TO TRAGEDY

*David J. Cherrington*

Over the past century, an interesting play has been performed in the United States called *Executive Pay, Starring Your Local CEO*. The play opened as a *comedy*, with executive bonuses and stock options rising at ridiculous rates compared to the pay of factory workers, teachers, and engineers.<sup>1</sup>

The performance didn't get a lot of laughs, but people would smile and shake their heads as if the surprise of ever-escalating pay was an amusing disclosure. During economic downturns there were fewer smiles, and some outspoken critics were remarkably blunt in labeling executive pay practices as "enormous," "immoral," and "outrageous."<sup>2</sup> The title of the cover story in a 2003 *Fortune* article forthrightly asked "Have They No Shame?"<sup>3</sup> This article described dozens of CEOs who accepted millions of dollars in bonuses and stock options while their firm's shareholder returns plummeted.

The play subsequently evolved into a *drama* and the players included not only CEOs but also others in the finance industry who received millions of dollars in salaries and outrageous bonuses. The audience's reaction to this drama can best be described as public outrage for the entire cast. The reason for this outrage is that the money for these outlandish bonuses was provided by government bailouts. However, it should not take much to see that the source of these outrageous compensation packages is not much different than before. It still comes from the same people: employees, stockholders, and tax-paying customers.

A new role was added to the cast of characters in 2009: a pay czar who is responsible for setting fair compensation. Like the traditional villain, this person is in an impossible position and knows that whatever he does will be criticized by some for doing too much and by others for not doing enough.

Our response to this drama contains an important lesson in morality for all of us. Should we rely on legislation to correct problems or should we act collectively to make ethical decisions? After careful thought, it becomes clear that legislation is a seductive copout that makes matters worse and detracts from our obligation to accept accountability for our individual and collective decisions.

### **The Failure of Legislation**

During the 1990s, the United States Congress thought it had the power to rein in rampant pay increases. It capped the amount of pay that can be treated as a pre-tax expense at \$1 million, *unless* the additional compensation was based on performance measures. Rather

than tying executive pay to performance, this law had the unintended consequence of establishing \$1 million as the minimum CEO salary. From this act emerged a new compensation norm and a scramble for higher pay.<sup>4</sup>

Quickly our drama became a *soap opera* as executives and their boards manipulated performance targets, granted additional options, and backdated stock options to perpetuate ever-increasing executive pay.<sup>5</sup> Dozens of executives and their compensation committees were shocked to see the vigor with which executives were prosecuted for simply altering the date of their stock options by a few days to increase the value of the grant. Dozens have been accused of such manipulations and most of them either resigned under pressure or were terminated in disgrace. Investigating and prosecuting this problem could overwhelm our legal system since it is estimated that as many as 2,000 companies improperly backdated stock options.<sup>6</sup>

On one hand, their punishments were just—they should have known the law and obeyed it. On the other hand, if their boards wanted them to get more money, they could have simply granted more shares or manipulated the requirements in other ways to get around the problem. At any rate, the soap opera continued with ever-escalating pay levels plus criminal sanctions and a cadre of inspectors and prosecutors. Keep in mind that inspectors and prosecutors do not produce consumer products that improve the quality of life; time spent in court is time spent away from other productive activities.

Something we should learn from this soap opera is that federal regulations are neither effective nor efficient. *Compensation needs to be viewed as a moral issue that must be guided by ethical criteria rather than legal constraints.* People who are smart enough to run our corporations are smart enough to subvert legislation restricting their pay.<sup>7</sup>

This drama is not unique to the United States; there is moral outrage in other countries calling for legislative restraints. Member states of the European Union have pleaded for international cooperation to launch a united front aimed at curbing excessive pay and bonuses. In the United Kingdom banks are required to pay a 50 percent tax on individual bonuses that exceed £25,000 (about \$41,000).<sup>8</sup> Thus a bank that gives someone a £35,000 bonus would have to pay a £5,000 tax.

Within the past few months, our executive-pay play has turned into a *tragedy*, as the 2009 stimulus law prohibits any company that receives a federal bailout from paying bonuses to top earners. Bonuses may not amount to more than one-third of their total annual compensation. This restriction will severely impact top officials in the financial services industry where they have become accustomed to receiving bonuses worth millions of dollars and in some cases even hundreds of millions of dollars.<sup>9</sup> Now, an employee earning \$1 million pay can receive a bonus of no more than \$500,000, which is one third of \$1.5 million total pay.

It will be interesting to see how the new law is administered and how public pressure impacts the interpretation of the new restrictions. It will be even more interesting to see whether executive pay moves toward reasonable levels or continues to escalate after the

companies that received bailouts repay the loans. History suggests that when the downturn reverses, moral outrage will subside, boards will find new ways to give exorbitant earnings, and executive pay will continue to escalate.

On the other hand, if the caps on executive pay are effectively enforced and heavy punishments are administered to those caught violating them, is this really a desirable situation? Do we want arbitrary limits on executive compensation and should these decisions be made by government officials? Do we want criminal sanctions imposed on those who violate the caps with all of the wasted time and effort that criminal enforcement entails?

Lost in this debate is any discussion about the morality of executive pay and what ethical standards should be used to make pay decisions. Why should the pay packages in the financial services industry be so much greater than wages in the retail industry? Does anyone appreciate how much money must be invested at a given interest rate to generate a \$10 million bonus for just one person? Do board members appreciate how many vehicles must be sold on narrow profit margins to cover the cost of an auto company executive's stock grant?

### **Ethical Processes**

From an ethical perspective, two ethical processes help us understand why executive pay has become so distorted: the normalization of bad behavior and paying for peril. The *normalization of bad behavior* refers to the gradual rationalization of misbehavior that occurs over time. The first time we do something wrong, we usually feel guilty because we know our behavior violates a standard of acceptable conduct. But when we do it the second time, and each succeeding time, the feelings of guilt are reduced as we rationalize what we have done. This process is illustrated by the proverb: anything you do wrong the first time is easier to do the second time. Another proverb in the behavioral sciences is that whenever there is an inconsistency between one's attitudes and behaviors, behavior always wins, meaning that we will rationalize our misbehavior by changing our attitudes rather than reform our misbehavior. Rationalization is especially easy when we see others doing the same thing.

The application of this ethical process to executive compensation requires only a cursory glance at the history of CEO pay. As a multiple of the average worker's pay, the median CEO pay has grown from a multiple of 24 times in 1965 to 50 times in 1985 to 91 times in 1995, to 194 times in 2005.<sup>10</sup> This long history of escalating increases naturally induces executives to expect enormous salaries, big bonuses, and large amounts of stock options. Rather than thinking they are overpaid, the normal rationalization process would cause them to honestly believe they deserve everything they receive, even if they are terminating jobs and closing factories.

The *paying for peril* process refers to rewarding short-term successes and overlooking the long-term suffering that might be caused. Executives have historically been rewarded for taking on excessive risk in the quest to increase next quarter's profits. This short-term

thinking has been driven by the increasingly clamorous demands of shareholders for higher earnings and compensation formulas that reward executives for immediate profits. The long-term consequences of these risky decisions may be unclear, but what is clear is that the executives will not be held accountable for them.

Paying for peril can be observed when executives who are eager to maximize the value of their stock options begin adopting massive stock-buyback programs that drain much-needed capital out of their firms, jumping into risky “proprietary trading” strategies with credit default swaps and other derivatives, cutting payroll and research and development budgets, and even resorting to outright accounting fraud to hide liabilities in off-balance-sheet entities.<sup>11</sup>

To reduce this unhealthy obsession with short-term profits, many have suggested tying executive compensation to long-term profitability. Many efforts have been made in this direction by giving executives restricted stock awards that vest over time when specific performance goals are achieved. Occasionally executives have been greatly disappointed when their companies have failed to achieve the necessary goals, often due to economic factors beyond their control. Others have been severely punished by receiving stock that has declined in value. This is the way capitalism is supposed to work, but it is not necessarily fair.

Across the board, we need to discuss a new paradigm for deciding executive pay; and we need to address it as an ethical issue rather than a legal problem. Hopefully, compensation committees will begin to recognize that enormous pay packages are outrageous and immoral—they destroy the viability of companies and society, and they are blatantly unfair relative to others.

### **A Fair Compensation Maxim**

I propose the following pay maxim (ethical guideline), not just for executives but for all employees: *employees should be compensated first according to the requirements of the jobs they perform and how well they perform them, and second by labor market conditions (supply and demand) and the organization’s ability to pay.* Obviously, this guideline is not precise; it requires judgment and experience to implement. But all managerial decisions are moral decisions that require judgment and skill.

The greatest obstacle to deciding what is “fair” is the absence of a clear standard for making pay decisions. There are no universal standards or formulas for calculating how much money an employee deserves. When we examine how much people earn, the range of pay is so widely dispersed that there seems to be no semblance of order. In frustration, many people conclude that pay is random and depends simply on whatever each worker can negotiate. This may be the case with executive pay, but it is not true for the vast majority of employees whose pay is established by legitimate compensation criteria.

## Pay Fairness Criteria

When we segment the labor market, we discover that there are legitimate criteria that ought to be used to make pay decisions. Stated differently, rational and reasonable decisions can be made regarding what is a fair range of pay when we divide the labor market into meaningful job categories. One labor-market segment consists of blue-collar and non-supervisory white-collar workers. These are the people who work in the offices, stores, and factories of America. They are typically paid according to an hourly wage rate with no bonuses or stock options. Their pay is determined by such compensable factors as mental and physical demands, knowledge and skill requirements, and working conditions.

In spite of a few exceptions, wage surveys indicate that most of the workers in this labor segment receive wages that seem quite legitimate. The range of pay for this labor segment is about 1:2 for blue-collar jobs and 1:3 for non-supervisory white-collar jobs. That is, an entry-level blue-collar worker makes about half as much as a highly skilled, senior worker doing the same job. The highest paid office workers make triple the pay of entry-level workers doing the same work. These pay ranges seem reasonable since highly skilled, experienced workers deserve to be paid more and organizations want to reward both performance and seniority. It seems legitimate for companies to reward loyal workers who stay with the company.

Another labor-market segment consists of professional employees. This segment includes employees such as teachers, engineers, chemists, and doctors. These workers typically receive an annual salary that is based primarily on the amount of knowledge and education required to certify as a professional. The pay of professional workers increases with years of service since experience is seen as an important predictor of ability and performance. Again, wage surveys provide useful data showing what professional employees ought to be paid and their compensation can be justified by legitimate criteria. The range of pay for these employees is usually about 1:4 or 1:5, depending on the profession and the company. That is, senior-level partners in accounting and law firms are typically paid about four or five times as much as entry-level professionals just joining the firm. The legitimacy of these wide pay differentials are sometimes questioned, but they are justified by the contributions senior partners make to the firm. Senior partners are primarily responsible for acquiring new business and making strategic decisions that protect and perpetuate the firm.

Professional athletes, entertainers, and entrepreneurs form a third labor segment, and their incomes are extremely diverse and frequently criticized. Some receive little more than minimum wage, such as dancers and singers in chorus lines, while others receive millions of dollars for only a few hours' work. The compensation of this group is not based on job-related compensable factors like the previous segments but on the laws of supply and demand. If two people can convince a million people to pay \$100 each to watch them put on gloves and bash each other in the face, they can split \$100 million dollars. Anyone who makes a movie or a CD and sells it to a million listeners for a ten dollar profit will earn \$10 million.

People who are outraged by the incomes of professional athletes and entertainers should think twice before seeing their movies or attending their concerts and games. But we should also think twice before we take any actions that would prevent these people from receiving the profits from their efforts. Some entrepreneurs make millions of dollars and we should congratulate them and appreciate their success because it means that they have done something that is perceived by the consuming public as providing a useful product or service. In general, societies benefit from the contributions and economic success of their entrepreneurs; the entrepreneurial spirit that is fostered in selected cultures ought to be viewed as a national treasure.

Executives and managers form the next segment of the labor market. This segment is where our ethical standards generally crumble with respect to compensation. The pay of this group ought to be determined by the requirements of the job (such as level of responsibility, number of people supervised, and number of levels in the company); how well they are performing (as reflected by the long-term profitability of the company); the uniqueness of the person's contribution to the company's success; and the profitability of the company. Instead, executive pay is determined more by sources of power than by rational compensable factors.

Before 1990, the pay of CEOs was criticized for being enormous and exorbitant. Year after year, the disclosures of CEO compensation were accompanied with surprise and indignation, and there were countless suggestions that "something" needed to be done. The moral outrage against exorbitant CEO pay was especially bitter during economic downturns when executives were reaping gigantic salary increases, bonuses, and stock options at the same time they were closing factories and firing workers.<sup>12</sup>

During the past two decades the disease of exorbitant pay has spread like a cancer beyond CEOs to other executive and administrative jobs, including boards of directors. Board chairmen, chief operating officers, chief finance officers, and other vice presidents have also come to expect lavish stock options and bonuses that often exceed a million dollars. In the financial services industry, exorbitant bonuses are even paid to hundreds of employees who have no managerial responsibilities. Many money managers, especially hedge fund managers, have come to expect multi-million dollar bonuses as an acceptable and normal part of their annual pay.<sup>13</sup>

### **Power versus Rational Compensable Factors**

Executive pay is set by the board of directors, which sounds quite rational except for the fact that pay recommendations are usually made by compensation committees comprised of other executives who are equally overpaid.<sup>14</sup> These pay recommendations are biased by comparisons with other executives and foolish myths.

One myth is the idea that every executive deserves to be paid above average. This is a myth that every good statistician knows is statistically impossible. It is easy to appreciate the interpersonal dynamics in a board of directors as they discuss executive pay and how this dynamic leads to large pay increases. If the board thinks the executive team is doing

well, they want to reward them with above average pay. But if the executive team is not doing well, the board may still decide to award above average pay to encourage them or to prevent negative feelings. Either way, no board wants to pay its executives below average even though, statistically, half of them must. But this is exactly what the boards need to do. They need to base their decisions on a totally different set of compensation criteria that ignore the distortions of history.

A second myth is that executive pay should be comparable to the pay of professional athletes, entertainers, and entrepreneurs, although there are no good reasons for such comparisons. Saying “If professional athletes get millions of dollars, why shouldn’t we?” is more like a greedy rationalization than a thoughtful reason. It would be more meaningful to compare their responsibilities for decision making, leadership, and financial control with such positions as governors, state and federal legislators, university presidents, and military leaders.

The market conditions of supply and demand that play such a prominent role in the determination of pay for professional athletes, entertainers, and entrepreneurs are not the same for executives and administrators. Even hedge fund managers do not deserve a fixed percentage of the profits they generate for their firm because they are not using their own money, they are not a sole proprietor bearing the risk of their actions (“entrepreneur” means *risk bearer*), and they do not suffer the consequences of bad decisions.

Executives are employees in an organization and their compensation should be based on reasonable compensable factors the same as for professional, blue-collar, and non-supervisory white-collar positions. Job evaluation systems, such as the point method, should be used to determine the pay ranges for executives. Obviously, executives will receive many points for such compensable factors as supervision and financial responsibility, so their pay will be noticeably higher than for other employees; but their pay will be based on reasonable pay factors rather than the power relations among board members.

Another myth is that executives are indispensable and could never be replaced by anyone else, a myth that history and experience fails to support. Rather than offering lavish bonuses, humongous stock options, and enormous retention packages, boards ought to pay reasonable amounts and be prepared to wish them well if they choose to leave. There are times in history when a key executive has made a crucial strategic decision or had a dramatic impact on the survival and success of a company because of his or her leadership or charismatic personality. At such times it is difficult to refute the claim that such individuals deserve lavish rewards for their unique contributions—they saved thousands of jobs, generated billions in profits, and produced valuable products and services for society. But most of the time, there are many other leaders who have the potential to step into the position and do just as well or better. Are gigantic signing bonuses and retention packages really necessary, or are they simply part of a culture of excessive pay and greed that has become disassociated with a careful ethical analysis of what is fair and reasonable?

## Conclusion

The history of executive compensation clearly illustrates a decision-making process that has escalated out of control because the decisions were based on biased comparisons and power relationships rather than sound compensation theory. History also demonstrates that legislative attempts to control executive pay have been dysfunctional and have only exaggerated the problem. Future legislation will likely be equally ineffective; but even if it succeeds, it will be undesirable. Neither the legislative nor the executive branches of government are equipped to set rational caps on salaries, nor are they capable of evaluating the performance of executives and making informed decisions regarding fair bonuses. Caps on bonuses and salaries would have to be administered universally and all incentive and innovation would be destroyed. Laws have never motivated people to excellence—they have always produced the moral minimum. The greatest disruption, however, would likely be the legal challenges against those accused of violating the caps and the loss of time and money on both sides trying to resolve these challenges. Decisions regarding executive compensation should not be decided or enforced by the law. This should not be a legal issue.

As a society, we need a new paradigm for deciding executive pay that is based on ethical criteria and sound compensation theory rather than legislative restrictions. Fairness needs to replace greed as our basic criterion for creating pay packages. ✎

*David J. Cherrington is a Professor of Organizational Leadership and Strategy at the Marriott School of Management, Brigham Young University. He received a DBA from Indiana University Bloomington and is certified by the Society for Human Resource Management as a Senior Professional of Human Resources (SPHR).*

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