Business Ethics

Decision Making for Personal Integrity and Social Responsibility

Second Edition

Laura P. Hartman
DePaul University

Joe DesJardins
College of St. Benedict/St. John's University

Moriarty—
"How Much Compensation Can CEOs Permissibly Accept?"

McGraw-Hill Irwin ©2008

interest of shareholders to support the formation of Stakeholder advisory forums.

Stakeholder forums also provide a framework for managers to work with suppliers to monitor Just In Time delivery of supplies and work with customers on Total Quality Control of goods and services. Research by Hippel (1986) found that most product innovations were contributed by customers rather than the R & D department of a firm. It is in these ways that Stakeholder Councils can improve operations and competitive advantages (Turnbull 1997, 2005a).

The introduction of watchdog boards and stakeholder councils creates "network governance" as found in living systems (Turnbull 2002a). Jones, Hesterly and Borgatti (1997) describe how competitive pressures in complex dynamic industries forces firms to adopt network governance. The reasons why network governance allows ordinary people to achieve extraordinary results as found in the MCC outlined in Section 3 and as explained by Turnbull (2000c: 239–49).

Network governance not only creates a division of power to remove and manage conflicts of interests but also introduces a requisite variety of communication channels, control and decision making processes to minimize errors and improve operations. Network governance as outlined in this reading indicates why so called "best corporate governance practices" are both unethical and less competitive.

End Note

1. It also means that directors can report a profit when a loss results. Consider a company that only owned an uninsured investment described above that was destroyed shortly after a profit was reported for its first year of operation. The return *of* the investment would be less than 40.

Note: Notes and references removed for publication here, but are available on the book website at www.mhhe.com/busethics2e.

Reading 10-4

How Much Compensation Can CEOs Permissibly Accept?

Jeffrey Moriarty

Executive compensation has received a great deal of attention. This is due, in part, to the large amounts of pay executives, especially CEOs, receive. In 2006, the median total compensation of the top 150 U.S. CEOs was $10.1 million. This is 314 times the $32,142 earned by the median full-time private industry worker in the U.S. that year. This paper examines some moral aspects of executive compensation. It is not the first to do so, but it engages the issue from a new perspective. I focus on the duties *executives themselves* have with respect to *their own* compensation, and argue that CEOs' fiduciary duties place a moral limit on how much compensation they can seek or accept from their firms. Accepting excessive compensation leaves the beneficiaries of their duties (e.g., shareholders) worse off, and thus is inconsistent with observing those duties. Like others who write on executive compensation, I am primarily interested in chief executive officer compensation. By 'executive', then, I mean principally 'CEO'. However, most of what I say applies, with minor modifications, to the pay of other top executives.

1. The CEO's Fiduciary Duty

I begin with the common assumption that executives are fiduciaries. What does this mean? Marcoux explains, "[t]o act as a fiduciary means to place the interests of [a] beneficiary ahead of one's own interests and, obviously, those of third parties, with respect to the administration of some asset(s) or project(s)" (2003: 3). In the CEO's case, the asset or project is the firm. So, CEOs are required insofar as they are fiduciaries to place one party's interests ahead of their own and others' when managing the firm. That is, they have a *fiduciary duty* to do so.

According to some writers, CEOs are fiduciaries for shareholders (Boatright, 1994; Marcoux, 2003). According to others, they are fiduciaries for all stakeholders (Evan & Freeman, 2005). The moral limit I identify exists if CEOs are fiduciaries for *anyone* who stands to lose when CEOs accept excessive compensation. This includes shareholders, stakeholders, and certain other parties. To fix ideas, however, I assume that CEOs are fiduciaries for shareholders.

I further assume that CEOs are fiduciaries in a *moral,* not merely *legal,* sense. To determine whether CEOs' fiduciary duties in law have implications for their pay negotiations with directors, all that is required is to look at the relevant law. My goal is to determine to what, if any, implications CEOs' moral fiduciary duties have for their negotiations with directors.

Assuming that CEOs have fiduciary duties in the moral sense (hereafter, I drop this qualifier), what follows about how they should manage their firms? It is standardly assumed that shareholders want to maximize the monetary value of their investments. Thus, in his classic defense of shareholder theory, Friedman says that a CEO is obligated "to conduct the business in accordance with [his employers'] desires, which generally will be to make as much money as possible" (2005: 8). Let us assume that shareholder value is maximized when firm value, which Jensen defines as "the market values of the equity, debt, and any other contingent claims outstanding on the firm" (2002: 239), is maximized. If so, then executives should manage the firm so as to maximize its value. Managing the firm this way has implications for how much compensation a CEO can permissibly seek or accept from it.

Compensation produces value for the firm by attracting and retaining talented employees, and motivating them to do their best. But compensation is a cost. Other things equal—where "other things" includes the firm's performance—the lower this cost is, the better. It is widely believed that directors have a duty to minimize this cost. I claim that *CEOs themselves* do too. Suppose a compensation package worth $10 million is sufficient to induce a CEO to do his best for the firm, i.e., to maximize its value, so far as he is able. But suppose that the CEO would also do his best if he were paid only $9 million. Then he should refuse the larger package in favor of the smaller one. Now suppose that, if the CEO were paid $8 million, he would not do his best, and the firm would be worse off by more than $1 million. In this case, the CEO is justified in accepting the $9 million package. In general, the optimum amount of compensation for a CEO is the amount that maximizes firm value, taking into account the cost of the compensation. Of course, a CEO is unlikely to work, or work hard, for free.[1] She will require some, perhaps even a lot, of pay. And shareholders are willing to pay for talent. Hiring a talented but expensive CEO, and properly motivating her, produces more net value for the firm than hiring an untalented but inexpensive one, or failing to properly motivate her. But still what is best for shareholders is that they pay the (talented) CEO no more than is necessary to attract, retain, and motivate her. The CEO's fiduciary duty prohibits her from accepting more than this amount.

Let us call this amount—i.e., the minimum necessary to attract, retain, and motivate the CEO to maximize firm value—her *minimum effective compensation,* or MEC. This amount is *effective* because it succeeds in attracting, retaining, and motivating the CEO, and *minimum* because no less would do. Let us further assume, as is standard, that the CEO is motivated exclusively by self-interested considerations, i.e., she is not intrinsically motivated by shareholders' interests. (Later in the paper I examine the implications of relaxing this assumption.) Finally, let us define "excessive compensation" for a CEO as compensation in excess of her MEC.

In economic terms, a CEO's MEC is her "reservation wage" for the job, i.e., the amount necessary for her to accept and retain it, unless, as is often the case, extra pay (e.g., in the form of performance-based incentives) would motivate her to produce an amount of extra revenue for the firm that exceeds the amount of the extra compensation. In this case, the CEO's MEC includes the *minimum amount* necessary to produce that extra revenue. A CEO's MEC will be a function of her next best alternative, including working for another firm, or not working at all. This in turn will depend on her talents, preferences, and market conditions. Note that the CEO's MEC is *not* defined in terms of what she is "worth," understood as how much revenue she adds to the firm (compared to the next most effective available candidate). So it is possible for an amount of compensation to be more than a CEO's MEC but less than her worth. However, the more revenue the CEO adds to the firm, the better alternative offers she will have. So her MEC and worth will tend to converge in a free market.

As I have suggested, the CEO's fiduciary duty entails not only a duty not to *seek* more than her MEC in negotiation, but a duty not to *accept* more than her MEC if it is offered. To illustrate: Richard Grasso, former head of the New York Stock Exchange (NYSE), famously was awarded a $187 million compensation package. In his defense, Grasso said he never had a "two-way dialogue" with the NYSE's directors about his pay. Assuming that $187 million was more than necessary to attract, retain, and motivate Grasso, this does not excuse his behavior. CEOs do not avoid blame by simply staying out of the pay setting process, as they would in a standard conflict-of-interest situation. They are required by their fiduciary duty to be proactive about ensuring that they do not receive excessive pay.

2. Objections and Replies

I have argued for a new moral limit on CEO compensation: CEOs should not accept excessive compensation—i.e., more than their MECs—from their firms. In this section, I defend it against objections.

Objection 1. This moral limit is moot: a CEO will never accept excessive compensation, because it will never be offered to her. Directors will make sure she gets paid no more than is necessary to attract, retain, and motivate her. Market pressures will aid directors in this effort.

Response. This objection assumes that directors are highly powerful and knowledgeable with respect to the CEO. Against this, first, many writers have argued that pay negotiations between CEOs and directors are not carried out at arm's-length, and in particular, that directors do not aggressively represent shareholders' interests at the bargaining table (Bebchuk & Fried, 2004). Second, even if they have the will to achieve the optimal result, directors are likely to be ignorant of what it is. Knowing, as they often do, the average compensation of CEOs of comparable firms does not tell them the precise minimum effective compensation of their *particular* CEO. Thus, we have reason to believe that it is possible for executives to receive excessive pay, and hence that it is worth determining whether or not they are morally permitted to.

Objection 2. When a CEO negotiates her compensation, she is not yet a member of the firm. The employment agreement through which she becomes a fiduciary has not been made. So, she does not yet have a fiduciary duty to the firm's shareholders and, as a result, is not yet forbidden to accept excessive compensation.

Response. This objection does not apply to CEOs who are negotiating *subsequent* compensation packages with their firms. Nor does it apply to CEOs negotiating their *first* compensation packages with a firm who are promoted to the CEO's position from within the firm's top management. Both kinds of CEO are already top managers in their firms, and so have fiduciary duties to their firms' shareholders. The objection applies, then, only to CEOs who come from outside the firm, and only when they are negotiating their first compensation packages. Although the number of outsider CEOs has increased in recent years, approximately 75% of new CEOs are insiders (Jensen, Murphy, & Wruck, 2004). In addition, at least half of CEOs engage in subsequent compensation negotiations while in office. Thus, the substantial majority of CEO compensation negotiations are immune from this objection.

Even given its limited target, however, the objection fails. Whether or not *some* CEOs lack fiduciary duties to shareholders when they negotiate their compensation packages (e.g., because they are outsiders), *all* CEOs have these duties when they receive them. This effectively prevents all CEOs from seeking in negotiation, or accepting, more than their MECs. Consider an example. C, an outsider, is soon to become the CEO of firm F. C negotiates her compensation package before she starts working for F. Call this time T1. She begins to receive the agreed upon compensation once she starts work. Call this time T2. Because C is not a member of F at T1, C does not have fiduciary duties to F's shareholders at T1. However, C will be a member of F at T2, and will have fiduciaries duties to F's shareholders at that time. Thus, at T2, C cannot accept more than her MEC. Given that C will receive the agreed upon compensation at T2, it would be wrong for her to seek more than her MEC at T1.

I am not claiming that, if a person has a duty at T2, and T2 is later than T1, then she has that duty at T1. This claim is easily refuted. Suppose a person who is now 30 will be a parent when she is 31. At 31, she will have a duty to care for her child. But it doesn't follow that she has a duty to care for her (or any) child now, when she is 30. Nevertheless, the fact that the 30 year old *will have* a duty to care for her child at 31 constrains what she can do at 30. She cannot at 30 promise a friend to devote all of her resources and attention when she is 31 to political activism in a distant nation, for she will be obligated, and knows she will be obligated, to care for her child at that time. In the same way, since C is negotiating at T1 the nature of an event that will occur at T2, the duties she will have at T2 constrain her actions at T1.

In sum, while the CEO's fiduciary duty exerts downward pressure on her compensation by encouraging selfless negotiation over compensation, it is unlikely to tell in favor of her receiving very little pay. And other considerations tell in favor of (permitting) more self-interested negotiation and thus higher compensation. Determining where the balance of considerations lies—i.e., how self-interestedly the CEO can and should act when negotiating her pay—is a complex inquiry lying outside the scope of this paper. It will be important in this inquiry to identify the foundational moral values that justify the CEO's fiduciary duty, and evaluate the extent to which they are promoted or thwarted by selfless negotiation over compensation. Whatever the outcome, my more modest conclusions seem safe, viz., that CEOs' fiduciaries duties apply in the pay setting context, and imply (minimally) that they should accept no more than their MECs, assuming that they are acting on self-interested motives only. Most people believe only that directors have a duty not to award CEOs excessive pay; I have argued that CEOs also have a duty not to accept excessive pay.

End Notes

1. But, it might be said, *shouldn't* she? After all, this would be *best* for shareholders. I explore this suggestion below.
2. But if this is the reason for high(er) CEO pay, one might wonder why its cost should fall entirely on shareholders, as opposed to the general public.

References

Note: Notes and references removed for publication here, but are available on the book website at www.mhhe.com/busethics2e.