Compensation Is Not Just About Market Forces---It Is About Ethics

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In recent days, Charles Prince and E. Stanley O'Neal have been pushed out of their CEO jobs at Citigroup and Merrill Lynch as a direct result of *billions* of dollars in losses at their companies. On Tuesday, November 6, 2007, Associated Press writer Madlen Read wrote that "Charles Prince is walking out Citigroup's doors with potentially millions of dollars in his pocket, leaving behind a bank that many believe needs serious fixes." "Prince will be leaving with about $100 million, based on calculations by compensation consultant James Reda using public filings." By Friday, November 9, however, Ed Welsch wrote in the *Wall Street Journal* (p. C3), that "Prince left the company with accumulated benefits valued around $29.5 million, but he won't get severance pay, the financial-services giant disclosed yesterday." Welsch went on to write "Stan O'Neal left Merrill Lynch & Co at the end of last month, also with no severance but with accumulated benefits valued at $161.5 million." My initial reaction to the Read report is considerably tempered by the news that neither Prince nor O'Neill seem to be getting the kind of obscene severance pay-offs we have seen in similar cases in recent years. However, the contrast between what these two failed leaders walk away with---and what investors and other stakeholders have to cope with in their wake---remains staggering. I don't pretend to have the answers but here are some questions and issues.

From 1998 to 2003 I had a job where we interviewed a lot of CEOs, including Phil Condit (Boeing), Lew Platt (HP), Roger Eigsti (Safeco), and others. I often asked them their opinion on executive compensation, specifically, whether they thought it was an issue of ethics or simply an issue of market forces. The vast majority (I think Jim Sinegal of Costco was the only exception) quickly assured me that it was just a market thing.

If today's executive compensation is a "value-free" market-driven phenomenon, it marks the first time in human history this has been the case. Everybody else who ever thought about it, everywhere around the globe and in every epoch, has recognized that wages and compensation are moral issues. Everyone except, apparently, today's Robber Barons. Where does the burden of proof fall here?

Wealth Can Be Good! High Pay Can Be Justified!

Let's be clear here. There are occasions when extraordinary wages and wealth are not only understandable but morally justifiable and perhaps even praiseworthy. I am not anti-wealth.

For example, the family that owns In'n'Out Burgers must be extremely wealthy by now. This is a booming business. But the food at In'n'Out is better quality (real potatoes, real dairy in the shakes) at amazingly customer-friendly prices (visit and compare!), entry level pay way above the minimum wage, manager pay very generous (both in stark contrast to most other fast food chains), and the only fast food company praised in Erich Schlosser's great study *Fast Food Nation* (a must-read page-turner). Visit In'n'Out and ask your server how they like working there.

Costco is a publicly-traded company, as is Southwest Airlines, with wealthy, successful people at the top. But all their employees and customers share in the bounty in impressive ways and there is no obscenity in wages and compensation at the top.

How Is Compensation Decided?

The compensation philosophy practiced by many of today's big business executives appears to be the following: *grab as much as you possibly can for yourself and do everything you can to ensure that you will not be adversely affected if you are fired or pushed out. Keep it hidden from others if possible.* And for their employees down the line: *pay them as little as possible, as low* *as the market will bear, with as few benefits as we can get away with. Try to get rid of pension and health care commitments if possible.*

My files are filled with news stories about United Airlines and American Airlines practicing this two tier compensation philosophy over the past decade and more, just to give two examples (have you flown either airline lately? Have you asked any of their employees how they like working for their company? Not quite what you hear at Southwest Airlines ---- or In'n'Out or Costco).

Executives don't seem to get it but the message their "grab all you can get" compensation philosophy sends to their employees is this: "grab all <u>you</u> can get wherever you are in the company." Look out for number one, cut corners, don't worry about colleagues, customers, etc.—take care of yourself!

Compensation Criteria?

Let's step back and review some historic principles of economic distributive justice (i.e., the fairness of how wealth gets shared). Here are some of the leading concepts:

1. An old formula says "from each according to their ability, to each according to their need." Sounds great. Works pretty well in families on a small scale, especially where there are age and capacity differences among the members. Not so workable in large groups or organizations. And where do needs end and wants (luxuries) begin?

2. "To each an equal share" --- whether lazy or industrious, healthy or sick, lots of dependents or few. Equality is an admirable value but most of us think it is equal *opportunity* rather than equal *results* that should be our target. To give equal shares irrespective of effort, achievement, or other relevant considerations often cuts the nerve of ambition, creativity, and energy. This is definitely not the way to go.

3. "To each according to their individual effort" --- whether successful or not. The question is whether and how they tried. It is also important to consider the circumstances of their effort: was there a great deal of risk, stress, or danger in their work? Also, were they attempting something which most people are neither gifted nor willing to attempt? These things matter and are widely embraced criteria of justice. An important issue here is the fair allocation of credit or blame if effort is your criterion. Is the effort and performance of the CEO twice as significant as that of the Executive VP? Maybe. Ten times as significant? Maybe, but it's a stretch. A hundred times as important as the lead engineer on a project? Doubtful.

4. "To each according to their achievement or contribution." The question is not about effort but about production. More hours, more sales, more people managed, more money managed. Better financial performance, better quality production. Pay for performance is a widely embraced criterion of justice. Thus, when pay is guaranteed despite a horrible performance, the grumbling begins. When a financial upside is held out to motivate superior performance and yet there is no risk of a financial downside for failure or incompetence, you can see why grumbling about injustice will happen. You can understand why employees and investors feel betrayed that boards would agree to contracts that shelter executives from any downside accountability. If they rolled the dice and could lose everything---we'd be less critical when they roll the dice and win it all. The rest of us risk lay-offs, cutbacks, and downturns. Why do the guys at the top get away with this so often? That's what the people often wonder.

We sometimes apply different principles of distributive justice to different situations, i.e., voting (equality), welfare benefits (need), school grades (effort), tax breaks (social contribution), job promotions (merit). Sometimes arguments are combined, e.g., high salaries of doctors are because they *need* lots of money for education and insurance---and they *deserve* to be paid more for their effort and social contribution.

Compensation Process?

Not just the criteria but the process of setting compensation deserves our careful attention. My interviewees liked to say that the free market set compensation levels. There is an element of truth to that but a lot of self-deception as well. When the compensation committee consists of similarly-situated, overpaid cronies of the CEO, a “market result” is hardly likely to emerge.

The market would be more authentically setting the compensation level if a job description was broadly distributed and all applicants considered, including those willing to work for (say) $500k per year in cash and stock. Would such a company get some great applicants? Yes. That’s what the market would do for this process but it is not allowed to operate. It’s a club decision not a market one.

Certainly these matters play out (and matter) differently depending on whether the organization is privately-held, publicly-traded, a state protected/regulated monopoly (e.g., utility companies), a public school, hospital, or university, a tax-exempt non-profit group, and so on.

To Be Continued

Some defenders of the status quo have an interest in closing off this kind discussion of compensation values, ethics, and practices. Some of you may be agitated by what I have said in this column. I certainly have not decided anything here and I don’t have the answers. But I think it’s important to stir the pot. Discussions of individual financial bottom lines are just as important as those about corporate financial bottom lines. Decisions about compensation affect all stakeholders. Harm can be done. Good can be achieved. It’s about ethics, not just a technical market question.