Compensation Wars / Bonus Battles

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There is nothing quite like a discussion about executive compensation for its ability to elicit strong opinions – both of the informed and uninformed variety. Throw in a crisis in the financial markets, an economy in recession, and a strange alchemy of public and private ownership of businesses, and you have a good old-fashioned brouhaha. The most recent controversy has surrounded the bonuses paid to AIG executives after billions of dollars of taxpayer money had been invested in AIG to keep it solvent. Before that, the issue was the Merrill Lynch bonuses paid out "in haste" this past December. Locally, there was a public scuffle over a raise given to the publisher of this newspaper prior to the bankruptcy filing. Even before our current economic crisis, there have been numerous examples of compensation battles, with each ide claiming the moral high ground. Remember Dick Grasso and the New York Stock Exchange? And outside of the spotlight, there are thousands of examples within companies regarding the proper and fair allocation of compensation dollars.

In a recent gathering of friends, I raised the issue of the Merrill Lynch bonuses and got a wide variety of passionate opinions. The fact that a group of people would have different views on the subject wouldn't ordinarily be surprising – but every member of this particular gathering was a CEO. It's difficult to predict where people will come down on this issue.

At its extremes, this is a battle between two equally unattractive human traits – greed and jealousy.

Let's start with the greed side. Consider the executive who is being paid truly extraordinary sums of money, and who has an almost blind sense of entitlement regardless of what is happening around him. He believes that he is perhaps singularly responsible for his company's success to such a degree that he has earned every penny of his compensation and that his employer and the stockholders are lucky to have him.

Years ago, a friend of mine was in the room at a Wall Street investment banking firm with a small number of people when someone suggested that the unusually large bonuses to be paid that year might create a public relations issue. I can't repeat the words the then-CEO used in reaction to the suggestion. In the most offensive language imaginable, he expressed his disdain for anyone who challenged the amount of his $18 million bonus – and $18 million was a lot of money back then. I'll paraphrase his concluding words (after the expletives and

the insults): “It’s my money and I’m going to keep it no matter what anyone says.” His zeal for the issue startled even this room of insiders. But he had a blind spot. Even though the bonuses were calculated according to a pre-determined, approved formula, his lack of sensitivity to the public’s potential reaction was, perhaps, a foreshadowing of the issues we are dealing with now. At least at that time, the CEO’s firm was showing extraordinary profits. Now we have situations where losses prevail, jobs are being cut, and bonuses are being paid anyway. Public outcry is certainly predictable even if not totally justified and needs to be considered before action is taken.

Now about jealousy. There are those who begrudge the good fortune of others as an almost automatic reaction. They are unhappy if peers get recognized or promoted. They are the first to “boo” a high-paid athlete when he doesn’t perform to their liking, and they can’t imagine how anyone in business could possibly be worth more than -- pick a number -- $250 thousand, $1 million, $10 million, $50 million? No explanation will suffice. The object of their scorn is simply overpaid and it’s unfair because believe that they themselves should be getting more. Their attitude is unfortunate. Because like it or not, our free market system, when working properly, provides equality of opportunity, not equality of outcomes. Productivity and talent are rewarded. Jealous complaining is wasted energy.

So what’s the answer? On what basis should people be paid and should there be limits? If so, who should set those limits? The simple answer is that people should be paid what their services are worth on the open market -- with a willing and informed “buyer” and “seller.” What are they worth? They are worth the unique value that they bring to the enterprise and its owners. What owner would willingly and knowingly pay more than someone’s worth to the enterprise -- more than they would need to pay someone else for the same added value? No owner would. And what owner would knowingly and willingly pay significantly less than someone’s worth to the enterprise, and risk the economic loss that would be incurred if that employee would be lost to a competitor? No smart owner would.

The problem is that, in public companies, the “owner” is typically a large pool of relatively disconnected shareholders. They have limited or no say in compensation matters other than through their vote for directors, which is usually a predetermined slate. Executive compensation is set by compensation committees of the Board of Directors who rely on expert consultants to give them data on what other executives in other companies are being paid. And they reward stock options or other equity participation mechanisms based on some standard practice. So they meet the test of comparability, but don’t always meet the test of “value added.” If the stock price soars, the executive compensation soars. This is true whether the executive was responsible for the increase in the price of the stock or not. It’s also true if the executive took actions to artificially prop up the stock price at the expense of the long-term financial health of the company. Did the CEO I mentioned above really and individually add enough value to warrant an $18 million bonus? Or could someone else have added the same amount of value for, say, $9 million? I don’t know -- but the problem is that the question was never asked. His pay was tied

to the price of the stock-- period, regardless of his personal contribution to its change in value and regardless of how much risk the company took. By the way, that same company's stock is now virtually worthless.

Reform is needed, but not in the form of artificial caps or ill-conceived penalty taxes. Compensation committees need to rethink compensation structures by measuring an executive's true value and contribution to the success of the company. And they need to place greater emphasis on the amount of risk the company is assuming by virtue of the executives' actions and decisions. I believe that too much emphasis has been placed on the market price of the company's stock and not enough on the fundamental success of the underlying business. To compensate executives significantly on the basis of the market price of the stock when they are not taking the commensurate risk of a stockholder is a potential recipe for disaster.

"Fair" pay is when value is paid for value received, adjusted for risk. Let's concentrate on the best way to achieve that, and keep the greed and jealousy out of the equation.