CEO Compensation and the Responsibilities of the Business Scholar to Society

by James P. Walsh

American CEOs make a great deal of money. The amounts must stagger people who are unfamiliar with contemporary business practice. The AFL-CIO's Executive PayWatch reports that the average CEO in the S&P 500 made $14.2 million in 2007.[1] Looking across companies, we find that the CEOs of the 1,000 largest public firms in the United States (ranked by sales) took home $9.025 billion in 2005. This sum sits between the 2005 GDPs of Myanmar ($8.90 billion) and Bolivia and Jamaica (tied with $9.71 billion). Each of these CEOs claimed, on average, .07% of his or her firm's total sales.[2]

Of course, CEOs make much more money than the average American worker. Executive PayWatch points out that while the average CEO made 42 times the average worker's salary in 1980, the ratio increased to 107 in 1990 and 525 in 2000. The latest data (for 2006) put the ratio at 364. It is no surprise to learn that the growth and magnitude of CEO pay is newsworthy (Deutsch, 2008) and subject to Congressional inquiry.

On March 1, 2007, Representative Barney Frank (D-MA) and 27 co-sponsors, all fellow Democrats, introduced House Resolution 1257.[3] Representative Frank would like a firm's shareholders to approve or disapprove, in a nonbinding fashion, the compensation arrangements for their firm's senior executives. One week later, Steven Kaplan, a distinguished finance professor from the University of Chicago, offered testimony in sharp disagreement with the plan. Unmoved, the House passed the resolution the following month (on April 20, 2007) by a vote of 269–134–30; 214 Democrats and 55 Republicans supported what is known as the Shareholder Vote on Executive Compensation Act (or more colloquially, the "Say on Pay" initiative).[4] That same day, Senator Barack Obama (D-IL) and seven of his colleagues introduced S. 1181.[5] As of this writing, the Senate version of the bill is being considered by the Senate Committee on Banking, Housing, and Urban Affairs. Professor Kaplan's testimony serves as a wonderful stimulus to consider both the complexities of CEO compensation and the proper role for a business scholar in society.[6]

Professor Kaplan vigorously defends U.S. cor-

This article is in response to Steven N. Kaplan's Congressional testimony on empowering shareholders on executive compensation and H.R. 1257, the Shareholder Vote on Executive Compensation Act before the Committee on Financial Services of the United States House of Representatives, on March 8, 2007. The ideas expressed in Mr. Kaplan's article in this issue are based largely on this testimony. Due to timing issues, we asked Mr. Walsh to respond to Mr. Kaplan's testimony, not to the article that appears in this issue. To access the full testimony, visit www.house.gov/apps/list/hearing/financialsvcs_dem/htkaplan030807.pdf.

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[1] See www.aflcio.org/corporatewatch/paywatch, accessed May 18, 2008.

[2] ExecuComp provided CEO compensation data; the EIU database provided the GDP figures. 2005 data will be used throughout this paper because they are the best, most recent data available. *Notice of Correction to article: The reference to 7% total sales was featured in three places within the content of the original printed article. In each case, the 7% should be .07%. This percentage appears on p. 26, left column, 1st paragraph, line 12; p. 29, left column, 2nd paragraph, line 2; and p. 29, right column, 1st paragraph, line 9. This error has been corrected on the electronic versions of this article.*

[3] See www.GovTrack.us; search for H.R.1257, 110th Congress, 2007.

[4] See www.govtrack.us/congress/bill.xpd?bill=h110-1257.

[5] See www.GovTrack.us; search for S.1181, 110th Congress, 2007.

[6] The article that Professor Kaplan wrote for *AMP* is largely derived from his Congressional testimony on March 8, 2007; however, there are some differences between the two documents. Given my interest in the responsibilities of the scholar to society, I am more interested in what he said to Congress than I am in what he says to his colleagues here. I will generally respond to his testimony and flag some of the differences between the two documents when appropriate.

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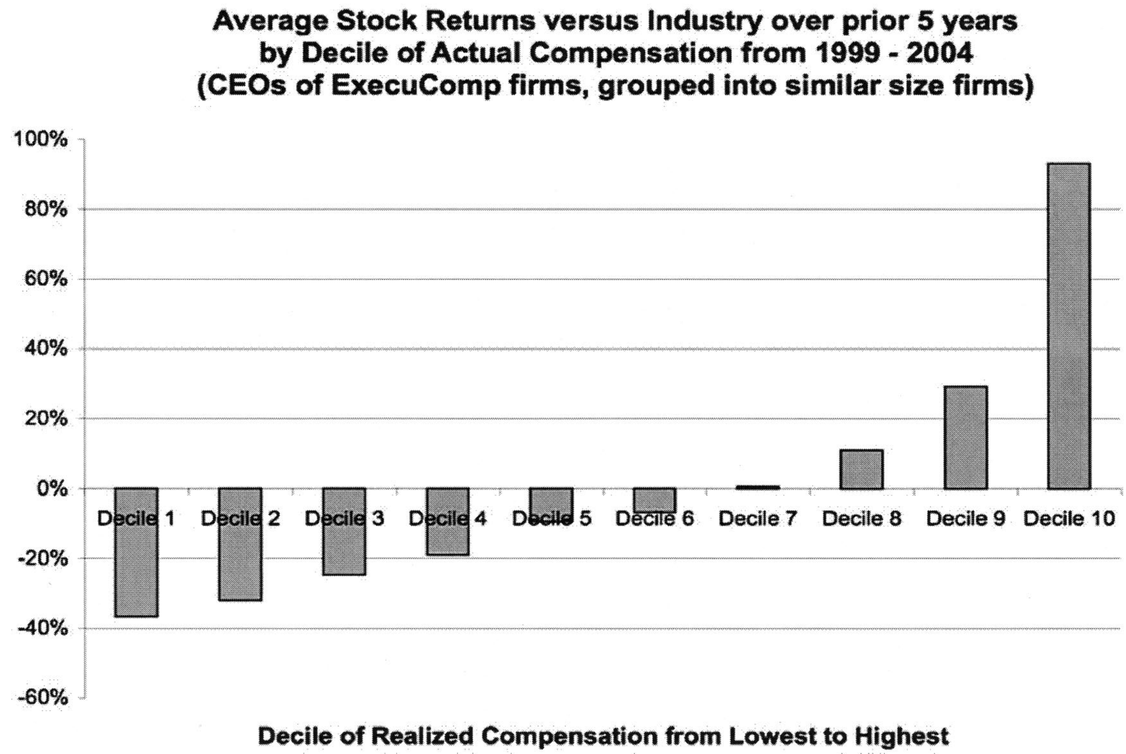
Figure 1
Exhibit 13 from Professor Kaplan's March 8, 2007 Testimony



porate governance practices. He argues that "there can be absolutely no doubt that the typical CEO in the United States is paid for performance" (2008, p. 6). He even suggests, albeit both times with some hesitation, that CEOs may not be overpaid but in fact, may be underpaid. Responding to concerns about self-aggrandizing boardroom practices, he argues that corporate governance systems/boards have "performed better in their monitoring role from 1998 to 2005 than in any previous period" (2008, p. 15). So what are we to make of Professor Kaplan's testimony?

I would like to look at it from two perspectives. First, I want to comment briefly on each of his three main points. I am under no illusion that anything I say here will affect contemporary CEO compensation practices. These are complex matters. But that is the point. I do not want to argue with Professor Kaplan. I only want to illustrate that reasonable people might disagree with his assessments. At a minimum, we need to know that there is more ambiguity here than he allows. And that observation leads to my second point. His testimony asks us to consider a scholar's responsibilities in public life. In a time when so many business scholars seek a greater voice in public affairs, Professor Kaplan's testimony asks us to think hard about how we are to engage the world. I am not so sure that he is a positive role model.

Are CEOs Paid for Performance?

Professor Kaplan says yes and builds his case around Exhibit 13 in his testimony (see Figure 1). This compelling evidence purports to show a strong linear relationship between a firm's stock market performance and CEO compensation. Compelling as it seems, that exhibit obscures as much as it reveals. For his testimony, he and his colleague, Josh Rauh, rank-ordered all CEOs in the ExecuComp database by their firms' size for each year between 1999 and 2004. They then cut those annual profiles into deciles. At that point, they looked at the "actual" compensation amounts for these CEOs (excluding the Black-Scholes estimated value of the options granted to the CEO each year) and rank-ordered the results, creating deciles of compensation within each size decile. Figure 1 captures the relationship between those compensation levels and the firms' industry-adjusted stock price performance in the previous five-year time periods, aggregated over the ten size deciles and the five years of compensation observation. (Figure 10 in Kaplan's *AMP* paper uses quintiles instead of deciles, reveals the results for the three-year performance window instead of a five-year window, and pictures the relationship in each of the five size categories. It is a more complex and perhaps less striking representation but the inference is the same—there is a strong relationship between CEO pay and performance.)

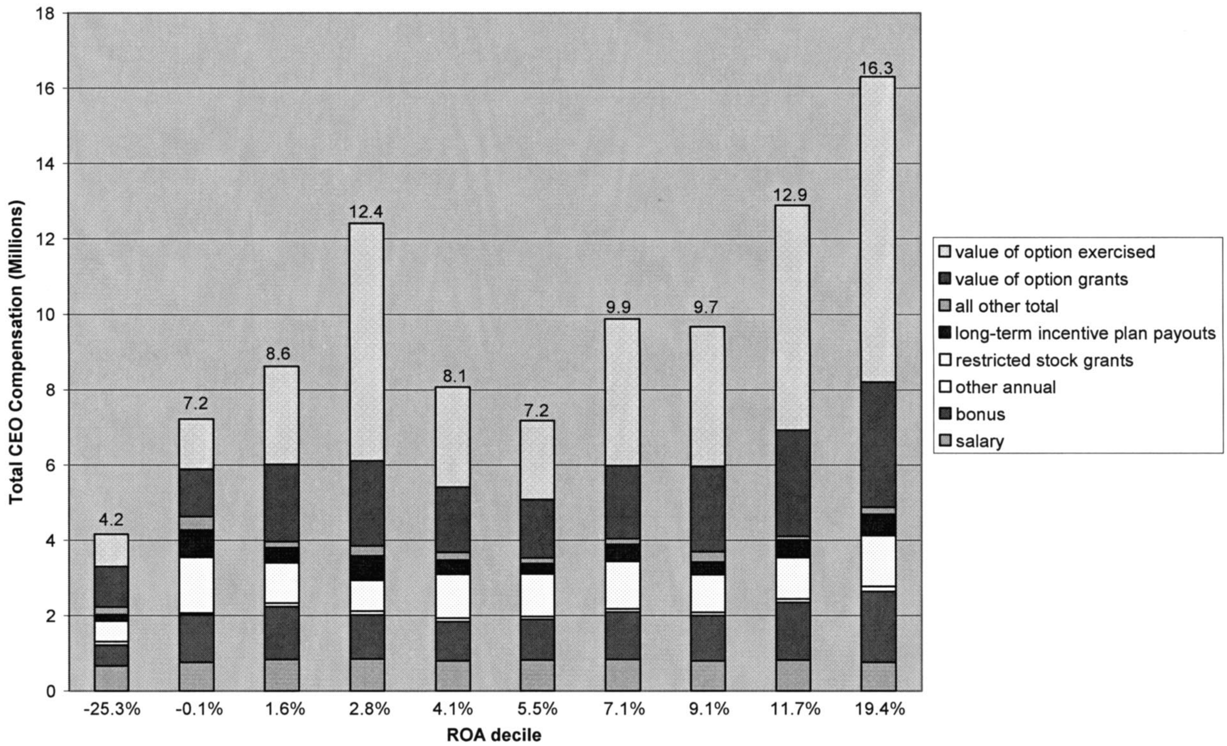
What are we to make of the figure Kaplan offered Congress? Perhaps one reaction is fatigue. It is difficult to keep track of these many data transformations and their implications. But once we digest the exhibit's meaning we begin to wonder about what is and what is not pictured. Typically, pay for performance sensitivities are analyzed in regression models that control for other relevant factors (Jensen & Murphy, 1990; Murphy, 1999). That aside, can we accept Kaplan and Rauh's evidence as definitive? I don't think so. This analysis raises three questions that warrant some scrutiny (especially when it is so authoritatively offered in the public square). First, the measure of performance (adjusted historical stock price performance, collected over a long, and idiosyncratic, time period) is just one of many ways to assess firm performance. Given that there are other measures and other time periods to assess, why did they choose this measure? Second, were the CEOs in office during those historical five- and three-year performance windows? We do not know if these CEOs were paid for their own or their predecessors' performance. And third, why did Kaplan and Rauh decide to exclude options that were granted in the year of observation? This is not the customary practice in this literature. Given that the properties of "theoretical pay" may be important, wouldn't it be better to examine them and not just dismiss them? As is true of almost all academic studies, there are other ways to analyze this relationship. Professor Kaplan's empirical approach deserves as much explanation as do his results. This is especially so because a meta-analysis of CEO compensation studies found that firm performance accounted for only 5% of the variance in CEO pay (Tosi, Werner, Katz, & Gomez-Mejia, 2000).

Let me illustrate this same pay for performance relationship in a different way. I am not saying that my approach is better. I just want to point out that it too has its appeal. The results may or may not be as compelling as Professor Kaplan's evidence, but they do give us pause. Figure 2 also pictures the relationship between CEO compensation and firm performance. Like Professor Kaplan, I went to ExecuComp and examined the compensation for all CEOs, in this case for all the available CEOs in 2005 (the compensation data are adjusted to March 2008 levels; the sample size is 1,691). Instead of rank-ordering the data on CEO compensation (thereby losing the ability to take a more fine-grained look at compensation), I rank-ordered the data on firm performance. I assessed performance with the firms' 2005 ROA instead of their historical share price performance. The pay-performance relationship revealed here is not nearly as linear as the relationship that Professor Kaplan reports. Indeed, we see that the value of exercised options seems to drive whatever linear relationship we see.[7] CEOs make a great deal of money by cashing in options when their firms perform well. Does that mean that compensation drives firm performance? Maybe. At a minimum, positive firm performance seems to present an opportune moment for profit taking. Take away the value of these options and the seeming linear relationship between pay and performance just about disappears.

This histogram reveals a fact about CEO compensation that Professor Kaplan's histogram does not. His figure does not tell us how much the CEOs made. Here we see that the CEOs in each decile earned between \$4.2 million and \$16.3 million. The CEOs in the bottom decile, a decile marked by very poor firm performance (a mean and median ROA of −25.3% and −12.5% respectively), still made more than \$4 million. If we perform a median split on firm performance and broadly compare the total compensation for those in the top half of the performance distribution

[7] The options grants, the "theoretical pay" that Professor Kaplan worries about, do add to the CEOs' compensation, but they do not seem to track the firms' ROA very closely—the Pearson correlation is only .06.

Figure 2
CEO Compensation and Firm Performance (2005)



with that of those in the bottom half, we see that those on top earned an average of $11.2 million, while those on the bottom earned "only" $8.1 million. Yes, those on top earn a great deal of money, but so do those on the bottom. When Professor Kaplan concludes that "there can be absolutely no doubt that the typical CEO in the United States is paid for performance," I suppose we should focus on the word "typical." The 676 CEOs in the first, second, third, and fourth performance deciles, for example—the CEOs who made on average $4.2 million, $7.2 million, $8.6 million, and $12.4 million respectively—may not be "typical" U.S. CEOs in his mind.

Are CEOs Overpaid?

We already know that the top 1,000 CEOs, as individuals, took home .07% of their firms' sales in 2005 and that as a collective, they made nearly the equivalent of Bolivia's GDP. Is this too much? Arguing that the CEO job is becoming "increasingly difficult and less pleasant" (2008, p. 17) and then noting that hedge fund and private equity managers, venture capital investors, investment bankers, professional athletes, and lawyers also earn a great deal of money, Professor Kaplan says no, CEOs are not overpaid. He even suggests that they are underpaid.

How are we to assess whether or not they are overpaid? We need reference points. Professor Kaplan points to well-paid lawyers, bankers, and athletes and seems to imply that "everybody" is making a good deal of money these days. What's the fuss? Notwithstanding the size of Alex Rodriguez's or Derek Jeter's baseball contracts, many will wonder why any one individual in a firm can claim .07% of its sales. Others will question why 1,000 top CEOs are paid the equivalent of Bolivia's GDP. And some may think it outrageous to pay a CEO $4 million to lead a firm that generates a return on assets of −25%. But CEO pay advocates can push back on all of these reactions. For example, one can argue that finding someone to lead an abysmally performing firm for only $4 million per year in this labor market is a bargain. While this kind of market-focused academic debate is important, we need to consider at least one other reference point, one that suggests more room for doubt than Professor Kaplan allows.

Let's consider this other reference point. It may reveal why executive pay feels so outrageous to so many and why it attracts the Congressional attention it does. *Parade* magazine, the Sunday news magazine with a readership of 71 million people, issued its annual report titled "What People Earn" on April 13, 2008. The article opened by noting that today's median U.S. salary is $36,140 and then followed with the provocative question "How does your salary stack up?" A profile of more than 100 individuals from all walks of life gave readers a type of barometer. Each person was pictured, along with his or her name, age, occupation, and city of residence. CEOs of two publicly traded firms were among the list. Kerry Killinger, 58, the CEO of Washington Mutual, earns $5.25 million and was pictured between Kim Leisure, a 41-year-old payroll administrator from Ocoee, Florida, and Sue Gage, a 52-year-old janitor from Shelby Township, Michigan. Kim and Sue earn $41,000 and $10,700, respectively. James McNerney, 58, the CEO of Boeing, earns $19 million, while Mitch Carmody, the 53-year-old church facilities manager in Hastings, Minnesota, pictured right below him, earns $42,000.

Complications of pay notwithstanding, I imagine that these juxtapositions leave many people angry. I'm not suggesting that *Parade*'s approach is in any way scientific, but the article and others like it in the mainstream press certainly raise questions for readers about the fairness of CEO pay practices. Academic arguments must be attuned to questions of legitimacy, especially if scholars seek to challenge conventional thinking. Concerns with executive pay have as much to do with the standing and credibility of business, measured relative to our accepted norms of fairness, as they do with the nature of the link between pay and economic performance. Economists tell us that these norms are no less important than economic gains (Camerer, 2003). It is just as important for CEO pay to be seen as legitimate by the people in Ocoee, Florida, and Hastings, Minnesota, as by Wall Street's bankers and lawyers—and those who care about Wall Street's bankers and lawyers.

Professor Kaplan refers to CEOs as "fortunate and talented" numerous times in his testimony (he uses the word *fortunate* seven times in the *AMP* essay, three times in the phrase *fortunate and talented*). There are many talented people in this world who earn far less than Mr. Killinger and Mr. McNerney. The key word here seems to be *fortunate*. While Professor Kaplan will not say that these CEOs are overpaid, he does admit that these individuals are very fortunate to take home millions of dollars each year in a nation where the median worker brings home less than $40,000. The legitimacy of executive pay is called into question when good fortune plays such a role in our understanding of it.

In the end, it does not much matter what Professor Kaplan or I think about the magnitude of CEO pay. If we want to consider the legitimacy of CEO pay, it is the opinions of *Parade* magazine's 71 million readers that count. Joe Bageant's (2007) sobering book, *Deer Hunting With Jesus: Dispatches from America's Class War*, gives us a look at the lives of people who may cast a jaundiced eye on these compensation practices—and any effort to defend them. Perhaps even a University of Chicago business school professor might question the legitimacy of contemporary CEO compensation practices after reading this book.

While scholars must be willing to challenge accepted thinking, it is also true that our work ought to grasp the underpinnings of that accepted thinking. Public concern about executive pay is not about the nature of pay/performance sensitivities, nor is it about envy. The concern is about fairness. Taken-for-granted norms of fairness are essential to the health of the free market system. They too need to serve as a reference point for assessing CEO pay. If we defend the CEO compensation practices pictured in Figure 2 as evidence of a spontaneous market process, then some might wonder about the viability of a society that tolerates such a process. It may not even be so far-fetched to imagine its downfall. What is to become of a society where the ultra-rich (pictured in Kaplan's *AMP* Figures 5, 6, 8, and 9) do not share a common destiny with the other 99.9% or 99.99% of the population?

Are Boards of Directors Doing a Good Job?

Quietly aware of the "Bebchuk critique" in his testimony, and explicitly aware of it in his *AMP* paper (c.f. Bebchuk, Fried, & Walker, 2002), Professor Kaplan asks if powerful CEOs corrupt the compensation-setting process. He asks what boards do and if their work is compromised by CEOs. Answering those questions before Congress, he shared results from two of his working papers. If we see evidence that CEO pay is tied to performance and that CEOs are dismissed for poor performance, he argued, then all is well in the boardroom. With respect to the dismissal question, we learn that the CEO turnover rate in the 1970s, 1980s, and 1990s (through 1997) was 10% per year. He reports that the rate increased to 12.8% in the 1998–2005 time period. He views that jump as "substantial" and offers it as evidence of admirable board discipline. Can we take comfort in knowing that CEOs are now more likely to be fired for poor performance? Again, I don't think so. Those 10% and 12.8% figures account for retirements, deaths, and voluntary departures of all kinds, as well as any performance-induced involuntary turnover. Given how difficult it was to be fired for poor performance in the 1970s and 1980s, I doubt that a 2.8% increase is meaningful. Let's look at the evidence for CEO discipline back when the annual turnover rate was 10%.

Gilson (1989) examined the dismissal patterns for two groups of CEOs who led 381 firms in the bottom 5% of the NYSE and AMEX for three consecutive years in the 1979–1984 period. One group led these bottom-dwelling firms absent any other extraordinary signs of distress; the other group led these same bottom-dwelling firms but their firms also defaulted on their debt obligations, restructured their debt outside of bankruptcy, or went into bankruptcy. He found that neither group of CEOs was necessarily destined to lose their jobs. Only 19% of companies in the first group changed their CEO, while 52% of the firms in the second group of even more distressed firms did so. Gilson showed us that CEOs who preside over three straight years of abysmal performance *and* lead their firms into default or bankruptcy faced only a 50-50 chance of losing their jobs back then. That is the kind of board discipline that was associated with a 10% annual turnover rate. I wonder how much more exacting our management discipline is today now that the base rate of dismissal inched up a few notches to 12.8%. The CEO's job is not as contingent upon performance as Professor Kaplan implies.

The Gilson (1989) study is just one of hundreds of studies of corporate governance practices. Shleifer and Vishny (1997) and, most recently, Dalton, Hitt, Certo, and Dalton (2007) provided comprehensive reviews of this research. There is also a huge literature on executive compensation, and comprehensive reviews of it (Devers, Cannella, Reilly, & Yoder, 2008; Murphy, 1999, 2002; Tosi, Werner, Katz, & Gomez-Mejia, 2000). Professor Kaplan knows that CEO compensation practices have come under a sophisticated and withering attack in recent years. Bebchuk and his colleagues led the assault (Bebchuk & Fried, 2003, 2004, 2005a, 2005b; Bebchuk, Fried, & Walker, 2002). While contemporary CEO compensation practices have their spirited defenders (Core, Guay, & Larcker, 2003; Core, Guay, & Thomas, 2005), I wonder why Professor Kaplan ignored this evidence when he prepared his Congressional testimony. His oversight leads me to wonder about the responsibilities of the business scholar to society.

Is Professor Kaplan a Positive Role Model?

Professor Kaplan is an enormously accomplished individual. Harvard educated, he joined the Chicago faculty in 1988 and earned the first of his two chaired professorships in 1997. He publishes routinely in his field's top journals. According to Google Scholar, his 10 most cited articles have been cited more than 4,000 times. He has served as a reviewer or an editor for his field's most renowned journals. He has won multiple teaching awards, and *Business Week* once named him one of the top 12 business school professors in the world. He is an extraordinarily accomplished scholar. What can we, as scholars, learn from his Congressional testimony?

Don Hambrick famously asked the question "What if the Academy actually mattered?" in his Academy of Management (AOM) presidential address 15 years ago (Hambrick, 1994). His remarks triggered all manner of soul-searching about our influence—or lack thereof—in the world of affairs. Tom Cummings, the 2006 AOM president, encouraged us yet again to become more engaged in the world (Cummings, 2007). Professor Kaplan is clearly engaged. Few of us are called to Congress to offer our views on pending legislation. I suspect that many of us would like to be him. His testimony gives us a chance to reflect on what we will say when we are asked to lend our expertise to address the problems and opportunities of the day.

Scholars, especially social scientists, hold a special place in society. Supported by tax dollars, private giving, or both, we are asked to live in society and, at the same time, somehow examine it as though we live apart from it. It is from that insider/outsider perspective that we can see what others, caught in the pressures of their daily lives, cannot see. Society trusts us to ask and answer questions that matter. And when we are asked to share our expertise with society, it is incumbent upon us to honor that trust and share all that we know about the topic. No matter the question, our answers are more often than not equivocal, bounded, or contested. Weick (1979) reminded us years ago that no theory can be at once simple, accurate, and generalizable. Professor Kaplan offered Congress what he imagined to be a simple, accurate, and generalizable view of contemporary corporate governance practices. His view that CEOs are properly paid and monitored is a simple and maybe even accurate statement for some firms, but I suspect that it is not true of most. His view may not be generalizable. Acknowledging the trade-offs among simplicity, accuracy and generalizability, Weick (1979, p. 42) cautioned us to be realistic, and not arrogant, when we do our research. This caution needs to be emphasized when we offer advice to others, whether it is before Congress or in our classrooms. We can certainly offer our best opinions about a course of action, but we need to do it with a clear eye on all of the evidence at hand, and its limitations.

Professor Kaplan simplified a very complex issue and then argued for the status quo. Did his advocacy collide with his responsibility as a public scholar? It is certainly our right as scholars to offer our opinions, especially when asked, but it is our expertise that earns us the invitation, sustains our credibility, and deserves the public's trust. Thus, precisely at the moment when we share our partisan conclusions, we must take extra care to weigh—and even share—evidence inconsistent with them. Unfortunately, his analysis and recommendation are based on a selective reading of the available evidence.

It is also unfortunate that he never revealed his other interest in this compensation question. Professor Kaplan is not just a business scholar. His University of Chicago Web page notes that he currently serves on the boards of Accretive Health, Columbia Acorn Fund, and Morningstar.[8] The Morningstar Web site reports that he joined their board in 1999 and currently serves as their compensation committee's chair.[9] If it were to become law, the "Say on Pay" initiative would invite criticism of his decisions. That site also includes SEC filings for the past few years. There we learn that Professor Kaplan enjoyed the proceeds from the sale of more than $3.8 million worth of stock in a recent 18-month period (June 16, 2006, to November 16, 2007).[10] While he is the Neubauer Family Professor of Entrepreneurship and Finance at the University of Chicago, he is also an extremely well-compensated insider in the governance regime he so passionately defends. Congress and his *AMP* readers should know that.

As the world becomes a more complicated place, as economic and environmental conditions become more unforgiving, and as partisan political passions intensify, business scholars may find themselves increasingly asked to share their expertise in support of or opposition to all manner of initiatives. We must neither shy away from this challenge nor numb the public with endless "on the one hand, on the other hand" disquisitions. But as we step up to serve, we must acknowledge—foremost, to ourselves—the limitations of

[8] See www.chicagogsb.edu/faculty/bio.aspx?person_id=165715.

[9] See corporate.morningstar.com/us/asp/subject.aspx?xmlfile=176.xml&page=16 and corporate.morningstar.com/us/asp/subject.aspx?xmlfile=441.xml.

[10] See investorrelations.morningstar.com/sec.cfm.

our findings and the biases that may shape our conclusions.

The Shareholder Vote on Executive Compensation Act promises to shed more light on CEO compensation practices. Oddly enough, while Professor Kaplan's strong opposition to this legislative initiative should answer our questions, it leaves us wondering instead. Are CEO pay practices really that sound? His opinion stirs us to dig deeper into the research about CEO compensation to form our own judgments. His testimony also asks us to think hard about how scholars are to engage the world of affairs. I believe that we need to honor society's trust by sharing a complete picture of the matter at hand, no matter its complexities and complications. And we should always do so with complete candor. No one should ever question our motives.

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