Ken Lay and Executive Pay

In 1985 the Houston Natural Gas company and the Internorth company of Omaha, Nebraska merged their individual gas pipelines to form the first national supply grid. Shortly thereafter Ken Lay, the former CEO of Houston Natural Gas, became the CEO of the newly-named Enron Corporation. The company expanded rapidly, making a market by setting up contracts with businesses and utilities to deliver gas and oil at fixed prices on future dates. From the late 1980s through the late 1990s, Enron began a series of acquisitions of energy-related businesses around the world. In the United States the company profited from the deregulation of electrical power markets, gaining access to an industry that had previously been controlled by government entities. To facilitate its numerous deals brokering energy commodities, Enron began to weave a complex web of financial operations and political connections.

When annual revenues topped $100 billion and the stock price peaked at $84.87 in the year 2000, no one could have imagined what lay just around the corner. The heroic general who had led the company to such a stunning conquest, chief executive Ken Lay, rewarded himself handsomely, receiving $53 million in annual compensation with exercised stock options of more than $123 million and un-exercised (year 2000) options of more than $361 million. A number of his most trusted top officers shared in the spoils as well. Then the meltdown began. In October of 2001 the company reported a $638 million loss for the third quarter and a $1.2 billion reduction in shareholder equity. A formal investigation by the SEC subsequently uncovered a host of unethical dealings and fraudulent actions by Enron executives and consultants from the prestigious accounting firm Arthur Andersen. In addition to the more than 6100 employees who lost their jobs, health insurance, and retirement benefits with Enron's collapse, thousands of others watched their retirement funds disappear as the price of Enron stock sank into oblivion (AFL-CIO).

The Enron debacle provides a poignant reminder of the urgent need to establish enforceable measures of corporate social accountability. Such *accountability* should be distinguished from *responsibility*. Corporate responsibility, since it is voluntary, still remains largely an ideal. Corporate accountability, however, is certainly achievable. In light of the Enron scandal and others that have filled the news in recent years, it is incumbent upon socially responsible citizens to demand greater accountability from the corporate entities that exercise so much control over their lives and futures. Of the myriad acts of social injustice that have been committed by certain irresponsible corporations—from polluting the environment to knowingly marketing unsafe products—there is perhaps none that has been more readily tolerated than the practice of granting exorbitant amounts of compensation to corporate chieftains.

The practice has been justified by the delusion that highly talented CEOs deserve lavish pay packages because they add real value which can ultimately be reaped by the stockholders. Their huge monetary rewards are believed to be part and parcel with capitalism itself. Yet it is ultimately the stockholders (the true torchbearers of capitalism) who lose out, since the rewards of production are not distributed to them as dividends or reinvested in the company to add value to the shares they already own. In the case of Enron, pillage of the corporate treasury and the confiscation of shareholder value by granting enormous stock options ultimately weakened the company's infrastructure to the point of collapse. Such a scenario has often been played out in the political realm by Third World dictators who enrich themselves from public funds and sell off government assets when the coffers become empty, leaving the citizens with a bankrupt nation and a debt-service burden that will remain for years to come. Unlike corrupt dictators, who frequently suffer the consequences of their actions in the end, executives are rarely called to account unless they have been guilty of outright fraud, as in the case of Enron.

Although there are numerous examples of excessive executive pay in the annals of America's business history, a marked change began to take shape in the late 1980s. In 1980 the average CEO to hourly worker pay ratio was 42-to-1. This ratio rose to 85-to-1 in 1990 and now stands at 380-to-1 (AFL-CIO). One of the principle causes of this trend was the growing belief among institutional investors that the performance of a company was inextricably linked to the performance of its CEO. Prior to 1960 less than 10 percent of the stock in publicly-traded companies was owned by institutional investors, a number which has grown to more than 60 percent today. As more and more institutions and money managers began acquiring stock, they became increasingly interested in the performance of the companies that they held.

During the heyday of corporate takeovers in the early 1980s, institutional investors used their enormous resources to facilitate leveraged buyouts and oust under-performing CEOs. Within a few years state governments began to frustrate these efforts by enacting anti-takeover laws. By this time the "personalization" of company performance in the figure of a superstar CEO had already become well established. With their ability to take over companies and oust under-performing CEOs severely limited, institutional investors began to put pressure on boards of directors to carry out this task for them. In order to entice corporate superstars to come over and take the helm, boards of directors began to offer larger and larger incentive packages, a process that has been spiraling upward ever since (Conan). Although many institutional investors now loath the monster that they helped to create, others in the money management business prefer not to rock the boat for fear of a backlash against their own exorbitant salaries.

At the height of the internet boom executive compensation packages reached truly astronomical levels. The average CEO paycheck in 1999 ($12.4 million) was more than six times the average CEO paycheck in 1990. The top five CEOs in a list compiled by *BusinessWeek* earned a cumulative $1.2 billion in 1999; and the top 20 CEOs averaged $112.9 million each (Reingold). Pay packages tapered off somewhat following the Internet bust, but many CEOs still received compensation packages worth tens of millions of dollars.

The 2007 financial crisis finally gave these corporate prima donnas their first real haircut. Then the Dodd-Frank Wall Street Reform and Consumer Protection Act kicked in 2010, requiring companies to ask shareholders for approval of executive pay packages. Unfortunately, the approval is non-binding, a loophole that allows the greediest CEOs to make off with more than their fair share of booty. Lawrence Ellison of Oracle was paid $96 million in 2012, even though less than half of the company's shareholders approved this amount. (Schwartz).

Compensation for chief executives can take a variety of forms. At the most basic level are salaries, which are benchmarked according to general industry surveys that report pay percentiles based on company size. Size is typically determined by revenues or market capitalization. These surveys fail to incorporate such relevant factors as age, education, and experience—items which must be built into various adjustments made by compensation committees. A typical contract will guarantee increases in base salary levels for the next five years. Most companies also offer annual bonus plans based on the performance for the year. A typical bonus plan provides a minimum bonus once a certain threshold of performance has been reached. Rewards then increase incrementally until reaching a cap. Although some companies include certain non-financial performance measures, most rely upon a percentage based on annual profits.

The stock option is another type of compensation that has become increasingly popular in recent years. Stock options allow CEOs to buy shares of the company's stock at a specified "exercise" price for a certain time period. Most options are valid for up to ten years and are exercisable at the fair market value at the time they are granted. Some firms issue "discount options" at prices below the fair market value of the stock, while others issue "premium options" at prices above the fair market value. The rationale behind stock options is that executives will be rewarded commensurate with appreciation of the company's outstanding shares. If share price declines options are sometimes re-priced at a lower value to maintain their incentive for the CEO. Thus, unlike the typical shareholder, many executives are to a certain degree insured against loss. In contrast to the traditional maritime code of honor, it is the passengers that go down with the ship while the captain and officers get into the lifeboats. One of the reasons stock options have become so popular is that they are, for the most part, invisible in the corporate financial statements, since the granting of an option does not constitute a taxable event either for the company or the executive until they are exercised.

Another important component of executive pay is the retirement plan. Most CEOs of major corporations enjoy *Supplemental Executive Retirement Plans (SERPS)* in addition to the regular retirement plans provided to other members of the company. SERPS constitute one of the most elusive forms of executive pay for those desiring to pin down the total value of a compensation package. Payments to SERPS are typically not disclosed in public financial statements, since retired executives are no longer company employees (Murphy, 9-24). When Jack Welch stepped down as CEO of General Electric, he received a Manhattan apartment and continued use of the corporate jet as part of his retirement package. These fringe benefits amounted to nearly $2.5 million in value and only became publicly known because of a mandatory disclosure for Welch's divorce hearing (Fonda, 63).

The natural question that emerges after surveying the typical CEO incentive package is: How do all of these financial motivators affect performance? Before this question can be answered, it is necessary to determine how performance is to be measured. Increasing stock price is a very inaccurate gauge, since bull markets tend to buoy up the majority of Fortune 500 companies. "When the tide comes in all the ships rise." Although a few of these "ships" may fail to maintain the integrity of their hulls and end up sinking, most will have enough strength in their ongoing business operations and market share to make it difficult to isolate the effect of the CEO. Academic studies of the effect of CEOs on company performance have generated mixed results (Murphy, 26-43). On a more intuitive level, it seems absurd to attribute so much value to the talents of a few individuals while ignoring the aggregate contribution of the numerous skilled employees that ultimately make a company function. Often the specific technical skills that are the lifeblood of a company are rewarded with a mere pittance in comparison to the rewards top executives receive for their charisma and supposed ability to see "the big picture."

Researchers in the field of Organizational Behavior (OB) have analyzed the effects of *organizational justice*—the sense of fairness people have about their treatment within an organization—on their job performance. Organizational justice has a number of forms, one of which has been termed *distributive justice*. Distributive justice refers to the perception people have about how fairly they are being compensated for their efforts within an organization. In a perfect world of unlimited resources employees might not be bothered by a huge disparity between their pay share and that of the top executives. However, since resources within any given organization are limited, it is unlikely that a company could have the means to pay every employee a large salary that would meet all of his or her needs. To the extent that everyone is compensated fairly and salary differences are pegged to readily identifiable skill levels, experience, or longevity at the company, such differences will be tolerated. Yet when such large multiples exist between the salaries of ground level employees and those at the top, workers will begin to sense distributive injustice and lose motivation. Ultimately performance will suffer (Greenberg, 38).

Equity Theory elaborates on the concept of distributive justice and describes the ways people respond to it. According to equity theory, people compare themselves to others on the basis of outcomes and inputs. When they perceive that someone else has a higher outcome/input ratio than they do, they feel angry and resentful and seek to create a greater state of equity. This may be accomplished by lowering inputs—slacking off on the job, calling in sick more often, or even quitting; or, by attempting to increase outcomes—stealing company property, etc. Although the effects predicted by equity theory are strongest when an employee compares himself to a highly visible coworker, the relative distance and invisibility of the CEO to the average ground-level employee is no safeguard. At some point higher up the ladder an employee will sense inequity when making comparisons with an immediate superior. To the extent that such differences seem reasonable based on job position they will be tolerated. Yet if the disparity is too large a sense of injustice will set in. If an unjustly paid executive attempts to co-opt his immediate subordinate through inclusion in the high pay "club," the sense of inequity will only be passed one more rung down the ladder—not eliminated (Greenberg, 192-194).

America, like so many other nations, is witnessing a gradual erosion of its middle class. Lower taxes and shrinking government services have the ultimate effect of reducing the income of the country's poorest citizens, since their taxes are already at a minimum and needed services such as healthcare, food and housing take a huge bite out of their total income. As the ranks of the nations' poor grow larger, the wealth of the country's richest citizens is reaching unprecedented levels. Those in the middle, once the backbone of America, are finding it increasingly difficult to hold on to their current position. As one might expect, the tendency is to slide downward rather than upward. Solid, middle-class jobs with a good wage, retirement benefits and health insurance are more and more difficult to find. Even when such jobs can be found, peoples' hold on them is tenuous at best. Many corporations prefer to hire temporary workers so that they are not bound to pay for their health insurance or retirement benefits.

In some ways the world has not changed much over the millennia. Even the ancient Romans often granted slaves their freedom at around age 30 (considered old age back then) so that they would no longer be a liability. In an era of such booming prosperity for American business it is hard to imagine that the country's largest corporations are too strapped to provide good wages and benefits for their employees. The fact is that a disproportionate amount of the harvest of America's productivity is being reaped by corporate overlords while the workers are left to glean the fields. Once a precedent has been set for greed, more and more people want to get in on the action. The companies that do choose to act responsibly and place reasonable limits on executive pay face strong pressure to conform to the culturally accepted norms or risk losing talented executives.

The greed which powers the capitalist system, like uranium, can unleash tremendous productive energy. But unless it is regulated by some social equivalent of a cadmium rod, it will burn out of control and destroy the lives of the people that it is supposed to benefit. Corporations are simply not capable of policing themselves. In the absence of responsibility there must be accountability. An external authority with sufficient power, i.e., the government, is needed to regulate the entities on which its citizens depend for their well-being.

For many, the idea of greater government involvement in business affairs seems like an anathema. However, the problem of excessive executive pay could be solved in a relatively simple way with minimal governmental intervention by using one of its most powerful and effective tools—taxation. If executives opt to receive an exorbitant amount of pay instead of plowing those funds back into the company infrastructure (including both its human and material resources), the government could step in and tax away the executive's windfall, plowing it back into society in some way.

The ranks of America's workers will certainly benefit from such a change, but ultimately the stockholders (who may also include those workers) will reap the greatest rewards. Reinvesting profits back into whole companies (instead of into a few individuals) will add greater value and equip America's industries to compete more effectively in the global marketplace, thereby increasing the value of the outstanding shares of stock. Perhaps in the short-run using company profits or equity to hire a superstar may drive up the stock price, but such a system is not sustainable.

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