Studies link CEO compensation to fraud, mismanagement

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A defining feature of US capitalism today is the vast social inequality fueled by multimillion-dollar compensation paid to chief executives and the steady decline of real wages for American workers. The average $26 million paid to the heads of top Wall Street firms is equivalent to the annual income of 2,083 workers earning the minimum wage of $6 an hour.

Two studies reported in the *New York Times* last month—under the title “Stock Options: Do They Make Bosses Cheat?”—analyzing executives’ pay over the last 15 years found evidence linking large performance-based compensation packages to CEOs cooking the books or mismanaging the companies they head.

Jared Harris, a doctoral candidate at the University of Minnesota, and Philip Bromley, a management professor, studied “435 companies that were forced to restate their financial statements with similar companies that did not run into such problems,” according to the *Times*.

The report found that (a) companies granting large compensations in the form of stock options are “more likely to go broke”; (b) of the “companies where bosses got 92 percent or more of their pay in options, about a fifth ended up faking their books within five years”; (c) bosses of companies that are doing much worse than their competitors may feel a need to cheat; and (d) companies that turn in a very good year have a propensity for faking numbers the next year.

The other study is by Moody’s, the rating agency. This study found that “companies with the highest paid bosses, adjusted for things like company size and performance, were far more likely to default on debt or to suffer major cuts in bond ratings,” said the *Times*.

In its analysis of this data, the *Times* found it natural for executives whose well-being most depends on the stock going up to focus on—and manipulate if necessary—short-term results, which ultimately lead to fraud or failure. An example of the latter is Northwest Airlines, where a series of drastic cutbacks in airport service and the aircraft maintenance and repair budget have crippled the airline. Today, Northwest mechanics are on strike fighting the company’s plan to cut $176 millions in pay and benefits.

According to Moody’s, there is a relatively benign explanation: such companies are taking risks to benefit shareholders. They offer two other possible explanations: one is that high management pay reflects weak board oversight and the other that incentive pay packages can “create an environment that ultimately leads to fraud.”

The *Times* article concludes by saying, “The lesson for corporate boards is that if they think it is a good idea to lavish stock options on top management, they also need to be vigilant in putting in safeguards to prevent and discover fraud.”

One is left with the sense that the problem is merely one of greedy, dishonest executives crossing the line to better serve their shareholders. The proposed remedy is to apply strict board supervision to ensure that it will not happen again or, at least, that the frequency of CEOs committing fraud is minimized.

In other words, there is nothing wrong with the system that cannot be fixed. What this palliative fails to address is the involvement of the directors themselves in CEOs’ criminal activity.

In the last month alone, numerous instances have emerged involving directors’ involvement in approving hundreds of millions in executive pay even when companies performed poorly or when CEOs were serving jail time as white-collar criminals.

The *Times* itself provided a striking example in a column by Nicholas Kristof entitled “Announcing an Award for Greed.”

The story involves Andrew Wiederhorn, the former chairman and CEO of the Fog Cutter Capital Group, “a brilliant and hard-driving businessman, a financial whiz.” A year ago, Wiederhorn “pleaded guilty to federal charges related to an unlawful gratuity and filing a false tax return” and was sentenced to 18 months in federal prison.

What is significant is that “corporate documents released this spring show that the Fog Cutter board awarded Mr. Wiederhorn $6.3 million in total compensation for 2004 and for the nine months of prison time in 2005.”

“I can’t think of a board that has ever so disgraced the principles of corporate governance by overpaying a CEO even as he sits in prison,” concluded Kristof.

Then there are those who were rewarded by the board of directors for “walking away during the first half of 2005: Bruce L. Hammonds, MBNA ($155 millions); Philip J. Purcell, Morgan Stanley ($114 million); James M. Kilts, Gillette ($95 million); Carlton S. Fiorina, Hewlett-Packard ($42 million); and Stephen S. Crawford, Morgan Stanley ($32 million).

The outrageous amounts paid to executives who performed poorly have triggered some nervousness in the media and political circles, in response to angered shareholders’ threats to take legal action against boards of directors.

The most notorious case, and the one that prompted Kristof to write his article, was the recent ruling by a Delaware judge to turn down a shareholder suit against the Disney board for giving Michael Ovitz a “$140 million severance package as a reward for having failed catastrophically in just 14 months as the company’s president.”

Nevertheless, the case terrified directors. Had the judge found that Disney directors violated their duties to shareholders, there was a real threat that their liability insurance would not have covered them, putting their personal assets at risk.

The judge in the Disney case merely counseled the board to be vigilant. “This court strongly encourages directors and officers to employ best practices,” wrote the judge.

As with the studies of CEOs committing fraud, the implication of the judge’s advice is that, aside from a few rotten apples, the system continues to function well.

Two recently published books—*Origins of the Crash* by Roger Lowenstein and Maggie Mahar’s *Bull!*—substantiate that these are far from isolated cases, and that the system encourages wrongdoing. The books describe the role played by the government in facilitating the outright theft of social wealth by the super-rich.

Lowenstein tells the story of how bipartisan pressure prevented public watchdogs from doing their job. In particular, he refers to California’s Democratic treasurer, Kathleen Brown. “When the Financial Accounting Standards Board tried to get companies to account for the cost of issuing stock options,” she “led a public rally at which she shouted ‘Give stocks a chance!’ “

In *Bull!* Mahar recounts that Federal Reserve Board Chairman Alan Greenspan, faced with growing concerns about accounting for derivatives, “repeatedly sided with private bankers to inhibit controls and even to suppress disclosure.” After the collapse of the hedge fund Long-Term Capital Management, which nearly caused a global financial crisis, Greenspan called for less regulation.

In another report titled “Remuneration: Where we’ve been, how we got here, what are the problems, and how to fix them”(published July 2004), the most prominent academician supporting stock options for top executives, Michael C. Jensen of Harvard Business School, wrote: “In 1992, base salaries accounted for 38 percent of the $2.7 million average CEO pay package, while share options (value at grant date using the Black-Scholes formula) accounted for 24 percent. By the peak pay year 2000, base salaries accounted for only 17 percent of the average $14 million pay, while options accounted for half of pay.”

That is, between 1992 and 2000, CEO compensation grew at an annual rate of 22.8 percent, outpacing the 17.4 percent annual growth of the S&P 500.

The average American CEO makes approximately 78 times as much in salary as an average worker—and a gargantuan 500 times as much once stock options and other forms of non-cash compensation are included. Given the argument made by academicians and boards of directors that this is needed to align CEO interest with those of shareholders and attract top executives, one would expect the US stock market to have outperformed the stock markets of other countries.

But this was not the case. For example, in the same period, 1992 to 2000, the S&P 500 appreciated 3.63 times (17.4 percent per year) and the DAX, the German stock index, grew 3.93 times (18.7 percent per year), slightly outpacing the US stock market.

German CEOs earn less than a third of the compensation paid to chiefs of American corporations, with average salaries that are 21 times greater than that of an average German worker. In Japan, CEO compensation equals approximately 16 times that of an average worker’s paycheck.

One arrives at the unavoidable conclusion that the granting of stock options to chief executives was part and parcel of the corrupt environment that has prevailed on Wall Street since the early 1990s.

Neither the *New York Times* nor the judge in the Disney case offered a satisfactory explanation of what really prompted CEOs to commit fraud. To do this, one must examine the causes behind the bull market of the 1990s.

Economic theory explains that the introduction of new “digital” technologies in a firm will result in increased productivity of labor. This will lead to the manufacturing of goods using less labor, creating in this manner a comparative advantage over firms that fail to “modernize.” As a result, investors pour large amounts of money into such firms, propping up stock prices in anticipation of future returns.

The press, meanwhile, has lionized ruthless executives committed to “downsizing” and “lean production.” High compensation is justified, the media suggests, as a means of attracting hard-hitting CEOs willing to do the dirty job of firing workers and destroying families’ lives in the name of “creating value” for the shareholders and themselves.

But as Marx explained, once technological innovation more or less modifies the entire economy, the final result is to bring down the rate of profit. The way this law of capitalist development has manifested itself is through “market corrections.”

Once the stock price run, triggered by cutbacks and technological innovation, comes to an end, “unable to replicate the high performance” CEOs resort “to financial misrepresentation” or taking “risks to benefit shareholder.”

In other words, the empirical findings linking large compensation for CEOs to fraud and companies defaulting is an indication of a decaying system in which the very introduction of the tools of progress is the source of wealth polarization and corruption.