Heard off the Street: Workers, if they keep their jobs, may fare better if CEO is overpaid

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By Len Boselovic, Pittsburgh Post-Gazette

With shareholders clamoring for a greater voice in how much executives of publicly held companies are paid and Congress threatening to make it the law of the land, nary a word is being heard in defense of those who -- when they're not winging their way in the comfort of the company's Gulfstream G-IV -- are going about the grim business of enhancing shareholder value from their posh aerie at headquarters.

But a recent study by three business school professors indicates chief executive officers have a more cultivated sense of fairness on the matter of compensation than more visceral students of the topic give them credit for. The study, published last fall in Organization Science, indicates that when CEOs are overpaid, those farther down the corporate ladder tend to be overpaid, as well.

"Our study suggests that CEOs are concerned with fairness as well as self-interest, and that their ability to garner compensation for themselves can also have far-reaching consequences for the fortunes of others," the authors conclude.

The study was conducted by Rutgers University's James B. Wade, Stanford University's Charles A. O'Reilly III and Penn State University's Timothy G. Pollock.

Their work was based on surveys a human resource consulting firm conducted at more than 120 companies between 1981 and 1985. Despite the age of the data, Mr. Pollock believes that more recent data would corroborate their conclusion that CEOs contemplate the fairness of what they're paid vs. what their employees are paid.

"I think they do think about it more than people anticipate," he said. "But it's also a question of what they think is fair vs. what other people think is fair."

Their study concludes that if a CEO is overpaid by 64 percent, an executive one rung down the ladder will be overpaid by 26 percent and those four levels down will be overpaid by 12 percent.

As refreshing as this perspective on CEO pay is, don't forget the Second Law of Executive Compensation: For every pay study there is an equal and opposite study. (The First Law of Executive Compensation? Too much is not enough.)

The opposing study is provided by Craig G. Rennie of the University of Arkansas and Jeffrey T. Brookman and Saeyoung Chang of the University of Nevada, Las Vegas. Their review of the data reaches a conclusion most critics of executive pay won't find as hard to believe.

Based on two studies of what happens to executive pay following layoff announcements, the trio concludes that CEOs who initiate layoffs are paid more in subsequent years than CEOs at similar companies that don't downsize. Nearly all of the pay increase that the ax-wielding CEOs realize results from their holdings of restricted stock and stock options, awards granted annually but which generally vest over periods of up to 10 years.

That's because layoff announcements boost the value of a company's stock, something compensation packages are designed to encourage.

"Accumulated portfolios of restricted stock and stock option grants encourage CEOs to adopt operating strategies that improve operating profits and stock performance," the researchers say.

Based on their study of more than 200 layoff announcements between 1993 and 1999, downsizing the work force typically results in one-time labor savings of $65 million and a $40 million to $95 million increase in the value of all of a company's stock.

CEOs who implement layoffs receive less cash compensation (salary and bonus) the year before and the year of the cutbacks than CEOs at companies with no layoffs, reflecting poor performance the layoffs are supposed to address.

However, once they announce layoffs, CEOs begin to take home more. Their stock-based compensation is 20 percent higher the year of the announcement than the stock-based compensation of CEOs at nonlayoff firms, the researchers found. A year later, it is nearly 43 percent higher.

The results were similar when the researchers included salary and bonus. Layoff CEOs received 9 percent more in total compensation the year of the announcement than nonlayoff CEOs, and 23 percent more the year after the announcement, according to the study.

Their second study looked at more than 500 layoff announcements from 1993 to 2003, examining the differences in CEO stock-based pay at companies with layoffs and companies without them. For every $1 change in the price of their stock, CEOs responsible for layoffs received an average of $899,000 vs. the $461,000 received by CEOs at nonlayoff firms.

Because of the impact stock price changes can have on executive compensation, Mr. Rennie would like to see the SEC require some disclosure of just how sensitive an executive's wealth is to changes in the price of his company's stock.

"We believe that's the CEOs primary source of incentive," he said.

Few will fail to understand why stock is a more powerful incentive for CEOs than fairness -- a fact of life shareholders have an easier time of accepting than workers who have been laid off or are grasping the bottom rungs of the corporate ladder.

However, the finding that fairness is somewhat of a consideration for CEOs -- no matter how distorted their perception of fairness may be -- gives hope to those who believe it should be more than a passing thought.

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