# Agenda

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## Study: CEO Pay Affects Employee Retention

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## Study: CEO Pay Affects Employee Retention

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News Analysis by Jonathan E. Braunstein

Directors who think **Exxon Mobile**’s $388 billion revenues justify its former CEO **Lee Raymond**’s $400 million exit package might be surprised to learn that the comp of any corner office occupant can have implications beyond its direct impact on the company’s bottom line. A CEO’s pay package has the potential to affect lower-level executives’ salaries and increase employee turnover, a new study shows.

The study, titled “Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation,” was published in *Organization Science*. Its co-authors are **James Wade** of **Rutgers**, **Charles O’Reilly** of **Stanford**’s Graduate School of Business and **Timothy Pollock** of **Penn State**’s Smeal College of Business. They argue that a board's decision to bestow exorbitant compensation on its CEO results in large and expensive portion of a company’s workforce also being overpaid.

In one of their models the CEO is paid 64% more than the CEOs in his company’s peer group. In turn, the company’s level-two employees (its COO and CFO, for example) are paid 26% more — and the level-five employees 12% more — than their counterparts at peer companies.

“Given the large sums paid to some senior executives, the total cost for overpayment could be a big number — and, in some cases, significantly affect shareholder returns,” comments O’Reilly.

Underpaying a CEO can bring down lower-level employees’ salaries, but the effect is usually less significant.

Defenders of high CEO pay argue that it is necessary for retention. Companies use salary and performance-driven compensation to retain and motivate employees. But the *Organization Science* study finds that overpaying the CEO actually is having a contrary effect.

Subordinates are more likely to leave when a CEO is overpaid. That's because they judge their own salaries relative to their superiors'. When employees realize they're not as relatively overpaid as the executives above them on the company's organizational chart, they are more likely to leave. This so-called "turnover effect" becomes more pronounced as you move farther down the company's organizational chart, according to the *Organization Science* study.

"It is quite possible that those most likely to leave because of perceived unfairness are precisely those employees coming up in the organization that would eventually rise to the top management team level," explains Wade.

The same effect is found among companies where the CEO is underpaid, but only when the subordinates are underpaid more than the CEO. For example, at a company where the CEO is paid 20% less than his counterparts at peer companies and the subordinates are paid within 20% of the mean salary received by employees at their level at other firms, turnover tends to reduce.

**Viacom** chairman **Sumner Redstone** may have had these ideas in mind when he recently reduced his compensation. Redstone's pay now will be based on Viacom's financial performance, and therefore will be aligned with shareholder interests more closely, *The New York Times* reports. The Associated Press points out that his new pay structure is similar to the compensation deals recently reached with the company's new CEO, **Philippe Dauman**, and its new chief administrative officer, **Thomas Dooley**. By making Redstone's pay more similar to Dauman and Dooley's, Viacom could reduce turnover in the lower ranks and improve employee morale, at least according to the tenets of the *Organization Science* report.

Starting in 2007, Redstone's salary will drop from $1.75 million to $1 million and his $1.3 million in deferred compensation will be eliminated. Moreover, his performance-based bonus will go from $6.1 million to $3.5 million. Among the other changes, Redstone, who is Viacom's founder, will receive $3 million each year in stock options. He has converted $9.4 million in deferred compensation into stock options. In doing so, he forgoes nearly $10 million in guaranteed money for an entirely risk-based equivalent.

"It is pretty significant," **Robert McCormick** of proxy advisor **Glass, Lewis** told the *Times*. "It is rare for a company to take such a step unless they are in dire circumstances."

McCormick also commented that Redstone, as founder, is already heavily tied to the company, making it that much more significant that they chose to lower his salary.

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