How Much Compensation Can CEOs Permissibly Accept?

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ABSTRACT: Debates about the ethics of executive compensation are dominated by familiar themes. Many writers consider whether the amount of pay CEOs receive is too large—relative to firm performance, foreign CEO pay, or employee pay. Many others consider whether the process by which CEOs are paid is compromised by weak or self-serving boards of directors. This paper examines the issue from a new perspective. I focus on the duties *executives themselves* have with respect to *their own* compensation. I argue that CEOs' fiduciary duties place a moral limit on how much compensation they can accept, and hence seek in negotiation, from their firms. Accepting excessive compensation leaves the beneficiaries of their duties (e.g., shareholders) worse off, and thus is inconsistent with observing those duties.

EXECUTIVE COMPENSATION has received a great deal of attention. This is due, in part, to the large amounts of compensation executives, especially CEOs, receive. In 2006, the median total compensation of the top 150 U.S. CEOs was \$10.1 million (Dash, 2007). This is 314 times the \$32,142 earned by the median full-time private industry worker in the U.S. in 2006 (Bureau of Labor Statistics, 2007). Most of the discussion of executive compensation has focused on its economic aspects. A popular question is: do executives' compensation packages give them incentives to maximize firm value (Hall & Liebman, 1998; Jensen & Murphy, 1990b; Tosi, Werner, Katz, & Gomez-Mejia, 2000)? If not, how might those packages be differently structured so that they do (Bebchuk & Fried, 2004; Jensen & Murphy, 1990a)?

This paper examines some moral aspects of executive compensation. It is not the first to do so, but it engages the issue from a new perspective. Many writers consider whether the amount of pay CEOs receive is too large—relative to firm performance, foreign CEO pay, or employee pay (McCall, 2004; Nichols & Subramanian, 2001). Many others consider whether the process by which CEOs are paid is compromised by weak or self-serving boards of directors (Moriarty, 2005; Perel, 2003). I focus on the duties *executives themselves* have with respect to *their own* compensation. In particular, I argue that CEOs' fiduciary duties place a moral limit on how much compensation they can accept, and hence seek in negotiation, from their firms. Accepting excessive compensation leaves the beneficiaries of their duties (e.g., shareholders) worse off, and thus is inconsistent with observing those duties.

A clarificatory note. Like others who write on executive compensation, I am primarily interested in chief executive officer compensation. By 'executive,' then, I mean principally 'CEO.' However, most of what I say applies, with minor modifications, to the pay of other top executives.

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1. BACKGROUND

I assume, as is standard, that CEO compensation is a result that comes about from a negotiation. The CEO proposes to sell her labor to the firm, and the firm proposes to buy it. Members of the board of directors—in particular, members of its compensation committee—represent the firm at the negotiating table.

It is widely accepted that, within certain limits, pay negotiations between CEOs and directors, as between any buyer and any seller, should be free. Each side should be free to make an offer, with the other side being free to accept or reject it. There is some debate, however, about what these limits are.

A familiar one applies to the negotiating *process* itself. Most think that a just negotiation is one that is conducted without force or fraud (Child, 1994). If this is right, then CEOs should not lie to or deceive directors, or threaten them or use other kinds of force, when negotiating their pay (and vice-versa).

There is more debate about what, if anything, justice requires with respect to *results*. Some claim that there is no independently just amount of pay for an executive (or any other worker). On this view, a just amount is any amount the executive and the directors would agree to through a free and fair negotiation (Nozick, 1974). Others think some results can be just or unjust, independently of what people would agree to. For example, some claim that a worker's getting less than a certain wage is always unjust (Bowie, 1999). Others claim that it is unjust if two workers who do the same work equally well receive unequal wages (Hurka, 2003). If certain results are unjust (or just), then CEOs and directors should avoid (or achieve) them.

I do not propose to offer a complete set of norms governing executive compensation, so I will not try to identify all of the ways that it can be just or unjust. My goal is to defend a single new norm, one limiting the amount of compensation it is permissible for a CEO to seek or accept from a firm.

2. A NEW LIMIT: THE CEO'S FIDUCIARY DUTY

I begin with the common assumption that executives are fiduciaries. What does this mean? Marcoux explains, "[t]o act as a fiduciary means to place the interests of [a] beneficiary ahead of one's own interests and, obviously, those of third parties, with respect to the administration of some asset(s) or project(s)" (2003: 3). In the CEO's case, the asset or project is the firm. So, CEOs are required insofar as they are fiduciaries to place one party's interests ahead of their own and others' when managing the firm. That is, they have a *fiduciary duty* to do so.[1]

According to some writers, CEOs are fiduciaries for shareholders (Boatright, 1994; Marcoux, 2003).[2] According to others, they are fiduciaries for all stakeholders (Evan & Freeman, 2005). As I will show, the moral limit I identify exists if CEOs are fiduciaries for *anyone* who stands to lose when CEOs accept excessive compensation. This includes shareholders, stakeholders, and certain other parties. To fix ideas, however, I assume that CEOs are fiduciaries for shareholders.

I further assume that CEOs are fiduciaries in a *moral*, not merely *legal*, sense. To determine whether CEOs' fiduciary duties in law have implications for their pay negotiations with directors, all that is required is to look at the relevant law. My goal is to determine what, if any, implications CEOs' moral fiduciary duties have for their negotiations with directors. While many agree that CEOs have moral fiduciary duties, they do not agree about why they do. Some appeal to consequentialist considerations (Boatright, 1994); others appeal to deontological considerations (Hasnas, 1998); others draw analogies between CEOs and others who we think have fiduciary duties, such as doctors (Marcoux, 2003). I do not differentiate among these types of arguments. This is because they all arrive at the common conclusion that CEOs have moral fiduciary duties.[3] If this conclusion is false, then my argument loses much of its force. However, since it is widely believed, it is worth considering its implications.

Assuming that CEOs have fiduciary duties in the moral sense (hereafter, I drop this qualifier), what follows about how they should manage their firms? It is standardly assumed that shareholders want to maximize the monetary value of their investments. Thus, in his classic defense of shareholder theory, Friedman says that a CEO is obligated "to conduct the business in accordance with [his employers'] desires, which generally will be to make as much money as possible" (2005: 8). Let us assume that shareholder value is maximized when firm value, which Jensen defines as "the market values of the equity, debt, and any other contingent claims outstanding on the firm" (2002: 239), is maximized. If so, then executives should manage the firm so as to maximize its value. Managing the firm this way has implications for how much compensation a CEO can permissibly seek or accept from it.

Compensation produces value for the firm by attracting and retaining talented employees, and motivating them to do their best. But compensation is a cost. Other things equal—where "other things" includes the firm's performance—the lower this cost is, the better. It is widely believed that directors have a duty to minimize this cost. I claim that *CEOs themselves* do too. Suppose a compensation package worth $10 million is sufficient to induce a CEO to do his best for the firm, i.e., to maximize its value, so far as he is able. But suppose that the CEO would also do his best if he were paid only $9 million. Then he should refuse the larger package in favor of the smaller one.[4] Now suppose that, if the CEO were paid $8 million, he would not do his best, and the firm would be worse off by more than $1 million. In this case, the CEO is justified in accepting the $9 million package.[5] In general, the optimum amount of compensation for a CEO is the amount that maximizes firm value, taking into account the cost of the compensation. Of course, a CEO is unlikely to work, or work hard, for free.[6] She will require some, perhaps even a lot, of pay. And shareholders are willing to pay for talent. Hiring a talented but expensive CEO, and properly motivating her, produces more net value for the firm than hiring an untalented but inexpensive one, or failing to properly motivate her. But still what is best for shareholders is that they pay the (talented) CEO no more than is necessary to attract, retain, and motivate her. The CEO's fiduciary duty prohibits her from accepting more than this amount.

Let us call this amount—i.e., the minimum necessary to attract, retain, and motivate the CEO to maximize firm value—her *minimum effective compensation*, or MEC. This amount is *effective* because it succeeds in attracting, retaining, and motivating the CEO, and *minimum* because no less would do. Let us further assume, as is standard, that the CEO is motivated exclusively by self-interested considerations, i.e., she is not intrinsically motivated by shareholders' interests. (Later in the paper I examine the implications of relaxing this assumption.) Finally, let us define "excessive compensation" for a CEO as compensation in excess of her MEC.

In economic terms, a CEO's MEC is her "reservation wage" for the job, i.e., the amount necessary for her to accept and retain it (Nicholson, 2005), unless, as is often the case, extra pay (e.g., in the form of performance-based incentives) would motivate her to produce an amount of extra revenue for the firm that exceeds the amount of the extra compensation. In this case, the CEO's MEC includes the *minimum amount* necessary to produce that extra revenue.[7] A CEO's MEC will be a function of her next best alternative, including working for another firm, or not working at all. This in turn will depend on her talents, preferences, and market conditions (Rajgopal, Shevlin, & Zamora, 2006). Note that the CEO's MEC is *not* defined in terms of what she is "worth," understood as how much revenue she adds to the firm (compared to the next most effective available candidate). So it is possible for an amount of compensation to be more than a CEO's MEC but less than her worth.[8] However, the more revenue the CEO adds to the firm, the better alternative offers she will have. So her MEC and worth will tend to converge in a free market (Shorter & Labonte, 2007).[9]

As I have suggested, the CEO's fiduciary duty entails not only a duty not to *seek* more than her MEC in negotiation, but a duty not to *accept* more than her MEC if it is offered. To illustrate: Richard Grasso, former head of the New York Stock Exchange (NYSE), famously was awarded a $187 million compensation package. In his defense, Grasso said he never had a "two-way dialogue" with the NYSE's directors about his pay (Farrell, Valdmanis, & Strauss, 2003). Assuming that $187 million was more than necessary to attract, retain, and motivate Grasso, this does not excuse his behavior. CEOs do not avoid blame by simply staying out of the pay setting process, as they would in a standard conflict-of-interest situation. They are required by their fiduciary duty to be proactive about ensuring that they do not receive excessive pay.

I have said that the truth of my conclusion does not depend on the truth of shareholder theory. It is easy to see how. What prohibits the CEO from accepting excessive compensation is the fact that she has a fiduciary duty to *someone* who stands to lose if she does. Not only shareholders stand to lose if CEOs gets excessive compensation. All stakeholders do. My conclusion applies, then, to theories of the firm that assign CEOs fiduciary duties to stakeholders, including, notably, the multi-fiduciary version of stakeholder theory (Evan & Freeman, 2005).[10]

3. EXECUTIVE COMPENSATION IS SPECIAL, BUT PERHAPS NOT UNIQUE

If the argument of the previous section is right, then executive compensation differs from the compensation of a variety of other parties. It differs, first, from non-executive, or worker, compensation. It is commonly assumed that workers lack fiduciary duties to shareholders. If this is right, then workers lack the duty to accept no more than their MECs from their firms.

The same is true of outside consultants. Outside consultants may owe fiduciary duties to the shareholders of their "home" firms, but they do not owe them to the shareholders of their "client" firms, i.e., those for which they consult. They are free to accept more than their MECs from the latter.

Executive pay also differs from "superstar" athlete and entertainer pay. This difference is especially notable. According to some writers, the critical focus on executive pay is unfair. If we criticize CEOs, they say, we should also criticize athletes and entertainers, because they too get paid a lot of money (Augustine, 2005; Snyder, 2003). In response, critics have pointed out a number of differences between CEO pay and athlete and entertainer pay. For example, Bebchuk and Fried (2004) argue that CEOs' pay negotiations are not conducted at arm's length,[11] whereas athletes' and entertainers' are (see also Nichols & Subramanian, 2001; Walters, Hardin, & Schick, 1995). If I am right, then we can add to the list of differences that CEOs have fiduciary duties to their employers (viz., shareholders), whereas athletes and entertainers do not. Of course, athletes and entertainers have *some* duties to their employers, viz., those specified in their employment contracts, typically to perform certain services in exchange for compensation. But these are not *fiduciary* duties. Athletes and entertainers need not put their employers' interests above their own. So they have no duty not to accept excessive pay in the way, I have argued, CEOs do.

I am not suggesting that it is impossible to criticize athlete and entertainer pay. It may be inefficient or unfair. My point here is just that, if the above argument is right, then one of the criticisms that can be leveled at CEOs cannot be leveled at them. If so, the case for criticizing high pay for CEOs is stronger in one respect than the case for criticizing high pay for athletes and entertainers.

Here a question arises. Do others who have fiduciary duties to their employers also have duties to refrain from accepting excessive pay? Consider, for example, doctors in private practice. Is it the case that, considered as fiduciaries for their patients, they can accept no more than their MECs? A similar question could be asked about privately employed lawyers and teachers.

I will not try to answer these questions. But it seems to me that the executive's duty not to accept excessive pay is more salient that any similar duty that might be had by doctors, lawyers, and teachers. What the CEO is charged with promoting for those for whom he is a fiduciary is the same as what he is paid with, viz., money. So it is manifest that a CEO's accepting more than his MEC is inconsistent with the maximal promotion of shareholders' interests. Shareholders value money. If the CEO extracts excessive compensation from the firm, then shareholders are, to that extent, worse off. By contrast, what the doctor, lawyer, and teacher are charged with promoting for those for whom they are fiduciaries is different than what they are paid with. They are paid with money, but the doctor promotes health, the lawyer promotes legal interests, and the teacher promotes learning. It is possible that, if, for example, doctors demand too much compensation, then their patients' health may be damaged. They may be left unable to pay for other valuable medical treatments. But the interests of the doctor and patient are not as directly opposed as the interests of the CEO and shareholder.

Some might doubt that the CEO/shareholder case is special. But nothing in my argument depends on its being so. If it isn't, all that follows is that doctors, lawyers, and teachers *also* have duties to refrain from accepting excessive compensation. It does not follow that executives have no such duty.

4. A DEFENSE OF THE LIMIT AGAINST SIX OBJECTIONS

I have argued for a new moral limit on CEO compensation: CEOs should not accept excessive compensation—i.e., more than their MECs—from their firms. In this section, I defend my argument against objections. I suspect that many will deny that the CEO's fiduciary duty applies in the context of determining her pay. I consider variations of this concern in objections 2, 3, and 4.

Objection 1. This moral limit on CEO pay is moot: a CEO will never accept excessive compensation, because it will never be offered to her. Directors will make sure she gets paid no more than is necessary to attract, retain, and motivate her. Market pressures will aid directors in this effort.

Response. This objection assumes that directors are highly powerful and knowledgeable with respect to the CEO. Against this, first, many writers have argued that the pay negotiations between CEOs and directors are not carried out at arm's length, and in particular, that directors fail to represent aggressively shareholders' interests at the bargaining table (Bebchuk & Fried, 2004; Bertrand & Mullainathan, 2001; Hambrick & Finkelstein, 1995; Main, O'Reilly, & Wade, 1995; for an opposing view see Core, Guay, & Thomas, 2005; Gabaix & Landier, 2008; Henderson, 2007).[12] Second, even if they have the will to achieve the optimal result, directors are likely to be ignorant of what it is. Knowing, as they often do, the average compensation of CEOs of comparable firms does not tell them the precise MEC of their *particular* CEO. Thus, we have reason to believe that it is possible for executives to receive excessive compensation, and hence that it is worth determining whether or not they are morally permitted to.

Objection 2. When a CEO negotiates her compensation, she is not yet a member of the firm. The employment agreement through which she becomes a fiduciary has not been made. So, she does not yet have a fiduciary duty to the firm's shareholders and hence is not yet forbidden to accept excessive compensation.

Response. This objection does not apply to CEOs who are negotiating *subsequent* compensation packages with their firms. Nor does it apply to CEOs negotiating their *first* compensation packages with a firm who are promoted to the CEO's position from within the firm's top management. Both kinds of CEO are already top managers in their firms, and so have fiduciary duties to their firms' shareholders.[13] The objection applies, then, only to CEOs who come from outside the firm, and only when they are negotiating their first compensation packages. Although the number of outsider CEOs has increased in recent years, approximately 75 percent of new CEOs are insiders (Jensen, Murphy, & Wruck, 2004; Allgood & Farrell, 2003). In addition, at least half of CEOs engage in subsequent compensation negotiations while in office. The median tenure of CEOs at five years (Felicelli, 2008) exceeds the standard length of their employment contract at three years (Schwab & Thomas, 2006). Thus, the substantial majority of CEO compensation negotiations are immune from this objection.

Even given its limited target, however, the objection fails. Whether or not *some* CEOs lack fiduciary duties to shareholders when they negotiate their compensation packages (because they are outsiders), *all* CEOs have these duties when they receive them. This effectively prevents all CEOs from seeking in negotiation, or accepting, more than their MECs. Consider an example. C, an outsider, is soon to become the CEO of firm F. C negotiates her compensation package before she starts working for F. Call this time T1. She begins to receive the agreed upon compensation once she starts work. Call this time T2. Because C is not a member of F at T1, C does not have a fiduciary duty to F's shareholders at T1. However, C will be a member of F at T2, and will have a fiduciary duty to F's shareholders at that time. Thus, at T2, C cannot accept more than her MEC. Given that C will receive the agreed upon compensation at T2, it would be wrong for her to seek more than her MEC at T1.

I am not claiming that, if a person has a duty at T2, and T2 is later than T1, then she has that duty at T1. This claim is easily refuted. Suppose a person who is now 30 will be a parent when she is 31. At 31, she will have a duty to care for her child. But it doesn't follow that she has a duty to care for her (or any) child now, when she is 30. Nevertheless, the fact that the 30 year old *will have* a duty to care for her child at 31 constrains what she can do at 30. She cannot at 30 promise a friend to devote all of her resources and attention when she is 31 to political activism in a distant nation, for she will be obligated, and knows she will be obligated, to care for her child at that time.[14] In the same way, since C is negotiating at T1 the nature of an event that will occur at T2, the duties she will have at T2 constrain her actions at T1.

The original objection might be pressed further. It might be said: CEOs' fiduciary duties require them to maximize shareholder value *within the terms* of their employment contracts. But those terms can be anything the parties mutually want them to be.[15] On this view, there is nothing wrong with, for example, a person's accepting a job as a CEO on the condition that he get to engage liberally in "empire-building," i.e., acquiring other firms, even when he knows the acquisitions to be bad for shareholders. It only matters that he seeks to maximize shareholder value in all other facets of his job. Similarly, it might be claimed, there is nothing wrong with a person's accepting a job as a CEO on the condition that he is paid in excess of his MEC, provided that he seeks to maximize shareholder value in all other facets of his job.

As is clear, I deny this. Given the nature of the relationship the person is entering into when he signs up to be the CEO of a firm, there are things he simply cannot contract for in good conscience. He knows he will be bound by his fiduciary duty to maximize shareholder value. How then can he seek an exemption for himself to engage in empire-building, or compensation for himself that he knows to be unnecessary? Compare a person who is considering entering a monastery where all are required to take a vow of silence. Might he say: "well, I'd like to talk a certain amount, but excluding this amount, I'll be silent"? This is not a deal the monks should allow the person to strike, and the person cannot in good conscience strike it. It is in deep tension with the role he will occupy once in the organization. Something similar is true, I suggest, of the CEO. Given the role he will occupy once he becomes CEO of the firm, he cannot in good conscience contract to receive excessive compensation.

Objection 3. CEOs are not required *always* to act so as to maximally benefit shareholders. They are only required to do so when they are acting *as managers*, i.e., managing the firm. So, for example, when they are acting *as parents*, i.e., raising their children, they need not act so as to maximally benefit shareholders by, say, trying to persuade their children to buy their firms' products. The same goes for when CEOs are acting as players on a softball team or members of a neighborhood watch. On this objection, when CEOs are negotiating their pay, they are not acting as managers. Put another way, this is not something they need be concerned with in their role as managers. Here they can act *as private citizens*: they are free of the fiduciary duty to shareholders, and so are free to accept excessive compensation.

Response. The claim that CEOs are required to maximize shareholder return only insofar as they are acting as managers is correct. It would be absurd to suppose that they are required to do so in every facet of their lives. However, the claim that, when they are negotiating the terms of their compensation, they are free to act as private citizens and not as managers, is wrong. Surely, the question of how much to pay a firm's workers is a business decision. Attracting, retaining, and motivating talented workers—while not overpaying them—is crucial to a firm's success. So, the CEO's fiduciary duty to shareholders to maximize firm value requires that she concern herself, at some level, with the compensation of the firm's employees. But the CEO is an employee too, so it follows that she must concern herself, *as a manager*, with her own compensation. In examining the firm's payroll to determine whether any cuts can be made to boost firm value, she cannot exclude her own pay from consideration. Much as she might like to be free of the duty not to accept excessive compensation, she is not.

Objection 4. A party to whom a duty is owed can waive its performance, wholly or in part. If they do, the party who owes the duty is not obligated to perform it. I can release you from your duty to drive me wherever I want with respect to, say, driving me to the airport. According to this objection, shareholders—or their representatives, the directors—have done something similar with respect to the CEO's fiduciary duty. While generally leaving it in place, they have waived it in the context of determining the CEO's pay. They have not done so explicitly, by declaring the duty to be waived, but they have done so implicitly, by employing a negotiation to set the CEO's pay. Employing an *adversarial* process signals that, in this context, the CEO's fiduciary duties are suspended: directors are safeguarding the firm's interests, and the CEO can do as she pleases, including accept excessive compensation.

Response. To be clear, the issue is not whether the CEO and directors (merely) *recognize* the application of the CEO's fiduciary duty to the pay setting process. This duty can apply even if it is not thought to apply. The issue is whether directors have *waived* its observance. The objection claims that they have.

In response, it is not clear, first, that directors *can* waive executives' fiduciary duties. Just because one is owed a duty—in the sense that one is the beneficiary of it—does not mean one has the power to waive it. I cannot waive your duty not to enslave me, though I benefit from your observance of it. If your duty to me is based on a contract we have entered into, then I can waive its performance. Thus, if the foundation of your duty to drive me wherever I want is that you have promised me to do so, then I can waive your duty. But it is not clear that the CEO's fiduciary duty to shareholders is contractually based. Boatright, for example, argues that the reason executives owe fiduciary duties to shareholders (as opposed to others) is that this is "the most socially beneficial system of economic organization" (1994: 401). If he is right, then *directors* cannot waive CEOs' fiduciary duties. It does not follow, of course, that they cannot be waived *simpliciter*. But if anyone can waive them, it is society as a whole.

For the sake of argument, however, let us suppose that directors can waive CEOs' fiduciary duties. According to the objection, the evidence that they have done so in the context of setting the CEO's pay is that the process used to determine it is adversarial in nature. This is poor evidence. At present, the CEOs' duties not to accept more than their MECs is not widely recognized, so it would be foolish for directors to allow them a free hand in setting their own pay. Even if this duty were recognized, directors might still wish to retain the negotiation as a way to protect the firm. CEOs will be tempted to seek excessive compensation, even if they know they should not.

Objection 5. According to commonsense morality, while people are sometimes required to benefit others at their own expense, they are not required to make enormous sacrifices for them. For example, this morality would have us give some—perhaps even a substantial amount—of our wealth to the poor, but not so much that we end up impoverished ourselves. Prohibiting the CEO from accepting excessive compensation, according to this objection, places too heavy a burden on him—i.e., it is too demanding—and cannot be justified by his fiduciary duty.

Response. One way to challenge this objection is to deny that the demandingness of a moral requirement is a reason to reject it. This is a standard criticism of consequentialism, but it is far from clear that it succeeds (Sobel, 2007). A better way is to deny that the prohibition on accepting excessive compensation is too demanding. Recall that excessive compensation is compensation in excess of the CEO's MEC, which is in turn of a function of his next best option. Since a CEO's MEC depends on his particular talents and preferences, it is difficult or even impossible to identify what any given CEO's MEC is. But few deny that CEOs are (perceived to be) highly talented individuals who command considerable premiums for their labor. As a result, every CEO is likely to have at least one other very high-paying option for work. This means that their MECs will be very high—far higher than the compensation of the average worker. Given this, it is implausible to suppose that prohibiting the CEO from accepting excessive compensation is too demanding. To be sure, a CEO who refuses to accept more than his MEC might have to refuse a large sum of money. But it doesn't follow that the burden he is under is heavy, given how high his MEC is likely to be.

We can appreciate the relative lightness of this burden by comparing it to other burdens imposed on parties by the CEO's exercise of his fiduciary duty. In order to carry it out, the CEO will occasionally have to lay off workers, change suppliers, and lobby governments for business-friendly legislation. On the assumption that CEOs have fiduciary duties to shareholders, these actions seem justified. However, they all place burdens on people—on employees, suppliers, and community members. To the extent that these parties are less well-off than CEOs, these burdens seem heavier than the burden placed on the CEO by the prohibition against accepting excessive compensation. More importantly, we recognize legitimate and significant burdens placed on the CEO himself by the observance of his fiduciary duty. It prohibits him from shirking, hiring unqualified friends, and undertaking unprofitable acquisitions. Refraining from engaging in at least some of these activities is likely to be as burdensome to him as refraining from accepting excessive compensation. So, even though the latter is a burden on the CEO, it cannot plausibly be described as too heavy, especially compared to the other legitimate burdens imposed by the exercise of his fiduciary duty.

Objection 6. The prohibition against accepting excessive compensation discriminates against steward CEOs, i.e., CEOs who are intrinsically motivated by shareholders' interests (Davis, Schoorman, & Donaldson, 1997). Because of this motivation, it takes less compensation, other things equal, to attract, retain, and motivate a steward CEO than an agent CEO, i.e., one who is motivated only by self-interested considerations (Wasserman, 2006). So it seems that the steward CEO accepts more than his MEC at a lower compensation level than the agent CEO. But intuitively, the former is more virtuous than the latter. The prohibition against accepting more than one's MEC thus punishes the steward CEO for his virtue.

Response. This objection misunderstands the definition of MEC. I said that a CEO accepts more than his MEC when he accepts more pay than is necessary to attract, retain, and motivate him to maximize firm value, *assuming he is acting on self-interested motives only.* This assumption is not an empirical conjecture but a normative standard. The MEC is defined relative to the compensation requirements of the agent CEO. So, a steward CEO who seeks more than he *actually needs* to be attracted, retained, and motivated does not accept more than his MEC, if that is not more than what he *would need* if he were acting on self-interested motives only.

It is nevertheless true that whether a CEO accepts more than his MEC is in large part a personal matter. It depends on the CEO's particular situation—whether he, given his preferences and options, would work just as hard for the firm for less. This has two important implications. First, one CEO's MEC may be less than another's even if both are equally talented. So, for example, if CEO A has a stronger preference for leisure than CEO B, then, other things equal, A will need more compensation to remain with his firm, as opposed to retiring, than CEO B. Second, it will be difficult or impossible to tell "from the outside" whether a CEO is accepting more than her MEC. The prospects, then, for enforcing a ban on doing so is dim. Some might regard this as problematic for my argument. It might be if my claim were that there should be a *law* against accepting more than one's MEC, so that violators should be subject to civil or criminal penalties. But my claim is that CEOs have a *moral duty* to accept no more than their MECs. The validity of a moral rule does not depend on its enforceability.

5. HOW LOW SHOULD CEOS GO?

Objection 6 raises an important issue which we have so far bracketed. We have measured the CEO's MEC by a partly objective standard, viz., that of the agent CEO. It is the minimum necessary to attract, retain, and motivate him to maximize firm value *assuming he is acting on self-interested motives only*. But, it might be said, while it is desirable to have *some* objective standard for measuring the CEO's MEC, why choose this one? Instead of pegging it to the motivational set of the agent CEO, why not peg it to the motivational set of the steward CEO i.e., the CEO who is intrinsically motivated by shareholders' interests?

It might be replied that CEOs cannot act other than on self-interested motives. But this is false, as evidenced by the fact that some CEOs are stewards (Wasserman, 2006). Or, it might be replied that this standard best fits the facts: most CEOs, like most economic actors, are self-interested. Indeed, the assumption that individuals are "agents" in this sense is standard within the economic literature. This reply is also unsatisfactory. We are interested in what CEOs *should do*. Whatever in fact CEOs *are*, perhaps, in view of their fiduciary duty, they *should be* stewards.

If we adopt the steward CEO as our standard, the prohibition on driving a hard bargain becomes more burdensome. As seen, because they are intrinsically motivated by their fiduciary duties, steward CEOs need less money to maximize firm value, other things equal, than agent CEOs (Wasserman, 2006). The more weight the fiduciary duty gets in the CEO's motivational set—i.e., the more of a steward he is—the less money he needs. At the limit, if we choose as our standard the maximally "steward-like" CEO, then it seems the CEO can permissibly accept very little, or even no, pay.

We see now why it makes sense to start, as we did, with the assumption that CEOs are agents. This minimizes the burden imposed on the CEO by the prohibition against accepting excessive pay. If this weak burden cannot be justified, then no stronger one can be. But since the former is justified, it makes sense to inquire into whether the latter can be. Our question is, how much weight should the CEO give to his fiduciary duty in his motivational set, as compared to self-interested considerations? To what extent should he do what is best for shareholders (viz., accept less and less pay), and to what extent can he do what is best for himself (viz., accept more and more pay)? Answering this question requires weighing the force of the CEO's fiduciary duty against moral considerations on the other side.

The CEO's fiduciary duty is thought to have considerable weight. It is appealed to to justify laying off workers and moving plants to foreign countries, despite the burdens these actions impose on employees and communities. It is also thought to justify prohibiting CEOs from shirking, hiring unqualified friends, and empire-building, despite the burdens these prohibitions impose on CEOs.

But if we take seriously, as many do, the idea that morality doesn't require people to take on *enormous* burdens in order to do what is right, then there is a limit to this duty's force. Having to accept a job as a CEO on the condition that one accepts very little compensation is a heavy burden not only on the CEO, but on his family. It is unlikely that the CEO's fiduciary duty requires this level of sacrifice. And surely, it does not require him to take on burdens that are physically or psychologically impossible for him to bear, such as subsisting on air while working 168 hours per week. If, as is commonly believed, ought implies can, then cannot implies not-ought. So, the CEO has no duty to make sacrifices that are impossible for him to make.

Moreover, it is probable that what is best for the firm is not that the CEO accept *very* little compensation. There must be incentives for others, both inside and outside the firm, to aspire to the CEO's position. One such incentive is high pay for the CEO. This is stressed by tournament theory, according to which employees in the firm work hard to win the "prize" of becoming CEO (Bognanno, 2001; Lazear & Rosen, 1981).[16] In this way, the CEO may be *required* by her fiduciary duty to receive a large amount of compensation. This is not to say that in some cases the CEO is justified in accepting more than her MEC, but that in some cases her MEC, which she may be required to accept, may be de-coupled from the minimum amount necessary to attract, retain, and motivate *her*. The "effectiveness" of compensation is a function of its effects on firm value. We have assumed, consistently with firms' own justifications of their executive compensation packages, that the utility of these packages results from their attracting, retaining, and motivating the very persons who receive them (Zajac & Westphal, 1995). But if their utility results from motivating *others*, then this must be taken into account in determining the most effective amount of pay.

Finally, it may be good not only for individual firms but for society as a whole if CEOs negotiate in their self-interest, at least to an extent. If CEO compensation is too low, few people will want to become CEOs. They will seek work as, e.g., lawyers or investment advisors. But society as a whole benefits when talented people occupy these important and demanding positions (Jensen & Murphy, 1990a). One way to make it more likely that they do is for CEOs to be highly paid. And one way to promote this is to encourage self-interested negotiation by CEOs.[17]

In sum, while the CEO's fiduciary duty exerts downward pressure on her compensation by encouraging selfless negotiation over compensation, it is unlikely to tell in favor of her receiving very little pay. And other considerations tell in favor of (permitting) more self-interested negotiation and thus higher compensation. Determining where the balance of considerations lies—i.e., how self-interestedly the CEO can and should act when negotiating her pay—is a complex inquiry lying outside the scope of this paper. It will be important in this inquiry to identify the moral values that ground the CEO's fiduciary duty, and evaluate the extent to which they are promoted or thwarted by selfless negotiation over compensation. Whatever the outcome, my more modest conclusions seem safe, viz., that CEOs' fiduciary duties apply in the pay setting context, and imply (minimally) that they should accept no more than their MECs, assuming that they are acting on self-interested motives only.

6. CONCLUSION

It is widely believed that directors have a duty not to award CEOs excessive compensation, but should instead seek to pay them the smallest amount necessary for them to maximize firm value, since this is what is best for shareholders. I have not challenged this view; indeed, I accept it. Rather, I have argued that CEOs *themselves* have a duty, deriving from their moral fiduciary duty, not to *accept* excessive pay—i.e., pay in excess of their MECs, assuming that they are acting exclusively on self-interested motives—from their firms. This result, if correct, is significant. Because of directors' lack of power and, more importantly, lack of knowledge, and because of CEOs' self-interest, it is likely that many are receiving excessive pay. If I am right, then these CEOs are engaging in morally wrongful behavior.

Questions remain about how much weight CEOs should give their fiduciary duty in the pay setting process. The more weight they give it, the lower their MEC is, and the less compensation they can permissibly accept. Even after this matter is decided, however, we are still a long way from determining what, overall, justice requires with respect to executive compensation. Resolving this issue requires no less than a complete theory of justice in wages. In this paper, I have called attention to what I think will be an important element of it, but I have not advanced a complete theory. Despite the attention lavished on executive compensation—and compensation generally—in recent years, there is a great deal more to be said.[18]

NOTES

1. CEOs—and other officers and directors of corporations—are commonly thought to have the specific fiduciary duties of care and loyalty. For convenience, I will refer to these collectively as the CEO's "fiduciary duty."

2. This view is codified in U.S. corporate law. See especially *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919) and *Katz v. Oak Industries*, 508 A.2d 873 (Del. Ch. 1986).

3. Not all of these writers explicitly claim that CEOs are fiduciaries in the moral sense, though their arguments imply this conclusion. They all give (various) *moral* reasons for thinking that executives are fiduciaries. If their arguments succeed, then they will have shown that executives are fiduciaries in a moral sense, i.e., that their fiduciary duties are moral in character.

4. This assumes that the positive effects on firm value of the CEO's compensation comes exclusively from attracting, retaining, and motivating the CEO. This is how firms themselves justify their CEOs' compensation packages (Zajac & Westphal, 1995). But the CEO's compensation could have good effects by motivating others, as tournament theory states (Bognanno, 2001; Lazear & Rosen, 1981). For now I put this issue aside, though I return to it at the end of the paper.

5. It might be thought that my conclusion applies only to *current* CEOs who are negotiating *subsequent* compensation deals from their (same) employers. However, I will argue that it applies to new CEOs as well, even those who come from outside the firm.

6. But, it might be asked, *shouldn't* she? After all, this would be *best* for shareholders. I explore this suggestion in section 5.

7. What is best for shareholders is not *maximally* motivating the CEO, i.e., making her as motivated as she can be, but *optimally* motivating her, i.e., motivating her up to the point where inducing one more dollar of performance costs more than one dollar in incentives. So the CEO cannot accept more than is necessary to optimally motivate her, assuming she knows what this amount is. She may not. But the following rule always applies: if the CEO would be just as motivated for less, she should accept less.

8. This raises a question. Can the CEO accept (even) the minimum necessary to attract, retain, and motivate her, if this amount is *more* than her worth (i.e., if the firm could hire someone else who would do

just as good a job for less)? Or does her fiduciary duty require her to step aside? This is a difficult issue; it requires us to think more broadly about the scope and limits of CEOs' fiduciary duties, a task which is too large for this paper. But notice this particular issue will not often arise, because it will not often be known whether the firm can hire another such person.

9. I say *tend to* converge because the market for CEOs is not likely to be perfect. If substantial imperfections (e.g., of information) persist, then so may a gap between a CEO's MEC and her worth. But this doesn't affect my argument. Like the prohibitions against force and fraud in negotiations, the prohibition against accepting more than one's MEC applies in any market conditions.

10. My argument is similar, though not identical, to Cohen's (1995) critique of Rawls (1971). Roughly, Rawls thinks resources should be distributed equally, unless the promise of larger (and hence unequal) shares is necessary to get the more talented to exercise their talents in ways that result in a net increase in the social product. Cohen counters that the talented person who takes seriously his commitment to Rawlsian principles, and in particular to equality, doesn't need, and shouldn't accept, the extra pay associated with the exercise of his talents. In the same way, my claim is, the CEO who takes seriously his fiduciary duty cannot accept more than his MEC.

11. Paradigmatically, an arm's-length transaction is one between parties who are free and independent (and thus who have no undue influence over each other), and who promote only their own interests, as opposed to the other party's (or parties') interests.

12. To be clear, my question is not (merely) whether a CEO can exploit her compromised board to extract maximum compensation from the firm. It is possible for a CEO's pay to be excessive on my account even if it is the result of an arm's-length negotiation, provided she would have done just as good a job for less.

13. This assumes, reasonably, that the class of top managers is co-extensive with the class of those who have fiduciary duties. Shareholder theory says that firms should be managed to maximally benefit shareholders. This implies that anyone *managing* the firm—especially anyone who is a *top manager* of it—has a moral fiduciary duty to maximize shareholder value.

14. I owe this example to J. David Velleman.

15. This objection might be thought to exempt even *current* CEOs from the prohibition on accepting excessive compensation when they are negotiating *subsequent* compensation deals. For in these cases it is the terms of the contract that are under consideration.

16. Pay inequality is hardly an unqualified good. The competition it fosters can hinder communication and cooperation (Cowherd & Levine, 1992).

17. But if this is a reason for high(er) CEO pay, one might wonder why its cost should fall entirely on shareholders, as opposed to the general public.

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