The Ethical Perspective of Executive Compensation and Firm Performance: Taxpayer Bailout in 2009 Financial Crisis

Kevin Yulianto
 Binus Business School

Abstract
Public has been questioning the basis for executive’s high compensation in relation to firm performance. High compensation given to top executives has widened the gap of income inequality between top executives and the average Americans, leading to ethical issue if the pay is better distributed more equally among management levels and agency problem in the firm. The case of bailed out investment bank giving enormous bonuses to its executives in 2009 crisis triggered a strong ethical issue of executive compensation. We conclude such act is unethical given the circumstances and bailed out firms should have paid their debt to government before distributing bonuses to its executives. We found that investment banks were operating at preconventional level of moral development and operating with productivism approach in doing business. Utilitarianism and universalism view of ethics also contradict the distribution of bonuses for firms receiving government assistance during the financial crisis.

Keywords: ethics, financial crisis, executive compensation, firm performance

Corporate Governance and Agency Theory

Public outrage about corporate scandals in the last ten years have highlights the importance of good governance in every business, especially large and public companies who have duty and responsibilities to many shareholders and stakeholders. Corporate scandals, which have occurred more often in the last two decades, emphasize the needs to have internal codes of conduct being followed through by Board of Directors and management to maintain the reputation in public eyes, ensure ethically accepted behavior and company integrity. (Aldama, 2003, Higgs, 2003) The issues of corporate scandals in financial firms such as Anderson and Merrill Lynch have brought up the importance of business ethics in managing corporation and doing daily activities in financial industry. While some failures are due to illegal practices, many are caused by ethical issue such as conflict of interest, irrational pay scheme and inexperienced directors. (Anderson & Orsagh, 2004) In this paper we want to
highlight the ethical perspective of whether high executives compensation is justified with corporate performance. We also highlight the use of taxpayer money in bailing-out troubled financial firms in 2009 that distributed enormous amount of compensation to its executives. In the first half of this paper we discuss the theoretical framework of governance, executive pay, and firm performance before going further with the cases of failing investment banks in 2009 and analyze the cases from ethical point of view.

Mass globalization occurring in the last two decades also caused deterritorialization and less government control over corporation, resulting in greater need for accountability. The lack of external control over corporation needs to be balanced with internal control from the corporation itself. (Crane & Matten, 2007) Corporate governance is a standard that manage interaction between various stakeholders of corporation. (Ching, Tan, & Chi, 2006)

Today most of big corporation have their own ethical codes in order to improve their corporate governance, company who doesn’t have those codes are increasingly pushed to develop one by shareholders or even forced by law. (Waddock et al., 2002) Ethical codes are deemed effective to prevent wrongdoing, increase honesty, ensuring good ethics in activities, obedience to law, increase of responsibility, and improvement regarding management and business habit. (Cleek & Leonard, 1998; Fleege & Adrian, 2004) However, the underlying motives for company to establish ethical code has tendency to avoid negativity instead of promoting positive behavior. Most of the ethical code content designed by organization has the objective to prevent illegal behavior and doesn’t provide details regarding visionary prospects or ethical guidance. (Stevens, 1996) Researches show there is positive impact of having formal code on individual ethical decisions and decrease of illegal activities within corporation. (Boo & Koh, 2001; Peterson, 2002)

It is found that corporate governance has a significant impact in company’s approach to CSR and business ethics. (Bonn & Fisher, 2005) Effective corporate governance can be achieved by valuing justice, truth, integrity and the manner in which business do their activity. In that sense, businesses have to earn profit within ethical boundaries. (Arjoon, 2005) Company with good corporate governance is seen
also as having a good CSR implementation and ethical behavior in its activities. Researches show that greater numbers of outside directors, women in board, and possession of company shares by directors impacts to more responsibility of company in social settings. (Haniffa & Cooke, 2005; Webb, 2004)

Ethics itself is a crucial factor in determining corporation’s success (Arjoon, 2005), but the emphasize of ethics implementation has only recently followed through. (Fleege & Adrian, 2004) Companies with reputation for ethical behavior in current marketplace engender customer loyalty and employee loyalty. (Arjoon, 2005) One from many ethical issues regarding corporate governance that arises and highly discussed since 1990’s is the compensation of top executives relative to firm’s performance.

One theory we need to understand regarding compensation structure in corporate governance is the agency theory. In agency theory, shareholders of the company hire management to work and give return to the principal invested. Agency theory models employee, in this case management, as selfish, focus on themselves and are driven by cost-benefit analysis in their action. (Jensen & Meckling, 1976) According to the theory, management will try to maximize their compensation and reap as much benefit in the corporation they worked for. This is what has happened in the last financial crisis, where failing firms are giving huge amount of bonuses to its executives. The ethical issue worsens when companies receiving bailout using taxpayer money are distributing that money to its executives. To understand why and how such ethical issue arises, first we need to understand the basic formulation of compensation scheme given to top executives and the role of BOD in approving the compensation scheme.

**Executive and Board of Directors Compensation**

Criticism regarding CEO pay among public US firms has been on the rise due to the divergence of pay and firm performance. (Tosi, Wener, Katz & Gomez-Mejia, 2000; Finkelstein & Hambrick, 1996) Researches shows high compensation among CEO may be caused by the outside compensation committee who sets the
compensation structure and amount was a CEO in another firm, therefore they hold high standard regarding CEO compensation. (Goodman, 1974; Suls & Miller, 1977)

Executive compensation may come in four schemes, monthly salary, yearly bonus that depends on firm performance, stock options, and long-term compensation plans (restricted stock plans and multiyear performance plans). (Murphy, 1999) Monthly salary among top executives is usually moderate, annual bonus and stock options are usually taking large proportion of total pay. This scheme motivates executive to increase firm performance and take more risks that leads to higher annual bonus and increased option value. Stock options that are not profitable yet (out-of-the-money) lead to excessive risk taking by executives, but profitable (in-the-money) options lead to risk aversion because of executives fear losing the option value. (Carpenter, 2000)

In large companies, executive pay levels are higher but pay-performance sensitivities are lower. US pay-performance is higher than other countries, driven mostly by stock options and stock ownership compensation to executives. The explosion of stock option compensation in the last decade has impacted on higher levels of pay and pay-performance sensitivities. Pay scheme in the form of stocks comprised most of the total compensation plan, however many CEO often focus on accounting bonuses rather than shareholder values because of the lack of understanding how their actions affect shareholder value. (Murphy, 1999)
In determining executive pay, compensation committee method involves external benchmarking, which is the most significant factor causing the divergence of pay scheme awarded to chief executives and average worker, also to the performance of the company they run. In determining the compensation of CEO, BOD matches the pay level with market of CEO pay in other companies. Researches show that senior executive pay schemes are different from one to another, despite top managers function as part of interdependent team. (Finkelstein & Hambrick, 1996; Henderson & Fredrickson, 2001; Hambrick, 1995) The determination of the pay schemes has an impact to the levels of alignment between top managers and shareholder’s interest. (Jensen & Murphy, 1990) The fairness or equity in determination of the pay schemes also impact the perceptions of procedural justice by top executives and able to influence their cooperation in management. (Kim & Mauborgne, 1996; Hambrick, 1995)

Despite the difference between CEO and other executive’s pay, their pay scheme and level are similar depending on the firm’s policy in pay schemes, such as firm’s principle to compensate above the market rate. The difference is that senior manager’s compensation is related to their unit performance, while CEO pay scheme is not weighed. (Hambrick, 1995) Pay gap between CEO and the second highest person pay range from 30-50 percent difference, but could be over 100 percent at certain condition. This may motivate the executives to work toward CEO position and promote competition among top executive (Hayward & Hambrick, 1997; Lambert, Larcker, & Weigelt, 1993)

Contrary to the perception that CEO compensation is somehow related to performance or company size, CEO total pay is unrelated to their performance or company size and profitability, but is related to the complexity of the organization it managed. (Henderson & Fredrickson, 1996; Sanders & Carpenter, 1998) Unsurprisingly, CEO total pay is larger in company with weak board supervision, signifying that agency theory may prove to be evident in certain companies. From ethical view, CEO have fiduciary duty to its shareholder and maximize the value of the firm, by taking excessive pay outside the Minimum Effective Compensation (MEC), they may have breach the their duty and engage in unethical behavior. (Moriarty, 2009)
Researches show that large gap between CEO and top executives pay is an indication of excessive CEO vanity and behaviorally divided top executives. (Hayward & Hambrick, 1997; Hambrick, 1995) Divided executive behavior is dangerous because when executive pay is determined by its unit result, executives starts to focus solely on their unit, leading to deterioration of collaboration and coordination. (Hambrick, 1995) Making alignment using long-term pay scheme and firm-level rewards could alleviate this. (Kim & Mauborgne, 1991)

Instead of agency theory that view executives as solitary and independent actors, in reality top teams are working better if its executives function with common interest and effort such as information exchange, collaboration and joint decision-making. (Hambrick, 1995) There is a view where high compensation for a “superstar” manager is justified; such managers working for the largest firms would translate into the most profit as a whole. Therefore, it suggests that manager compensation is bid by the highest paying company that could optimize the manager’s capability of generating profit. (Becker, 1973) In such competitive market, board needs to match CEO’s compensation to economic environment to retain talented manager.

The functions of BOD are overseeing executive’s action, design their pay scheme, and protect shareholder’s interests. However, board of directors at many times fail to monitor management effectively due to culture that prevents growth mindset and creates asymmetry of information between management and board members. (Jensen, 1993) This cronyism attitude is related to the BOD pay scheme because their high pay lowers the likelihood to take position against management.

Apart from our discussion of executive compensation above, we also need to know the relationship of director’s pay and executive compensation. Director’s compensation is correlated positively to firm size, intangible assets, and firm volatility. CEO who owns a larger part of the firm has interest that is aligned with owners and need less oversight. Therefore, director compensation is inversely related to CEO ownership in the company. (Bryan, Hwang, Klein, & Lilien, 2000) CEO that also act as chairman of the board is negatively associated with firm performance. (Callahan, Millar, & Schulman, 2003) When CEO is also a chairman, directors receive larger compensation. This suggests cronyism between CEO and directors.
Excessive director pay is significantly related to poor governance. Research show that excess compensation of CEO and directors is not caused by more effort or complexity, but an agency problems that lead to future underperformance. (Brick, Palmon, & Wald, 2006) Below we will discuss about the effect of executive pay to firm future performance to determine whether the high compensation is justified by their ability to create value for shareholders.

**Executive Compensation and Firm Performance**

As we have discussed above that high executive’s pay may be caused by agency problem, researches confirmed this theory and found inverse correlation of executive’s pay and future stock performance; top ten percent of highest paid executive predicted future negative abnormal stock returns. Companies with such executive have their stock underperformed by 13% over the next 5 years. This suggests pay spreads should be moderated to induce healthy competition and decrease the risk of misbehavior by company executives. (Cooper, Gulen, & Rau, 2002; Bloom & Michel, 2002) Hiring external managers also doesn’t produce better firm performance compared to internal hires. (Nagel & Hardin, 2007) In the period of 1986-2005, Ang and Nagel (2011) research conclude underperformance of externally hired executives in listed companies CEO. Internal hires produces significant economic gain compared to outside hires.

To explain why firm performance lag with high CEO pay compared to the average employee, research concluded that employee benchmark their judgment regarding equitable treatment on how their reward or compensation relative to their colleague, instead of the absolute pay number itself. (Wade, O’Reilly, & Pollock, 2006) Once top manager has promotion and raise, his peers could perceive inequitable treatment by their lower relative pay, resulting in dysfunction, disloyalty and workforce instability. They tend to respond by lowering their effort or try to increase effective compensation by corruption. (Adams, 1966) This is one of the reason why some executives prefer to start their own firm rather than working in large corporation. Wage dispersion on the executive’s pay is associated with decrease in firm performance and various negative results. (Fredrickson, Blake, & Sanders, 2010) This cause-effect relationship raised question on whether it is ethical and rational to
pay few executive with enormous compensation rather than distributing the pay more proportionally to all executives, as they do much of the work.

Agency theory suggests that pay structures such as stock and stock options for executives are more aligned with shareholder’s interest, since long-term reward takes into account future firm performance. (Jensen & Murphy, 1990; Baysinger & Hoskisson, 1990) This alignment is important for companies to adapt quicker to changing industry driver and return superior firm performance. (O’Reilly, Snyder & Boothe, 1993; Hambrick, 1995) Research found that CEO pay influenced executive’s pay, but top executives pay could better predict future firm performance than CEO pay. It highlights the importance of CEO pay relative to executive’s pay, but also conclude that the effect to firm’s performance may be indirectly through its executives. (Carpenter & Sanders, 2002)

**Highly Paid Executive and Income Inequality**

In this section we will discuss the ethical perspective of income equality issue resulted from the concentration of executive’s pay compared to the average worker. Scandals regarding executive compensation have been rising to be the top problem in corporate law. In 2009 taxpayer money was used to bailout failing firms, public outrage occurs when they found that these firms were paying sizeable bonuses to its executives. This creates further gap of income inequality between most Americans and top executives.

In 2007, top 1% family owned 34.6% of total wealth; the next 19% had 50.5%. This signifies the concentration of wealth among few wealthy individuals. The recession of 2009 have hurt average Americans more than wealthy Americans, making the disparity even wider. In 2008, net worth of median family dropped 36.1% while the wealth of top 1% dropped by merely 11%. Much of the increase in productivity doesn’t translate to the people who generated the wealth but to the top executive of management. (Morrisey, 2013) Highlighting the CEO pay, data shows that in 1965 average American CEO made 24 times the average worker, but in 2007 they make 275 times. (Owen, 2009) American Federation of Labor and Congress of Industrial Organization (AFL-CIO) even stated compensation of American 300
largest companies CEO was 343 times the average employee compensation in 2010. (Liberto, 2011)

In controlling CEO and executives compensation, BOD are the one responsible for violation in fiduciary duty if they have granted too large pay increment to executives, this is a strong ethical issue especially if shareholders stated their disapproval by negative Say-on-Pay votes, as in the case of Citigroup. Citigroup former CEO, Charles Prince was accountable for billions dollar losses during the financial crisis, before departing in 2007 he was awarded $68 million. It raised question as to whether Citigroup board was having adequate information and being careful and rational in approving that pay scheme. (Morrisey, 2013)

Even stock options could be engineered by executives to their own benefit, they only need to issue stocks and options when the prices of those securities are very low. In 2008-2009, more than 90% of CEO at S&P 500 acquire significant amount of stocks, and when the market rebounded in 2011, they gained in total $3 billion. (Kocieniewski, 2011) Stock options also dilute the wealth of their initial shareholders, reducing the proportion of their share in the company to compensate for the newly issued stocks. It also encouraged them to take excessive risk taking that ultimately failed as the economy tanked. (Bebchuk, Cohen, & Spammann, 2010) Due to CEO influence in selecting and determining director’s pay, it encourage back-scratching between CEO and BOD in giving generous pay for each other.

In 2010 Securities Exchange act of 1934 add a new subsection on owner approval of executive pay. The regulation push listed companies to hold shareholder advisory votes on executive pay scheme at least once every three years. However, shareholders be discourage to give negative vote on generous pay at well performing company, fearing that their action may offend management. (Morrisey, 2013)

The Case of Investment Bank in Financial Crisis: High Executives Compensation with Taxpayer Dollar

In the effort to contain the financial crisis of 2008-2009 that stems from the property credit bubble, Federal Reserve and Treasury of United States propose a
stimulus bill of $787 billion of taxpayer money to bail out problematic financial firms through Troubled Asset Relief Program (TARP). In February 2009 the bill was passed and the stock market had drop 50% from its highest level, unemployment was 8% and millions of American citizen lost their home.

In January 2009 public anger surfaced due to the paper that states Wall Street firms giving about $18.4 billion in bonuses for 2008 performance. Merrill Lynch paid $4 billion in bonus before the completion of Bank of America acquisition. American International Group (AIG) was distributing $168 million in “retention bonuses” to its employee, as a part of $450 million contractual obligation to employee bonuses in troubled unit. Bankers were receiving hefty amount of money despite the fact that their firms were failing, triggering the worst economic recession since 1929. (White, 2009; Farrell & MacIntosh, 2009)

<table>
<thead>
<tr>
<th>Corporation</th>
<th>2008 Earnings/ (Losses) ($bil)</th>
<th>2008 Bonus Pool ($bil)</th>
<th>Number of Employees</th>
<th>Number of Employees Receiving Bonuses Exceeding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>$4.0</td>
<td>$3.3</td>
<td>243,000</td>
<td>$3 mil 65 $2 mil 172</td>
</tr>
<tr>
<td>Bank of NY Mellon</td>
<td>$1.4</td>
<td>$0.9</td>
<td>42,900</td>
<td>$3 mil 12 $2 mil 74</td>
</tr>
<tr>
<td>Citigroup</td>
<td>($27.7)</td>
<td>$5.3</td>
<td>322,800</td>
<td>$3 mil 124 $2 mil 176 $1 mil 738</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>$2.3</td>
<td>$4.8</td>
<td>30,067</td>
<td>$3 mil 212 $2 mil 391 $1 mil 953</td>
</tr>
<tr>
<td>J P Morgan Chase</td>
<td>$5.6</td>
<td>$8.7</td>
<td>224,961</td>
<td>$3 mil &gt;200 $2 mil 1,626 $1 mil 626</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>($27.6)</td>
<td>$3.6</td>
<td>59,000</td>
<td>$3 mil 149 $2 mil 696 $1 mil 496</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>$1.7</td>
<td>$4.5</td>
<td>46,694</td>
<td>$3 mil 101 $2 mil 189 $1 mil 428</td>
</tr>
<tr>
<td>State Street Corp</td>
<td>$1.8</td>
<td>$0.5</td>
<td>28,475</td>
<td>$3 mil 3 $2 mil 8 $1 mil 44</td>
</tr>
<tr>
<td>Wells Fargo &amp; Co.</td>
<td>($42.9)</td>
<td>$1.0</td>
<td>281,000</td>
<td>$3 mil 7 $2 mil 22 $1 mil 62</td>
</tr>
</tbody>
</table>

Source: Cuomo (2009). Wells Fargo losses include losses from Wachovia (acquired in December 2008).

Congressional panels was arranged for the CEO of Bank of America and Merrill Lynch, determining if shareholders were aware about the financial condition of company when they vote for the bonuses. Few weeks later a federal judge insist that individual should be charged and claim that the deal is not based on the notion of justice and morality. But later the judge reluctantly approved the settlement after it was revised. (Scannell, Rappaport, & Bravin, 2009; Fitzpatrick, Scannell, & Bray, 2010)
The financial crisis affects not only the average American but also the employee of banks itself. Mass layoff occurred during the period of 2008-2009, the record was held by Citigroup who fires 75,000 of its employees while still retaining $38 million for its CEO compensation. In July 2009, Kenneth Feinberg nominated Citigroup as the worst executive pay offender for giving $400 million in excess compensation to executives. (Anderson, Collins, Pizzigati, & Shih, 2010) The very infamous incident is perhaps the Citigroup trader, Andrew J. Hall, who has rights to be paid $100 million in bonus while Citigroup was receiving $45 billion in taxpayer funds. The contract occurred before the TARP and Citigroup argue it was the employee rights. To solve the conflict Citigroup sold the unit involved and paid Hall his bonus. It is estimated that the divestiture cost taxpayers $400 million annually that could be used to pay dividends or retire the preferred stock from TARP. (Murphy, 2012) During the same time, Goldman Sachs set aside $11.4 billion in incentive bonuses for its 29,400 employees.
Public and political anger stems from the decision that banks were distributing bonus after their collapse and help from government. It is perceived as a shift of money from American citizen to the bankers that helps create the crisis in the first place by taking excessive risk. (Murphy, 2012) In January 2010, five of Wall Street giants disclose $114 billion in compensation of their executives.

<table>
<thead>
<tr>
<th>Financial firm</th>
<th>Highest-paid executive</th>
<th>Title</th>
<th>2009 total compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>John Havens</td>
<td>CEO, Clients Group</td>
<td>$12,126,261</td>
</tr>
<tr>
<td>Bank of America</td>
<td>Thomas Montag</td>
<td>President, Global Banking and Markets</td>
<td>$29,930,431</td>
</tr>
<tr>
<td>JPMorgan</td>
<td>William Winters</td>
<td>Co-CEO, Investment Bank</td>
<td>$19,637,702</td>
</tr>
<tr>
<td>PNC Financial</td>
<td>James E. Rohr</td>
<td>CEO</td>
<td>$14,801,880</td>
</tr>
<tr>
<td>American Express</td>
<td>Ken Chenault</td>
<td>CEO</td>
<td>$16,796,132</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>$93,292,405</strong></td>
</tr>
</tbody>
</table>


There is an argument, however, that blame most of the cause of financial crisis wasn’t the mistake of top executives of investment bank but lies in the trader and lower level management. Top executives have more at stake, including their loss of stock based compensation during the financial crisis than junior management who have little invested in the firm. (Murphy, 2012) Fahlenbrach and Stulz (2010) research concluded banks whose CEO incentives were in-line with shareholder’s interest performed worse and bank with high pay in bonuses for their CEO didn’t perform worse during the crisis.

In February 2009, Obama’s administration propose to give ceiling of annual compensation for top executives to $500,000, except for restricted stock awards for firms receiving exceptional assistance such as AIG, BoA, and Citigroup. The proposal includes all TARP recipients to disclose their pay policies and allow nonbinding say-on-pay shareholder resolutions. Afterward, there is Dodd Amendments that restrict
compensation to two types of compensation only, base salaries and restricted stock that is limited to grant-date values less than half of base salaries. It prohibited performance-based bonuses, retention bonuses, signing bonuses, severance pay and all forms of stock options on TARP recipients. The law was passed as Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010.

**Compensation Scheme in Banking Industry**

Financial sector is highly regarded for contributing a significant portion of top US income distribution. (Bell & Reenen, 2013; Kaplan, Steven, & Rauh, 2010). Despite the number of fresh graduates pursuing career in investment banking being paid lower by the big banks, competition among bankers fail to drive compensation down (Philippon and Reshef, 2008). It is estimated that financial sector offer $1.5-5 million excess pay compared to alternatives such as consulting (Oyer, 2008). Empirical research result is consistent with public perception that many financial sector employees are overpaid. This may be explained by the long-hours and up-or-out promotion structures. Investment bankers who are very successful usually are employed by higher-paying firms. (Axelson & Bond, 2013)

Banks have much higher leverage and market capitalization than manufacturing firms; hence their pay-performance sensitivity is significantly lower. If executive’s interest is in-line with shareholder’s interest in banks, they will have a strong incentive to undertake high-risk investments. Regulator has to consider such cause and effect relationship when establishing procedures. (John & Qian, 2003) Regulation regarding incentives of top executive is concluded to be more effective in ameliorating risk-shifting incentives. (John, Saunders, & Senbet, 2000)

In the banking sector, FDIC provides bank regulators an authority over the compensation of senior bank executives and requires institution without adequate capital to obtain written approval from regulators to pay executive’s bonuses or pay increment. Giving stocks to bank managers is the most certain scheme to encourage risk taking in banking due to the attractive benefits and limited down-side. But Houston (1995) argue that bank pay schemes are not designed to promote excessive
risk taking through equity based incentives, although there may be other mechanism that provide incentives for risk taking.

**Ethics and Stakeholder Analysis**

In this section we discuss the issue from ethical perspective, starting from the business ethics level of the issue, stakeholder analysis of party involved in the decision, and Kohlberg’s moral development of investment banking firms. Then we see how the issue arises from seven phases issue development process and analyze it from consequentialist and universalism view.

From the perspective of individual business ethics level, high compensation given to top executives may be justified due to the quality of people working in such sector and as part of their reward in fulfilling their job obligation. These top executive who were entitled to receive millions of dollar in bonus have done their job and create value for shareholder as well as enriching themselves, therefore they may see this bonus as nothing extraordinary. Top executive owning stock and stock options also losses most of the value during the crisis, highlighting that they also suffer from the crisis. We don’t see conflicting ethical issue from individual perspective, but when we expand the perspective broader to organizational and associational view, we found strong case for ethical issue.

In the case of 2009 financial crisis, investment banks are failing and their stocks depreciated significantly up to 80% of its highest level. It does look out-of-mind for failing firms who receive government bailout to distribute bonus for its executives. Is it ethical for a firm to pay bonuses while receiving help from taxpayer? On the other side, is it ethical to deferred bonuses that are obligated to executives? We found that in this case, returning taxpayer money is a priority over distributing the bonuses. It is explained by the fact that investment banks would fail without assistance from government and the bonuses would vanish with the firm. However, because of government decision to intervene in order to prevent further crisis, taxpayer become the most important stakeholder to be prioritized due to its good deed motives. Because of taxpayer position as the prominent stakeholder in the firms with government help; the government therefore had a legitimate interest in the firm’s pay
scheme. (Murphy, 2012) The ethical issue became association level as many investment banks disclose their plan to distribute huge amount of bonus and create an outrage among the public.

When we analyze the case from Kohlberg’s stages of moral development, we found that investment banks were acting in preconventional level, focusing on what it could gain and avoid punishment from law. It is clear that these firms are motivated by punishment avoidance by not breaking the rules and seeking rewards for oneself, it understands other needs but not of right and wrong as abstract concept. The moral development of the industry didn’t reach stage 3 because it neglected the will to be accepted by societies.

The case outlines the seven phases issue development process in a very ordered manner. First there is a felt need among group of people to fight against executive bonus during the period of financial crisis, mainly caused by the bailout given to investment banks. Then the issue exacerbated when public awareness was increased due to extensive media coverage about the crisis that happened, government effort to prevent further collapse, and the executive pay among industrial giants. Interest group such as “occupy Wall Street” movement and other groups were formed and protested the outrageous compensation given to executives whose firms were failing. Senators of United States such as Senator Dodd also took the effort in creating policies to regulate compensation scheme in firms receiving government assistance. Hearings and studies regarding the case and policy happened before the legislation was effective in early 2009.

In the view of utilitarianism ethics, bonuses for executives in firms with bailout may be better used to repay the debt to government, which government could use to enhance the public service quality. The total bonuses of $114 billion could benefit more people through unemployment benefit that is crucial at the time of financial crisis. Executives entitled to the bonuses are wealthy individuals who need the money less than unemployed people at the time.

Universalism ethics also contradicts the pay to executives because parts of the funds utilized to pay that compensation is derived not from corporation profit but
from taxpayer bailout money. It is simply unethical to distribute bonuses when the firm is clearly failing and receive assistance from government. The productivism approach by investment banking is perhaps the reason such ethical issue arise, due to orientation focus on stockholder and executive individual needs with self-interested motives.

**Conclusion**

Public has been questioning the basis for executive’s high compensation in relation to firm performance. High compensation given to top executives has widened the gap of income inequality between top executives and the average Americans, leading to ethical issue if the pay is better distributed more equally among management levels and agency problem in the firm. The case of bailed out investment bank giving enormous bonuses to its executives in 2009 crisis triggered a strong ethical issue of executive compensation. We conclude such act is unethical given the circumstances and bailed out firms should have paid their debt to government before distributing bonuses to its executives. We found that investment banks were operating at preconventional level of moral development and operating with productivism approach in doing business. Utilitarianism and universalism view of ethics also contradict the distribution of bonuses for firms receiving government assistance during the financial crisis.

**Recommendation**

To avoid public outrage and ethical dilemma during bailout, company could defer the compensation of executives until the performance of the company itself improved and the bailout is paid. The amount of bonuses also should be capped to one third of total pay and must be paid in restricted stock. There is a proposal for incentive bonus to take form of only restricted stock and restricted stock options, which may not be sold or exercised until 2-4 years after leaving the company. It could be more effective in providing motivation for management to drive the firm with longer-term interest. (Romano & Bhagat, 2009) Directors also took an important role to correct the false belief that CEO skills are interchangeable and are urged to take into
consideration the effect of relative compensation between top executive and average worker in working environment. (Elson & Ferrere, 2012)

Recommendation for future compensation plan includes the use of independent compensation committee to determine pay scheme, encouraging executives to have shares in the corporation in significant amount relative to their wealth, greater disclosure of their pay, and increase institutional investors involvement in governance. (Matsumura & Shin, 2005) Another solution for executive compensation would be fixed dollar amount of bonus that would be canceled if the bank goes bankrupt or receives government assistance. (Murphy, 2012) This would prevent excessive risk taking by company that could cause future bailout and deprived taxpayer money.

Despite public outrage regarding CEO pay as excessive, empirical research shows that CEO also suffer losses during the crisis as there is no evidence that bank’s CEO attempt to sold shares before the crisis. In fact, CEO holdings of shares on net increased and lead to significant losses on their holding. On average these CEO lost $30 million with median of $5 million. (Fahlenbrach & Stulz, 2009)

5002 words, 68 References
Bibliography


Aldama, E. (2003). Report by the special commission to foster transparency and security in markets and in listed companies. *Comisión Nacional del Mercado de Valores*


Graduate School of Management.


Haniffa, R. M., Cooke, T. E. (2005). The impact of culture and governance on


Liberto, J. (2011). CEOs earn 343 times more than typical workers. *CNN MONEY*


Morrissy, D. J. (2013). Executive compensation and income inequality. *Wm. & Mary Bus. L. Rev. 1*


