

The Ethical Riddle of Executive Remuneration

By Clément Labi*

Excessive executive remuneration causes public unease, debate, and very often legislative initiative. There could be actually good reasons for that: from times immemorial, betray the trust of a fellow and to take a decision as a judge in one's own cause, have been considered despicable. Those ethical concerns are so "etched in legal nature" that the principles of sanctioning corporate mismanagement and conflicted decision-making have been considered parts of natural law. Such is not the case of the current (but not novel) concern with compensation "levels" irrespective of the merits of their earners, for which an ethical foundation is elusive.

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Introduction

Universally, shareholders appoint their company's directors, who are sometimes paid for the exercise of their mandate. Such remunerations however tend to be very modest compared to those of executives, especially at the C-level. Chief Executives Officers of S&P 500 firms earned on average USD 16.7 million in 2022¹, and among those same companies, *Fortune* found twenty Chief Financial Officers (CFOs) earning at least USD 50% more than their CEOs². Tales of individual instances of extraordinary compensation packages occasionally hit the news cycle and provoke a *moral* outrage. Why is this exactly?

The Abhorrence of "Extracted" Remuneration

The Roman lawyer Ulpian has stated that the basic principles of law are three: a) to live honourably, b) not to harm any other and c) to render each other his own – *juris praecepta sunt haec: honeste vivere, alterum non laedere, suum cuique tribuere.*³ Although not in that particular order, the result of this research is that the ethical malaise surrounding "excessive" executive remuneration can be best approached along those three categories. Maybe the simplest idea to

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¹Kerber (2023).

²Estrada (2023).

³Watson (1985).

comprehend does correspond to the second item in Ulpian's enumeration and to the thesis of Lucian Arye Bebchuk.⁴

Bebchuk's starting point is the agency problem: shareholders, to the extent that they could be considered as a class, have utility curves and return-to-risk profiles that are typically very different from the board and the executives. Bebchuk posits three features for an optimal arrangement to align the interests of those two classes: it must attract and retain high-quality executives, provide said executives with enough incentive to make sufficient effort and serve the shareholders' interests, and minimise overall costs (agency costs). As minimal conditions, the board should act at arm's length and spontaneously determines the optimal remunerations, market forces should prevent incorrect remuneration and company law should enable shareholders to veto unsatisfactory agreements on remuneration.

Through political manoeuvring ("collegiality, team spirit, a natural desire to avoid conflict within the board, friendship and loyalty"⁵), and thanks to the weakness of shareholders, however, executives are in such a commanding position that they are able to "tunnel" the firm's resources for their personal profit⁶. In other words, through their "managerial power", the higher-ups mismanaging the firm often succeeded in obtaining unearned income without creating any wealth, or, in public choice theory parlance, they "extract rent". The argument that there is some persistence to the issue alludes to what is known in public choice theory as Tullock's paradox: the advantages of "extracting rent" vastly surpass the costs of obtaining such extraction⁷, which should be impossible or at least unsustainable if the conditions under which the efficient market theory would be applicable. It is notable that Bebchuk emphasises how it is the poor quality of the information communicated to the company's shareholders that allows the extraction to occur, as, if they were better informed of the details of the higher-ups' remuneration, they could challenge it either by dismissing the company managers, initiating legal action, or simply selling their stake in the company and re-invest in another. Similarly, many arguments against letting remunerations be spontaneously set, without specific legal regulation, are, explicitly or not, arguments against the ideas that markets are in reality, efficient.

It is not difficult to see how the defrauding of investors by the firm's powers-that-be is ethically repulsive. In fact, presuming that natural law does indeed exist, two of its most incontestable elements are that there should be a strict punishment of the abusers of others' trust, especially when it comes to the management of another person's wealth - hence the money invested by the shareholders should be managed with "the punctilio of an honor the most sensitive" according to then-Chief Judge of the New York Court of Appeals Benjamin Cardozo⁸ - and that no one could be a judge in his or her own cause, from where it follows that management should, at least, consider the question of

⁴Bebchuk & Fried (2005).

⁵*ibid.*

⁶Johnson, La Porta, Lopez-de-Silanes & Shleifer (2000).

⁷Tullock (1980).

⁸*Meinhard v. Salmon*, 164 N.E. 545.

their remuneration not as their own cause, but rather a question of allocation of assets from the perspective of the firm.

For his defence of Sextus Roscius of Ameria, a man accused of murdering his own father, Cicero found that the real culprit was Lucius Cornelius Chrysogonus, a recent ally to the dictatorship. During his speech, Cicero remarkably emphasised, as a way of establishing his deplorable character, that Chrysogonus had mismanaged the resources put under his trust, while “[i]n private business, if any one carried out a trust, I do not say fraudulently for his own interest and profit, but even without proper care, our ancestors deemed that he had been guilty of a most dishonourable act”⁹. From this Cicero concluded that Chrysogonus was a worthless person, as “it betokens an utterly worthless character to break the ties of friendship, and at the same time to deceive a man who could not have been wronged had he not had confidence in his friend”¹⁰.

It is therefore not a hyperbole to state, as Tamar Frankel does, that the question of “how to trust, or at least reliably depend upon, others who undertake to act on behalf of our interests” is “etched in legal nature”¹¹, at least in that common law jurisdiction under the concept of fiduciary duty.

In the case of *Pepper v. Litton*¹², Litton, the controlling shareholder of the Dixie Splint Coal Company, had \$33,468.89 in “back salaries paid to him just before putting the company in bankruptcy. Justice William O. Douglas was very explicit about grounding the Supreme Court’s opinion on jusnaturalist and ethical bases:

“A sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilise his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandisement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation”.

⁹Dyck (2010).

¹⁰*Ibid.*

¹¹Frankel (2011).

¹²*Pepper v. Litton*, 308 U.S. 295.

As for the “etching” of that principle, Justice Douglas noted the resemblance in spirit of the Court’s decision with English Fraudulent Conveyance Act 1541, promulgated under Queen Elizabeth I¹³.

When Natural Law and Positive Law Meet

The critical importance of the legal fiduciary principle, mirroring the ethical abhorrence for abuses of trust but also by other names in many if not all legal systems. Celsus’ *Digest* already made the depositary care for the deposited good as he would do for his own¹⁴ and Gaius wrote eloquently about the standard of responsibility for the *socius*¹⁵. Commenting on the Talmud’s position that “all robbers must reimburse the value of the item at the time of the theft”¹⁶, Maimonides states that, in the context of a deposit the same principle applies to “a person who without the owner’s consent takes an object entrusted to him for safekeeping to use for his private purposes in a way that will diminish it, or to take as his own”¹⁷, although Jewish law’s position is somewhat weaker in the particular case of partnership¹⁸. While it has been proposed that the *concept* of fiduciary principle has been imported from English and American laws to France or Germany in the late twentieth century, the same (or similar) emphasis is placed on the duties of the depositary as early as 1745 by French juriconsult Jean Domat, himself referring to Celsus¹⁹. Even better, the classic English law decision that equates the duties of a company director to that of a trustee, *The Charitable Corporation v Sutton*²⁰, even mentions Domat as support of their findings.

The second jusrationalist concept upon which an executive compensation could be challenged as excessive is also one which is strongly grounded in ethics, namely that according to which no man can be a judge of his own cause, which the Justinian Code phrased as “*Ne quis in sua causa iudicet vel sibi ius dicat*”²¹. Evidently, when a company director votes on his own compensation, or when an executive influences the board as to approve a package in his or her favour, one of the issues is that his action is likely to be biased.

Thomas Hobbes wrote in *Leviathan* that “[f]or the same reason no man in any cause ought to be received for arbitrator to whom greater profit, or honour,

¹³13 Eliz 1, c 5.

¹⁴Celsus, 11 dig., D. 16,3,32: *quod Nerva diceret latiore culpam dolum esse, Proculo displicebat, mihi verissimum videtur. Nam et si quis non ad eum modum quem hominum natura desiderat diligens est, nisi tamen ad suum modum curam in deposito praestat, fraude non caret: nec enim salva fide minorem is quam suis rebus diligentiam praestabit.*

¹⁵Gaius, 2 cott. rer., D. 17,2,72: *socius socio etiam culpa nomine tenetur, id est desidiaae atque negligentiae. Culpa autem non ad exactissimam diligentiam dirigenda est: sufficit etenim talem diligentiam communibus rebus adhibere, qualem suis rebus adhibere solet, quia qui parum diligentem sibi socium adquiret, de se queri debet.*

¹⁶Talmud, Baba Kamma, p.66a.

¹⁷Maimonides (1180).

¹⁸Saiman (2019).

¹⁹Domat (1745).

²⁰(1742) 26 ER 642 ; 2 Atk 4.

²¹Codex Iustiniani 3.5.

or pleasure apparently ariseth out of the victory of one party than of the other: for he hath taken, though an unavoidable bribe, yet a bribe; and no man can be obliged to trust him. And thus also the controversy and the condition of war remaineth, **contrary to the law of nature**".

Similarly, in the case of *Thomas Bonham v College of Physicians*²², Lord Justice Coke found that the College of Physician Act 1553 was not legally empowered to authorise anyone to practice and to sit as a court of delegation of prerogative powers from King Henry VIII, because that would be a violation of the *nemo iudex* rule. The ruling is worded in unmistakably jusnaturalist language: "One cannot be Judge and attorney for any of the parties[...] And it appears in our books, that in many cases, the common law will control Acts of Parliament, and sometimes adjudge them to be utterly void; **for when an act of Parliament is against common right and reason, or repugnant, or impossible to be performed, the common law will control it, and adjudge such an Act to be void; and, therefore in [...]** *Thomas Tregor's case*²³ [...] / Herle saith, some statutes **are made against law and right**, which those who made them perceiving would not put them in execution".

That being said, it is also obvious that those who harm others by defrauding them of their money are *ipso facto* preventing the allocation to each of their own, and also tantamount to living dishonourably, thus violating all three of Ulpian's precepts.

Hence a confusion arises: regardless of whether the remuneration was earned or usurped, independently of whether the gain for the company was at least equal (or, if possible, greater) that managers' reward, with no consideration of the stock prices, benchmarks, incentives, is too much *morally* to much?

The work of the concept of "inequity aversion", defined in a landmark article by Fehr and Schmidt²⁴ as meaning that "means that people resist inequitable outcomes; i.e., they are willing to give up some material payoff to move in the direction of more equitable outcome"²⁵. For example, in the "ultimatum game", the proposer offers to the responder a certain fraction of a surplus with a fixed size. If the responder accepts the offer, then he or she acquires the proposed fraction, if not, both proposer and responder get nothing. Although it would be rational for the responders to accept any offer superior to zero, experiments have evidenced that they certainly do not²⁶. The feeling according to which company executives should not earn more than a certain multiple of the pay granted to other workers seems to be widespread, although to various extents²⁷. This is expressed by Kiatpongsan and Norton in words such as "universal desire" and "ideal pay gaps"²⁸. In Switzerland, however, a 2013 federal popular initiative sought to cap the amount of the highest *salary* (defined as "the sum of compensations in cash and in kind [...] paid in relation to a profit-seeking activity") in a given business to twelve

²²*Thomas Bonham v College of Physicians* (1610) 8 Co. Rep. 107, 77 Eng. Rep. 638.

²³*Thomas Tregor's case* (1324) Y.B. Pasch. 8 Edw. III, 26, 30a-31a.

²⁴Fehr & Schmidt (1999).

²⁵*Ibid.*

²⁶*Ibid.*

²⁷Gavett (2014).

²⁸Kiatpongsan & Norton (2014).

times that of the lowest salary²⁹. However the initiative was handily defeated by referendum³⁰. The idea has been popular with certain left-wing parties even in developed economies: in France, Jean-Luc Mélenchon's 2017 presidential campaign aimed at a multiple of twenty³¹. The Labour manifesto for the 2019 general elections in the United Kingdom promised to "require one-third of boards to be reserved for elected worker-directors and give them more control over executive pay"³², implicitly to restrain executive compensation not by setting maximum amounts but by subjecting it to employees' consent. Ultimately, the Conservatives won that election and the idea has not come to fruition.

Conclusion

Is there an ethical issue at stake in censoring remunerations above a certain amount? Words are important: regardless of the scientific merits of their position, Fehr and Schmidt were careful to use the word "*inequity*" instead of "*inequality*": implicitly in the ultimatum game or the dictatorship game is the idea that the proposer has substantially no greater claim on the surplus than the responder. There is no ethical case to forbid compensation above a certain amount *unless* one ascertains that one's work cannot be *worth* more than the cap amount, which is never certain. Although not an executive, basketball player Stephen Curry is scheduled to earn USD 51.9 million for playing point guard for the Golden State Warriors³³, which is *considerably* higher than the average CEO pay figure cited above. However, his team is valued USD 7 billion³⁴, to which he certainly contributed a lot, as since joining the Warriors in the 2009 season, he alone accounted for 128³⁵ of his team's 656 wins³⁶. Would it be fairness to limit Curry's pay to a maximum twenty times that of his teammate Gary Payton II, who only played 7 games during the 2022-2023 season and scored a total of forty points³⁷?

As per Ulpian, who stated that the principle *suum cuique tribuere* (*to render each other his own*) as one of the three principles of law, it would not be fair if an

²⁹Initiative populaire fédérale 1:12 - Pour des salaires équitables'. <https://www.bk.admin.ch/ch/f/pore/vi/vis375t.html>

³⁰FF 2014 1693, Arrêté du Conseil fédéral constatant le résultat de la votation populaire du 24 novembre 2013 (Initiative populaire «1:12 – Pour des salaires équitables»; initiative populaire «Initiative pour les familles: déductions fiscales aussi pour les parents qui gardent eux-mêmes leurs enfants»; modification de la loi fédérale concernant la redevance pour l'utilisation des routes nationales [Loi sur la vignette autoroutière, LVA]. <https://www.fedlex.admin.ch/eli/fga/2014/303/fr>

³¹Delmas (2017).

³²Labour Party (2019).

³³Knight (2023).

³⁴Sim (2023).

³⁵Basketball Reference, Stephen Curry. https://www.basketball-reference.com/players/c/currys_t01.html

³⁶Basketball Reference, Golden State Warriors.<https://www.basketball-reference.com/teams/GSW/>

³⁷Basketball Reference, Gary Payton II. <https://www.basketball-reference.com/players/p/paytoga02.html>

employee or anybody else who brings or makes a lot of profit for a business was to be paid “equally” to an underperformer, and it would be certainly unequitable.

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