USA CEO Pay Is Up While Shareholders Lose Their Shirts: Legal and Ethical Communication Issues

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Over the last few years CEO pay has received much attention. While one may contend that CEO pay reflects market forces, one may also argue that CEO pay is too high and needs to be regulated. In the spring of 2009, CEO pay and perks received additional attention when automobile executives arrived for congressional hearings in Washington, D.C. in private jets. In view of the economic crisis, it is instructive to examine how CEOs communicate the weak performance of their companies to stockholders and what some of the legal and ethical communication issues are.

It is well known that American CEO and upper-level executive compensation is at record levels at a time when the Dow Jones Industrial Average has fallen from a high of over 14,000 to a low of just over 6,000. Most corporations sent out annual reports to shareholders just as the Dow was finding lows not seen this century. This paper covers laws and procedures governing CEO pay and examines how the generally bad news of the past year was communicated to shareholders. Comparisons will also be made with communications in the happier year of 2007.

In the 1970s, CEOs of large American corporations received about 70 times the pay of the average worker. By 2003, this had grown to 300 times, and in 2004, it was 430 times greater (Sahadi).The CEOs in large Japanese companies receive an average compensation of $1.5 million; their European counterparts receive about $6.6 million; and the Americans lead the pack with an average of $13.3 million (Hall). CEO and top executive pay is, by law, public information. Upon examination of CEO comments on the relative fortunes of their companies, one notes not one remark explaining or justifying the fortunes taken home by this top echelon. This paper covers two overlapping issues of the how and why of CEO pay and also how CEOs have communicated in annual reports the generally bad news to their shareholders.

For the analysis of communication with shareholders, we will focus on a sample of companies from three industries. After analyzing the communication of bad news during a time of economic crisis, we will examine legal issues relating to communication strategies and CEO pay.

Business communication researchers have examined annual reports for decades. Typical topics are: delivery of bad news, rhetorical devices used in communication, visuals, discourse communities, international comparisons, and gender issues. An online search for articles on annual reports in *The Journal of Business Communication* (JBC) lists 365 entries and on bad news 158 entries. The electronic database of JBC goes back to 1964. Clearly, business communication has examined annual reports and bad news delivery from every conceivable angle. The list of authors of these articles includes all the leaders in the field, including Locker, Jameson, Dulek, Penrose, and Hildebrandt. Every textbook on business communication provided a detailed discussion of the delivery of bad news (Lesikar & Flatley, 2004; Locker, 2004; Murphy & Hildebrandt, 1997; Wilkinson, Clark & Wilkinson, 1983). Clearly, this is a field of great interest. Writers were instructed to begin with a buffer, bury the bad news in the middle, and end on a positive outlook. This approach resulted in an almost mechanical approach to the delivery of bad news. Gradually, as the field matured, there was a change, and Kitty Locker suggested that the buffer might not always work and in fact be counter-productive and viewed as insincere (Kienzler, 2006).

While economic times were good in the roaring 90s and beginnings of the 21st century, research of bad news delivery in annual reports was not of great interest, but during the economic meltdown of the last two years, communication of bad news in annual reports warranted another look.

Several factors have come together in American business to give meaning to the curse, "May you live in interesting times." There is general outrage over the extremely high compensation packages of American CEOs and corporate officers. At the same time, wages and salaries have been flatter and more and more ordinary employees have defined contribution retirement plans whose value is based on corporate performance. Yet investors (these ordinary employees) have lost trillions in the market meltdown of the last couple of years. To gain insight into these events, we are studying Dow companies with an emphasis on the legal issues of compensation and communication. What are the communication styles and how do they differ as companies transitioned from the relatively good year of 2007 to the recession of 2008? Next, the legal structure is examined that has allowed CEOs to seemingly uncouple themselves from the laws of market economics and give themselves lavish compensation packages. For this part of the study, General Electric, Bank of America, IBM, Johnson & Johnson, and Boeing are identified, all companies that are part of the Dow Jones Industrial Average, the best known of the American stock market indices.

Delivery of Bad News

A major challenge for CEOs in preparing their annual report letter is having to give the bad news from the preceding year while not causing alarm among investors. The CEO's letter in a company's annual report is often a classic example of what is called a good news/bad news letter. Over the years, shifts in priorities and in ethics have changed the way these letters are written, but their overall purpose remains: to temper the negative effects of bad news by providing it at the same time as good news.

Historically, the good news/bad news letter concentrated primarily on minimizing bad news. Maintaining goodwill in one's audience was the writer's primary objective, and, therefore, bad news would be given in sometimes oblique language while interspersed among lots of good news. In so doing, the writer, while not concealing the bad news entirely, might at least hope for the good to outweigh, or at any rate to mitigate, the bad. Perhaps the reader wouldn't even notice the bad news if it was overshadowed by enough good news?

More recently, such methods of delivering bad news have raised questions of law and ethics. Hiding bad news in a forest of good news, hoping that it will be overlooked or missed, can be regarded as dishonest, possibly even fraudulent or illegal, particularly in the case of a CEO's annual report letter. In any case, it can be confusing for the reader ("I don't understand. Are things at the company going well or not?"), and certainly the question of whether the writer is hiding any *additional* bad news is often warranted. So, the modern good news/bad news letter, while having the same goal of maintaining the reader's goodwill, attempts to meet that goal in a different way.

Bad news is delivered bluntly, immediately. Consider the 2008 annual report letter from General Electric CEO Jeffrey Immelt: "2008 was a tough year, and we expect 2009 to be even tougher" (General Electric, 2008, p. 1). Giving bad news so frankly, right at the start of the letter minimizes ambiguity. The writer need not fear accusations of concealing bad news or burying it in fine print. While obviously distressing to the reader, being so candid can, ironically, increase the writer's credibility. After all, the thinking goes, only an honest person would so directly state such bad news without trying to sugar-coat it. Even investors who have lost money might want to keep their stock in a company that is so forthright with its shareholders, that is confident enough not to be afraid of bad news. If bad news can be so clearly confronted, perhaps it isn't so bad after all.

Once the blow of bad news has been delivered and the readers have had their initial shock, the writer begins to temper its effects by providing good news. Good news now, rather than being used to obfuscate bad news, is used to counteract its negative impact on the reader. In a CEO's letter, for example, the writer might list company accomplishments over the course of the preceding year, talk about the company's history of overcoming challenges, or outline recent positive changes in the economy or industry. This information reassures the reader that, despite the bad news, things are not *all* bad, and the good might actually outweigh the bad. Again, shareholders should ideally conclude that their investments, despite having decreased in value, should remain stable.

Annual Report Covers

The cover of the annual report is, of course, the investor's first glimpse of how the company is presenting itself. It is the company's initial opportunity to inspire confidence or to reassure, to put its best foot forward. The differences in how companies chose to do that from one year to the next were sometimes vast, and often were a reflection of each company's change of fortune. Those that had weathered the collapse of late 2008 relatively well generally created report covers that were more similar from year to year than those that had been more negatively affected.

Two companies whose annual report covers exemplified this phenomenon were Johnson & Johnson and Bank of America. While both companies suffered from the economic crisis of 2008, Bank of America was much more profoundly affected than Johnson & Johnson, which is evident even from a cursory look at their annual reports.

In late 2007, when the Dow had just hit its all-time high, both companies were enjoying periods of prosperity. Johnson & Johnson's stock price was about $65, while Bank of America's was at about $50. Contrast that with their stock prices in late 2008: Johnson & Johnson had, like almost all publicly traded companies, suffered a decline in stock price due to the market collapses of that year. It was, however, not nearly as steep a decline as that of many other companies, having gone down only about 10% to approximately the $58 mark (SmithBarney.com).

The covers of Johnson & Johnson's 2007 and 2008 annual reports reflect the perception that, despite overall market turmoil, it was business as usual for them. The 2007 cover includes a photo of children washing their hands at a row of sinks. The girl standing at the front is looking at the camera and smiling while she rinses her hands at the sink. At the top of the cover are the company's name and the words, "Our Caring Transforms." The photo and the slogan together convey a feeling of confidence, vitality, and compassion. The 2008 cover portrays a similar feel. It shows a photo of a South African woman holding her young son. She is smiling broadly at him and he is beaming directly at the camera. Looking at this cover, with its apparent optimism and enthusiasm, one would never guess that the economy had been suffering – certainly things appear to be going well for Johnson & Johnson.

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Bank of America, on the other hand, was much more directly affected by the credit and banking crises of 2008. Despite being regarded as one of the healthier survivors in the banking industry, their late-2008 acquisition of Merrill Lynch, which was on the edge of bankruptcy, as well as general investor skittishness about banks and concerns about government intervention, caused their stock price to fall dramatically. From late 2007, when their stock price had been at about $50, it dropped to approximately $14 in late 2008, a decrease of over 70%.

The contrast between the 2007 and 2008 annual report covers could hardly be starker. The 2007 cover is a collage of photos of Bank of America employees. All of the people are smiling and appear confident. In the center of the collage is a large Bank of America logo and the bottom of the cover reads, "Insights + Innovations = Opportunities." It then gives the company name and the words, "Bank of Opportunity." Upon opening the cover, another collage of smiling faces is presented with the following: "We are a company of more than 200,000 associates, serving a vibrant community of customers and clients around the world. Our size and scope – unmatched by any other bank – give us the insights that help us innovate and create opportunities for all" (Bank of America, 2007, p. 1). This report suggests a company that is on the go, full of vigor and ideas. It certainly is not a company about to lose almost three-quarters of its stock price and be forced to accept billions in federal bailout money.

The 2008 report cover, however, seems to come from a very different Bank of America. The most striking change is its bare white cover, printed not on the customary glossy paper, but on ordinary matte cardstock. The cover is free from any unnecessary language or ornamentation. It simply says, "Bank of America 2008 Annual Report," and only half of the company logo appears. Inside the cover, there are no photos of smiling employees or declarations about insights and innovations. Rather, it launches directly into a series of graphs and charts. There is no preamble; it gets right to the facts. While no one looking at the 2007 report would call it frivolous, it seems positively carefree in comparison with the down-to-business, no-nonsense style of 2008. The spare, serious style of the 2008 report presents a company trying to reassure its investors that, despite a very bumpy road, Bank of America is on track and in charge.

CEO Letters

While the cover of an annual report is an investor's initial communication from the company, it can sometimes be a bit abstract. Images and slogans, while powerful, can have a variety of interpretations. A much more direct way for the company to communicate encouragement or reassurance to its shareholders is through the CEO's letter. Depending on the relative fortunes of the company in the preceding year, the CEO letter may be congratulatory or it may require a more delicate touch: giving bad news while still conveying competence. It can be a difficult balance, and comparing CEO letters from the more positive perspective of 2007 and then the darker days of 2008 illustrates how companies communicate these different kinds of news.

Many of the 2007 letters, composed during a period when the credit crisis had yet to fully explode, are generally full of energy and confidence. W. James McNerney, Jr., CEO of Boeing, stated, "2007 stands out as a year of significant – and accelerating – progress" (Boeing, 2007, p. 3). Johnson & Johnson CEO William C. Weldon said, "Caring for the health and well-being of people throughout the world is an extraordinary business" (Johnson& Johnson, 2007, p. 1). And Samuel J. Palmisano of IBM did not beat around the bush: "Let me briefly recap 2007. It was, quite simply, a great year for IBM" (IBM, 2007, p. 3).

Even in companies that had started to feel the credit crunch, like Bank of America and General Electric, the tone was one of cautious optimism. From GE: "[GE is] [a] company leading in the essential themes of this global era. …We performed well against the operating metrics that we use to measure our progress" (GE, 2007, p. 1). And CEO Kenneth D. Lewis of Bank of America stated, "Despite the short-term fallout from the so-called credit crunch, I remain confident and optimistic about our competitive position and our ability to generate attractive financial results in the future" (Bank of America, 2007, p. 4).

The 2007 letters generally evoked a congratulatory, what-a-great-year feeling or, in some cases, a more sober, stay-the-course, we're-on-the-right-track feeling. Generally, things seemed quite positive.

By 2008, however, the tone of the CEO letter had generally undergone a major shift. Since every company included in this study suffered financial setbacks in 2008, each CEO had the duty to give investors the bad news while simultaneously not driving them away in fear. In looking at letters from a number of annual reports, a pattern emerges. Most letters start with a blunt acknowledgement of recent economic catastrophes. At Boeing, the CEO wrote, "2008 was a challenging year for Boeing" (Boeing, 2008, p. 2). From Bank of America, "2008 was an extraordinarily difficult year for our company" (Bank of America, 2008, p. 2). From GE, "2008 was a tough year, and we expect 2009 to be even tougher" (GE, 2008, p. 1). And IBM said, "As I write to you, the global economy is experiencing profound disruption" (IBM, 2008, p. 1). Even relatively healthy Johnson & Johnson said, "We remember 2008 as a year of extraordinary economic events that shook our financial markets and global economies" (Johnson & Johnson, 2008, p. 1). There is direct admission by the CEO that the company is going through turbulent times.

Conceding up front that the previous year was difficult gives the CEOs credibility. They are not shying away from bad news, trying to cover it up or minimize it. But once the bad news is given, it is the CEO's job to reassure panicked investors, to show that despite the year's challenges, the company is recovering and moving forward. Consider, for example, the letter from CEO Lewis of Bank of America. After spending a few paragraphs recounting the bad news from 2008, he changed his tone: "Despite a year with no shortage of bad news, I maintain a positive and optimistic outlook for our future. Here's why: For the full year, in the midst of the worst recession in generations, we earned more than $4 billion." He went on to list some of the company's strong points: "We are well-capitalized, deposit-funded, and extremely liquid. We have one of the largest, broadest customer bases in the industry" (Bank of America, 2008, p. 3).

Such a recounting of the company's positive points in the midst of an economic downturn is a common feature of the 2008 CEO letter. Boeing talked about how its "order book is the fullest it has ever been" (Boeing, 2008, p.3). At GE, where Immelt readily admitted that 2008 had been a "tough year," he went on to provide comfort to wary investors. "In this very tough environment, GE earned $18 billion, our third highest year in history….We have a $172 billion backlog in infrastructure products and services….We also have a great pipeline of new products" (GE, 2008, p. 2). Palmisano from IBM reported, "Since the dot-com crash in 2002, we have more than doubled our pre-tax income and free cash flow, and more than tripled our earnings per share" (IBM, 2008, p. 5). Johnson & Johnson told investors, "During the turbulent economic times of 2008, Johnson & Johnson was the third-best-performing stock on the Dow Jones Industrial Average. Our shareholder returns over one-, three-, five-, and ten-year periods have exceeded our major comparative indices" (Johnson & Johnson, 2008, p. 2).

Once the CEOs recounted their company's strengths, the conclusion of the letter is often an attempt to rally investors, cheer them up and inspire them. At IBM,

> From cabinet rooms, to board rooms, to kitchen tables around the world, people are eager for change. Such a mandate doesn't come around very often – perhaps once in a generation, or once in a century. It's not something to squander. I and my fellow IBMers have no intention of doing so (IBM, 2008, p. 9).

Boeing's McNerney wrote,

> Over the course of its nearly 100-year history, the people of Boeing have consistently defeated the toughest challenges through innovation, determination, and a relentless focus on execution….Boeing stands on the brink of almost unprecedented opportunity in a moment of unprecedented challenge. With our history strengths and a collective will to succeed, we will move forward to fulfill our legacy as the global aerospace leader – today, tomorrow, and far into the future (Boeing, 2008, p. 6).

Bank of America's CEO letter, despite discussion of some very serious problems, also managed to rally in its conclusion:

> [T]his is not the first time this company has faced and successfully managed through economic or business crises. We have a 225-year history of persevering during hard times, and positioning ourselves to be even stronger when economic growth returns….I remain undeterred (Bank of America, 2008, p. 10).

GE's CEO letter is particularly illustrative of this type of rallying conclusion. Immelt has dutifully given investors the bad news. Then he listed the company's strengths, and at the end of the letter, he concluded with a call to action:

> The current crisis offers the challenge of our lifetime. I've told our leaders at GE that if they are frightened by this concept, they shouldn't be here. But if they're energized, and desire to play a part in transforming the Company for the future, then this is going to be a thrilling time to be a part of GE. GE will be a better company winning through this crisis. Your GE teams have dug in and are dedicated to the tasks ahead….If you are a prospective investor, let me say, now is the time to invest in GE! (GE, 2008, p. 8).

The language in this conclusion is not about setbacks, losses, or economic catastrophes, but about challenges and opportunities. Despite the bleak picture presented earlier in the letter, by the end, he seemed almost to dare his audience not to share his confidence.

General Motors, which did not declare bankruptcy until June 2009, did not issue a standard 2008 annual report. The GM website did, however, carry a rather blunt warning that debt was overwhelming and common stock was most likely worthless. The year 2007 was, however, one of celebration as the company was 100 years old. The annual report featured glossy pictures from a nostalgic past, as well as pictures of current cars. Rick Waggoner, then-CEO, said, "A century is a long time to be in business," but with the celebration, "it is an opportunity to look forward to our next 100 years." He pointed out that after certain one-time expenses, the company had fairly strong earnings in its core business. At the end of his letter, he said, "I believe that 2007 will stand as a tipping point in the history of our company…. We have the right strategy, the right products, the right technology, and most important the right people…" (General Motors, 2007). Once more an inspired letter, but this one didn't work as things tipped the wrong way.

In summary, the letters invariably begin by admitting problems. In that sense, they do not use a traditional buffer; however, the problems are never the result of poor decisions, failures in judgment, or bad intentions. There is always some outside force to blame. From the admission that things are not rosy, the letters then point out that the company is okay even though struggles may be ahead. In the last part, the CEO focuses on what will be done to solve the problems. The question is why the letters, even though the economy is crumbling, do not admit any failings by executives and why CEO pay is not addressed. These points are examined in the remainder of this paper.

Legal Foundation

The federal government was created in the drafting of the Constitution in 1787 by the states. It was to be a government of limited powers with more general powers inherent in government remaining with the states. Over the past 200-plus years, the power of the central government has grown, but the 50 states retain substantial power to legislate and govern in their own way.

Unlike in the European Union, there are no United States corporations. Each corporation is the creature of *state* law. There are no restrictions of CEO pay in state law. The owners, or stockholders, elect members of a board of directors who in turn appoint and determine the compensation of corporate officers who run the day to day affairs of the company. The directors do have a fiduciary duty to the shareholders. Their decisions must be in the interest of the shareholders as a whole and not one group of shareholders or simply to enrich themselves.

The Constitution gives the federal government authority over interstate commerce and the postal system, which today includes electronic communication. Thus, to assert authority to deal with fraud in business and regulate publically traded companies, Congress adds the words "in interstate commerce or by use of the mails" in many statutes. These words put almost all business transactions within reach of federal authority, the Securities and Exchange Commission (SEC). It was established in the 1930s to improve market transparency and avoid future market collapse like the one that led to the Great Depression.

The SEC requires something called the 10-K, which is a report on the financial state of the company along with other required information. The information is then published in the annual report. The annual report consists of financial statements that are part of the 10-K and a usually glossy spread on the progress of the company. It normally begins with a not-required letter from the CEO and pages of pictures of happy employees doing good in the world and benefiting shareholders. Notice of the annual meeting typically includes financial statements, but also information the company often wants to keep in small print. This includes information of the board members and, since the 1990s, the compensation of the CEO and other top officers. Recent regulatory changes tightened requirements to make sure there was no unreported compensation.

CEO Pay Issues

As stated above, there are no regulations on CEO pay, except that it must be in the interest of shareholders. It is possible for shareholders to sue their company or introduce a resolution at the annual meeting regarding excessive CEO pay, but it is difficult. Here is how it works: Boards of major companies range in size from 12 to about 20. From that group, three or four are selected to be the compensation committee and must be so identified in the 10-K. They make a recommendation to the entire board, which then votes on compensation. The companies we looked at paid an average of over $10 million. How did things get out of hand and American CEOs make multiples more than their European or Japanese counterparts?

Our theory is that a number of elements come together. The actual work in putting together a recommendation is not done by committee members themselves but by staff, and they follow formulas. SEC regulation provides a lot of information on what other companies are doing. It is public knowledge what competitive companies pay. What company wants to be below average? Every company seeks to give their top people above average pay. So the race begins and the spiral goes rapidly upward. Next, we ask who is on the board of directors. Boards tend to be made up of high-level people from other companies. In many cases they have similar compensation committees determining their salaries. Despite the last year or so, large companies generated enormous wealth in recent decades. There is a lot of money around. This top class of people is given the rare privilege of deciding how much of it should go to themselves or, in other words, what they at the top are worth.

In theory, the board is answerable to the shareholders, but boards have found shareholders to be very passive. The reason seems to be that ownership is incredibly broad. CALPERS (California Public Employees' Retirement Fund) is the largest investor in the country, yet it owned less than two percent of GE. If CALPERS were to work together with other pension funds, it could have a huge impact. Dow companies are typically 35-70% owned by institutions, but who is to complain when things are going well? Why rock such a profitable boat? These attitudes, in theory, allow corporate officers to uncouple themselves from the normal rules of market capitalism and reward themselves more than normal markets would allow. Shareholders of ADM and Caterpillar (local to us) have suffered market losses of $9 and $20 billion, respectively, yet their CEOs received $17 million each (ADM, 2008 & Caterpillar, 2008).CEO compensation is a little less than 1% of earnings, and institutional shareholders have other uses for their energy than going after that relatively small amount of money. CEOs would argue that because their compensation is in line with other companies, it is reasonable and that the drop in stock price is not their fault and would probably be worse if less qualified (less highly-paid) people were in charge.

Conclusions and Implications

The law generally drives the CEO letters and corporate communication. The bad news in 2008 is stated fairly bluntly; however, difficulties are never the fault of executives at either high or low levels. The villain is the business environment. To admit a mistake in business judgment might draw a lawsuit for reckless actions with shareholder assets. After stating the bad news, the language tends to be stirring and invokes a sense of pride in the company and looks to the future. CEOs never say they will accomplish the turnaround or that the company will meet certain goals. That could be seen as a promise and might result in a lawsuit. But the language is nevertheless reassuring and inspiring.

In an effort to rein in excessive compensation, CEO pay has been public knowledge for about the last 20 years. As the discussion has demonstrated, however, the hoped-for results have not occurred. In fact, CEO pay continues to skyrocket.

This paper has covered two different, yet related topics of importance to business communicators. One is the law and policy that has led to American CEO compensation that is way out of line with the American past and its current, similarly-sized counterparts in Europe and Japan (Sahadi). The other is of CEO communication with shareholders in times of distress. None of these communications sought to in any way justify the compensation of those at the top. Instead, the focus was totally on the day-to-day business of the company.

The legal structures of corporations in Western Europe and Japan are about the same as those in America. Yet a culture of very high compensation has taken hold in America (Sahadi). While fairness is in the eye of the beholder, one may ask if American CEOs are adding so much more value that they deserve so much higher pay. Several factors have fueled this culture. First, ownership of major corporations is widespread. Seldom does an individual or institutional investor own even one percent of a company. Shareholders have little sense of ownership. With no sense of ownership, the boards of directors become detached from their traditional responsibilities to the owners. Since they are in great part high-level executives themselves, a self-serving cycle soon develops. There is also a sense of wanting to be in a place "where all the children are above average." Does anyone want to be a member of a board that pays the officer corps in the bottom ten percent? When these factors are combined, the cycle of ever-higher pay is set in motion.

Understanding the cycle of ever-higher pay is one thing; breaking it is another. One looks for some *deus ex machina* to change the culture. Several things should be watched: Will pension and mutual fund managers band together and assert themselves as owners? Will general public outrage shame boards into giving more modest pay packages? Will government restrictions on pay in companies receiving bailout funds have a ripple effect? Finally, will recently proposed Federal Reserve regulation restricting pay and bonus policies that encourage reckless financial actions have a wider effect? With the background of how CEO pay got where it is today, the business communicator should monitor the effects of the above.

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