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Executive Compensation and Moral Luck

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Abstract: Executive compensation is wrought with problems of moral judgment. To the extent that compensation rewards or penalizes behavior for which an executive is not justifiably responsible, it is also a problem of luck. Although executive compensation is both a problem of morality and luck, moral luck—which seems to occur when our moral judgments about a moral agent's conduct or character are influenced by factors beyond the agent's control—has not been a factor in the compensation debate. There remains controversy as to whether moral luck is a real or imagined problem, but if it exists, it should be factored into the compensation equation; if it does not, we cannot deny that moral performance presents a measurement problem. Thus, we are forced to accept that moral luck, real or imagined, has important implications for the ways and means by which executives are compensated.

Key Words: business ethics, executive compensation, moral luck

Bad Moral Timing?

Within a year after Ken Lewis's Bank of America bought John Thain's Merrill Lynch in a deal that was at the time celebrated as the "strategic opportunity of a lifetime" (Baer 2010), both men had reluctantly left the combined company and its rich potential behind. While mounting financial losses contributed to their respective demises—Merrill lost a reported $41.2b in 2008 as Thain was supposed to be saving the firm from the sub-prime assets accumulated by his predecessor (Farrell 2009a), and as a result Lewis was criticized for overpaying for Merrill and stripped of his Chairmanship for having to accept a $20b Washington rescue package (Farrell 2009b)—bad moral timing arguably sealed the deal for both men.

Thain was the erstwhile Clark Kent, nominated as one of twelve "Best CEOs" of 2008 in a *Wall Street Journal* poll of management professors (White

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and Thurm 2008) for engineering the Merrill sale. The moral questions began for Thain when it was disclosed that Merrill had paid $3.6b in bonuses before the end of a disastrous fourth quarter, earlier than usual to beat the Bank of America transaction close date despite heavy losses through three quarters that triggered the need for U.S. Treasury Troubled Asset Relief Program (TARP) funds. He further undermined his moral credibility by allegedly asking in October, and again in December, for a substantial bonus as a reward for rescuing the firm with the sale, meanwhile redecorating his office for $1.2m (Story and Creswell 2009; Farrell and Sender 2009). He left the office, and the never-awarded bonus, behind. Just months after pushing Thain out, Lewis, another of the *Wall Street Journal*'s Best CEO nominees and *American Banker*'s Banker of the Year in 2008, announced his retirement to a board that he no longer controlled, amid an investigation by the New York Attorney General into Lewis's pre-close knowledge of the Merrill bonus fiasco. His pay in 2009 was 99.6 percent less than his pay in 2008 after negotiations with Kenneth Feinberg, who oversaw executive compensation for the U.S. government at banks receiving TARP funds (*Financial Times* 2010).

Signs of the general economically troubled context in which these events occurred included the fact that some government officials were pushing such deals as the Merrill-to-BofA sale with the promise of TARP support, others scrutinized the deployment of those funds, populist shareholder and voter anger against well-paid bankers was reaching a crescendo, nearly everyone was losing money, and those who were not were sometimes investigated because nobody could be *that* smart. If this chain of events had occurred under different contextual circumstances, Lewis and Thain might still be the "great partnership" Mr. Lewis had prophesied it, champagne glass raised, to be (Craig, McCracken, Lucchetti, and Kelly 2008). Instead, both iconic figures fell from grace and in the process lost substantial wealth. There is substantial debate about whether their financial performance earned them an early exit, raising the important question as to how fairly to evaluate executive performance in turbulent economic times. The lingering debate about financial performance leaves substantial room to speculate whether it was really *moral* performance that did them in, and whether that moral performance would have mattered as much under different economic circumstances. If it was indeed their bad moral timing that was to blame, then there is a case to be made that Lewis and Thain, and their substantial compensation packages, were victims of moral luck. Some might argue that these things could not have occurred under circumstances other than the ones under which it did, and because of their very moral tone-deafness to the circumstances at

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hand, Lewis and Thain got what they deserved. But that is easy to say in retrospect, when they might have just been doing what banking executives had always done—taking care of their own—while unwittingly being suffocated by the moral outrage in the air around them.

Executive Compensation and Moral Luck

Moral luck seems to occur when our moral judgments about a moral agent's conduct or character are influenced by factors beyond the agent's control. The very possibility that morality can be subject to luck is a controversial proposition, as moral value in modern philosophy "has to possess some special, indeed supreme, kind of dignity or importance . . . [entailing] not only morality's immunity to luck, but one's own partial immunity to luck through morality" (Williams 1981: 21). Indeed, moral luck was introduced by Williams to modern philosophy as "an oxymoron because of the contradiction in the implication of the two terms: morality is associated with control, choice, responsibility and therefore praise and blame, whereas luck is about chance, unpredictability, lack of control and therefore the inappropriateness of praise and blame" (Athanassoulis 2005:1). According to Nagel, although it presents a problem, "the view that moral luck is paradoxical is not a *mistake*" but rather a serious threat to received conceptions of morality, "one of the ways in which the intuitively acceptable conditions of moral judgment threaten to undermine it all" (Nagel 1993: 60). Williams, Nussbaum (1986), and others contrast our modern resistance to the idea of moral luck with a view, which they attribute philosophically to Aristotle and some other ancient Greek thinkers, that luck is an inescapable part of the human condition. Williams concurs on the seriousness of the threat to our received modern views of morality, suggesting that it might require us to "give up . . . altogether" (Williams 1981: 22) the Kantian attempt (and that of modern moral theory in general) to escape luck. Indeed, Williams's reintroduction of moral luck has been one of the forces behind a revival of virtue ethics over the past few decades.

Moral luck, however, has not been a factor in the executive compensation debate, which is perhaps unsurprising for multiple reasons. First, moral luck—"which seems to appear when circumstances beyond a person's control influence our moral attributions of praise and blame" (Michaelson 2008)—is an obscure term, until recently the province of academic philosophical debate and only relatively recently being introduced to applied ethics fields such as medical ethics (Dickenson 2003), military ethics (Lawlor 2006), social work ethics (Hollis and Howe 1987), and business ethics (Michaelson 2008). Second,

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moral luck, even among those who write about it, is not well understood; some experts characterize it as a framing problem (e.g., Rescher 1990; Richards 1986; Zimmerman 1987), others seek to minimize it through clearer argumentation and removal of psychological bias (e.g., Athanassoulis 2005; Dickenson 2003; Domsky 2004), but many others (e.g., Williams 1981; Michaelson 2008; Nagel 1993; Nussbaum 1986) are resigned to believe that as much as we think we might prefer a world without it, it is fundamental to the human condition. Third, and most centrally to the debate about executive compensation, morality in its purest form is not supposed to have monetary value. That is, the reason that moral luck is a philosophical problem at all is that morality is supposed to be the one form of value that is immune to luck. The value of morality is supposed to be intrinsic. However, this paper suggests that moral luck is a relatively common (if not ubiquitous) feature of executive risk and reward and therefore an inescapable and unjustifiably neglected element of the debate about executive compensation.

Within a worldview that accepts the possibility of moral luck, Lewis and Thain might be taken to resemble morally unlucky reckless drivers who hit a pedestrian. Indeed, they have been accused of far worse than inflicting unintended collateral damage, but let us benevolently and realistically suppose that they were not intentional conspirators in the financial crisis. In Nagel's classic example of moral luck, "Whether a reckless driver hits a pedestrian depends on the presence of the pedestrian at the point where he recklessly passes a red light." We may uncontroversially hold the driver morally responsible for recklessness, but the position of the pedestrian and thus whether the driver reaches home without incident is beyond the driver's control, a matter of luck—which yields "a morally significant difference between reckless driving and manslaughter" (Nagel 1993: 57). This time, the reckless banking of Lewis and Thain happened to occur during some particularly hectic times in history at the notoriously busy intersection of Wall Street and Main Street, and as a result, they caused more damage and so were sanctioned with a more severe loss of compensation and job security than they might have been at any other point in history on their careless, carefree joyrides toward their well-appointed North Carolina and Connecticut estates. On an ordinary day or point in history, with an ordinary police presence or regulatory oversight, the chances of the driver being caught for reckless driving or the banker being caught for excessive risk-taking are close to negligible, evading our moral scrutiny altogether.

The possibility that morality could be subject to luck is deeply troubling, and modern moral theory has tried with all its rational might to eliminate the

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influence of luck on moral judgments since Aristotle implied that the good life was contingent upon luck. Notwithstanding the prevailing preference to explain away moral luck, it has not been able conclusively to overcome the contention that the problem is serious yet ultimately insoluble. As a result, the arcane, philosophical problem of moral luck intersects with the current, practical problem of corporate governance over executive compensation, which similarly seeks to reduce the influence of luck on allocations of (material rather than moral) praise and blame. The possibility that executives may not deserve what they earn is potentially deeply troubling to shareholders who want a "say on pay" to ensure fair value for their investments, board members and compensation specialists who claim to "pay for performance," and, for that matter, to executive conceptions of self-worth. Arguably, recent corporate governance reforms targeted at improving the process for determining how executives are paid have been substantially concerned with eliminating luck, where possible, from the compensation equation. In the deliberations over reform, moral luck, arcane and philosophical as it is, has not even been contemplated as a factor in that equation.

This paper explores the potential implications of moral luck for executive compensation. If there is such a thing as moral luck, and if it does cast its unpredictable spell over executive compensation, then it gives us yet one more reason, if one more were needed, to wonder whether pay for performance is as unattainable an ideal as is morality that is immune from luck. As with morality, the recognition of the pervasive and persistent influence of moral luck need not dissuade us completely from the project of coming up with the best theory or equation that we can. However, as moral luck introduces radical uncertainty into the rational process of moral judgment, as demonstrated by the vast and realistic cavern between judgments of recklessness and manslaughter, or mistakes and malfeasance, it also threatens to expose radical volatility undermining the perceived rationality of judgments about pay, as demonstrated by the all-to-nothing progression in Lewis's compensation from 2008 to 2009 and the all-or-nothing hero or villain standing of Thain in those capricious and unstable days. If moral luck and its infiltration of Wall Street are not illusions, then accepting these realities should remind us once again, in a materialistic culture that insists that everything of value can be measured in financial terms, that some of the most important factors in life and in executive performance cannot be so measured. Recognizing this truth gives us reasons to doubt the just efficacy of market-driven executive compensation and to support remedies to mitigate financial inequality, challenge financial measures of non-financial performance, or both.

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Executive Compensation and General Luck

Even as we put moral luck aside for a moment, executive compensation remains a notoriously inexact science. Executives are typically compensated with reference to a multitude of factors, each of which is itself inexact and given an imprecise weight according to its perceived importance: experience, tenure, reputation of the executive, reputation of the enterprise, size of the enterprise (potentially measured in terms of present revenue, future earnings, number of employees, complexity, etc.), performance of the enterprise (relative to the market, the industry sector, expectations, goals, and other measures that are themselves difficult to measure), and so on. Each of these factors is ordinarily benchmarked by an external advisor against peer executives and comparator companies (Wade, Porac, and Pollock 1997)—which while increasing the appearance of rationality in the process potentially increases the ambiguity of the result. Moreover, since there are various forms of compensation, from cash to stock to options to retirement benefits to perquisites, deferred and not deferred, adding up what a typical executive makes in any given year is really only meaningful to regulators and tax authorities and ultimately reflective of the similar imprecision of accounting methods.

Thus, the practical business problem of executive compensation is wrought with problems of moral judgment about desert and justice. In fact, in recent years, public company executive compensation in the United States, European Union, and Japan, among other jurisdictions, has increasingly been subject to public scrutiny and regulatory disclosure requirements (Labaton 2006; Nakamoto 2010; Oxford Analytica 2010; Weil, Gotshal, and Manges LLP 2010), often the result of moral outrage regarding compensation packages that seemingly encourage excesses among "spiys and gamblers" as Britain's business secretary controversially expressed it (Parker 2010), reward failure (the "golden parachute" phenomenon, for example, Disney's Ovitz (Orwall and Marr 2005) and Morgan Stanley's Purcell (Davis and Smith 2004)) or that basically seem unfair (Dick 1975; Harris 2009; Moriarty 2005).

Moral criticism of executive compensation typically is of two, interrelated kinds that tie back to the ways in which compensation packages are structured. One concerns the problem of attributing praise and blame, or "pay for performance." How should executive compensation packages be structured so as to motivate and reward only that performance which deserves praise and to compensate relatively less the executive who fails to do as well? Answering this question is the objective of certain advocates of corporate governance and pay reform who focus on the compensation process as an agency problem (e.g.,

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Bebchuk and Fried 2003, Moriarty 2009, Tosi and Gomez-Mejia 1989). Paying executives for doing or not doing what they are contractually bound to do for shareholders is fraught with problems of measurement (Nichols and Subramaniam 2001), but pay for performance claims are a typical reaction to criticisms of the fairness of executive compensation (Lublin 2006). Not only is it difficult to establish measurable objectives, but it is also difficult to ascertain in a complex marketplace when objectives have been met. Because measurement is subject to interpretation, a self-protective bias influences the evaluation process (Porac, Wade, and Pollock 1999), such circumstances as IPOs and transactions add instability to the picture (Beatty and Zajac 1994), and egos collide (Bebchuk and Fried 2004)—even leading to "incentives to cheat" (Harris and Bromiley 2007).

Another moral criticism of executive compensation is a perhaps more fundamental problem of justice regarding income inequality and whether there is such a thing as "too much" (Kolb 2012). How can absolute differences in economic earning power, particularly between executives and "ordinary" workers and citizens that do not reflect corresponding differences in human worth, be reconciled within a more general framework of equality and the good life? Answering this question requires a framework for evaluating justice. Empirically, the growth of executive compensation has accelerated relative to corporate earnings (Bebchuk and Grinstein 2005, *Economist* 2010) and has soared in relation to the incomes of production workers (Felton 2004; Labaton 2006). Of course, this becomes a normative problem in a market in which we wish to promote both free enterprise and some degree of political and economic equality (Bloom 2004; Moriarty 2005; Kolb 2006). It becomes a problem of luck insofar as differences in well-being satisfaction sometimes result from differences in luck (Barry 2006). These criticisms of executive compensation are distinct but intertwined, reflecting a relative problem of tying compensation to a picture of performance as well as a problem of justifying absolute and vast differences in wealth and the associated opportunity for well-being.

So, not only is executive compensation a moral problem, it is also a problem of luck. Like the Tolstoyan general, the business executive is perched at the top of a pyramid carried by the actions and choices of tens or thousands below her or him, ordering many people but controlling none and buffeted by the winds of nature and the forces of history. Today's investors tend to be more wary of than impressed by executives with a record of double-digit returns year over year; not even the best gamblers win all of the time. Potentially catastrophic risk emerges from within and beyond the firm in forms, known, unknown, and unknowable (World Economic Forum, 2006). Successful business inventions,

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from the assembly line to the discount retail chain, are as much the product of fortuitous timing as of hard work and ingenuity. Similarly, the moral of the stories of successful business executives—notwithstanding elaborate succession planning processes—is more often than not a variation on the theme of having been "at the right place at the right time." To the extent that a compensation arrangement rewards or penalizes behavior for which an executive is not justifiably responsible, and in so far as an individual is not wholly responsible for the formative circumstances and causal chain ultimately leading to anointment as an executive, executive compensation depends significantly on circumstances outside of the individual's control for which the individual is rewarded or penalized and/or receives benefits or incurs costs. Firms that lack a large shareholder who could scrutinize corporate governance over executive compensation more carefully tend to award more "luck-based" pay (Bertrand and Mullainathan 2001); moreover, the impact of luck on pay is asymmetric, tending to bestow rewards more often than to apply penalties (Garvey and Milbourn 2006). The debate over luck egalitarianism in the market concerns the extent to which luck intervenes in outcomes to the point of unfairness (Lazenby 2014).

Accordingly, one of the shared aims of recent corporate governance reforms over executive compensation has been to mitigate the impact of luck on executive compensation. Greater disclosure requirements increase the possibility that accidents and manipulation will be noticed and corrected. In the United States, a "say on pay" provision in post-recession regulation gave shareholders a non-binding advisory vote on executive compensation, offering moral comfort if not formal power to shareholders to approve pay packages. While "say on pay" does not directly address concerns about luck, it might be seen potentially to reduce the unjustified intrusion of luck on pay packages by subjecting pay to an additional layer involving the scrutiny of the many on the pay of a few. Compensation limits, a more direct way of reducing the impact of luck on pay essentially by reducing the possible range of variance, were considered by United States regulators and enacted by European Union regulators who limited the proportion of bonuses that could be paid in cash and mandated that a portion of bonuses be deferred. The deferral plan, along with "clawback" conditions in both United States and European Union regulation allowing companies to reclaim compensation after the fact when performance over time does not materialize as expected, reflect a general emphasis prioritizing long-term over short-term performance—another way of reducing the impact of luck on performance (Weil, Gotshal, and Manges LLP 2010; Oxford Analytica 2010). The shared aim of these provisions to mitigate luck is part of a moral general goal in

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agency theory to align rewards with results, or "pay for performance" (Bebchuk and Fried 2003; Bertrand and Mullainathan 2001; Garvey and Milbourn 2006).

Of course, the attention that executive compensation has received from corporate governance and business ethics specialists is in part due to the fact that the luck-mitigation enterprise is itself intended to address a moral problem of pay for luck. But comparatively little or no attention has been paid to the unique capability of moral luck (as distinguished from luck-as-a-moral-issue) to frustrate attempts to "pay for performance," or as the case may be, to "pay for moral performance." If moral luck is even a small but significant part of that luck which remains in the rationalist executive compensation model, then it poses a heretofore under-represented concern for that model insofar as moral luck is harder to accept than general luck. Beyond our best attempts to mitigate the influence of general luck on executive compensation, a certain acquiescence to luck remains among us, ranging from reluctant resignation that a certain amount of luck is inevitable, to overt acceptance that luck is a legitimate and even desirable part of the game. We seem to accept that a certain amount of luck is inevitable when trying to put a fixed monetary value on an evolving portfolio of performance. Markets rise and fall beyond the control of any particular executive or company, options vest and are exercised with a blend of foresight and fortuitousness, deals go through or fall through notwithstanding equal investments of meticulous care and effort, exogenous risks—economy, environment, technology, politics, society—intervene unpredictably. Striking it rich is an important part of the lore that engenders the romance of capitalism which holds that anyone, with a lot of hard work and a little luck, can succeed.[1] However, it is harder to accept unearned *moral* rewards or unallocated *moral* penalties as legitimate features of the game, thus obfuscating the general project of eliminating luck from the factors that influence executive compensation.

That concern alone is enough to justify the exploration of moral luck in relation to executive compensation, but we may go even further to suggest the possibility that moral luck poses a special problem for executive compensation. One reason why moral luck might pose a special problem is that successfully implemented pay for performance provisions might address the problem of relative fairness in executive compensation, but it does not address the potentially more pressing moral problem of absolute differences in wealth. Another reason why moral luck resists rational performance evaluation is that it, like moral judgment in general, often involves the legitimate influence of emotions. On the one hand, the boiling outrage in the air at banking executives in 2008–2009 was perhaps overwrought and would dissipate to a more reasonable,

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simmering resentment—a testament to the wisdom of long-term measures of performance—but on the other hand, to downplay the legitimacy of moral emotions on the heels of the events that stirred them would be to cheapen them, to suggest that moral values are temporary. Yet another reason moral luck is exceptional is the all-or-nothing nature of moral evaluation; although we might not want to deny that there are varying degrees of moral excellence, at the same time we want to show decisiveness while being unequivocal in our moral judgments as indicators of general approval or disapproval.

Examples and Outcomes: Shame, Heroism, Tragedy

When the reckless Wall Street banker gets away with a risky transaction, he (or she, but usually he) might be found afterward at Bull Run hubristically high-fiving and telling the tale of how he came *this close* to ruin only to come away from his brush with oblivion with enough to buy everyone a round and then some to take home. When a reckless driver leaves the bar intoxicated, narrowly escaping tragedy on the meandering path home, nobody else raises a glass to toast the fortunate evasion of the tragedy that might have been. Somewhere nearby walks a pedestrian, the unwitting beneficiary of the driver's moral luck of a particular kind, *circumstantial* moral luck—"the kind of problems and situations one faces." Somewhere else, a pedestrian is the victim of a reckless driver whose circumstantial moral luck turned the other way, who got into this circumstance in the first place because of the *constitutive* moral luck of being a certain sort of person—"your inclinations, capacities, and temperament." Two other kinds of moral luck "have to do with the causes and effects of action: luck in how one is determined by *antecedent* circumstances," and *resultant* "luck in the way one's actions and projects turn out" (Nagel 1993: 60).

Lewis's steep reduction in pay from 2008 to 2009 was doubtlessly the result, in part, of circumstantial and resultant (non-moral) luck; general economic conditions were poor in 2009, and Bank of America was more strapped for cash in the wake of the now seemingly expensive Merrill transaction and continuously falling asset prices. But Lewis's lack of a 2009 pay package was also influenced by multiple types of moral luck, including the circumstantial moral approbation of bankers for being the alleged instigators of the poor economic conditions, along with the constitutive condition itself of being a banker. Lewis's decision to forego his salary and bonus was the result of an agreement with the Treasury Department's "pay czar," Kenneth Feinberg, over banks that received large government loans, conceding "it was not in the best interest of Bank of America or him to get into a dispute with the pay master" (Yousuf 2009).

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Thain's pay master, on the other hand, turned out to be his own hubris followed by humility. When he arrived at Merrill in 2007 with the promise to restore the venerable bank's lustre, he received a $15m signing bonus that began to look like a bargain until the system began to fall apart a year later. Thain was rumoured to be seeking a $10m bonus as late as December 2008, that fateful month when he was pressured to reconsider his own bonus while he still pushed through bonuses for other Merrill executives. Like Lewis, Thain was arguably the victim of constitutive and circumstantial moral luck, along with the bad (non-moral) luck of antecedent circumstances that saddled his tenure with the falling asset values left by his predecessor and the resultant outcomes that led his bonus decision to be viewed as the last moral straw. A year after ordinary workers began to lose their jobs, or to suffer pay freezes or reductions, according to a *Financial Times* survey, "CEO pay at 17 leading US and European banks dropped 57 per cent, from an average of $14m in 2008 to just over $6m in 2009" (Murphy 2010). Of course, the fact that certain bank CEOs made so much money in 2008 is a testament to the difficulty of paying for performance, when financial results that might have looked good at fiscal year-end turned out to have been inflated by an asset bubble that suddenly burst. Consider the drop in pay from 2008 to 2009 to have been, in part, moral recompense directed at surviving executives for letting things get out of hand, with a dose of distributive justice thrown in to palliate those offended by all the zeros following non-zeros in executive compensation checks. Had they not been *public* company bank chief executives, had they not been public company *bank* chief executives, or had they not been public company bank chief *executives*, arguably the furor would have affected them less, or perhaps not at all. However, as a result of being a certain kind of person that belonged to a certain category of moral agent, they were figuratively painted with a brush which all such agents in that category were painted and, as a result, literally paid the price.

Of course, moral luck can work the other direction as well, when executives are rewarded quite handsomely for moral performance despite the role played by luck in the resultant outcomes of that work. In such cases, virtue may not be its only reward. Consider, for example, the case of Roy Vagelos, the Merck executive who is credited with authorizing the research and development funds to explore whether there might be a human application for the veterinary anti-parasitic drug, Ivermectin. As the story is told, Vagelos knew going into the decision that the drug that was to become Mectizan could not, even if medically successful, become a direct revenue generator, since the potential patients who were vulnerable to river blindness could not pay for the drug. Vagelos, at

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the time the head of Merck research labs, nevertheless authorized the project, guided by the company's mission that put "people before profits" (Hanson and Weiss 1991; Michaelson 2008; Useem 1998).

A moral deontologist might praise Vagelos for his moral courage no matter what the outcome of the project, while a consequentialist would take additional moral comfort in the fact that Mectizan proved to be a resounding medical success. We have no way of knowing how the decision would have affected Vagelos's career and associated compensation had Mectizan quietly failed before reaching the market, or worse, if it had reached the market and then proved to have unintended adverse consequences, as Merck later learned could happen with seemingly tested and true drugs like Vioxx (Bowe 2004). But it is reasonable to suppose that the medical success of Mectizan, which was pursued more for moral than monetary reasons, had something to do with Vagelos's eventual rise to the helm of Merck. It is also reasonable to suppose that if the Mectizan project had resulted in quiet failure or noisy tragedy, it might have obstructed Vagelos's rise. We have good reasons to suppose that Vagelos did what was within his control to enable to success and to avoid tragedy, but the avoidance of failure was not entirely within his control, and so by implication the rewards he enjoyed for success, including monetary compensation, can be said to have been in part the consequence of resultant moral luck. Speaking in 1994 of the company's investment in China, Vagelos acknowledged the role of luck: "Our hope is that the long-term relationship we have built and the goodwill we have created will help our company in the long run. If not, we've still done the right thing. But like everything else we've done, it's a big bet" (Nichols 1994).

Vagelos's rise was also aided by constitutive moral luck, the condition being in a potentially life-saving business, and circumstantial moral luck, the antecedent circumstances being that there were lives, in the balance, hoping to be saved. Misery, tragically and/or fortunately, creates opportunity, as it did also in the case of former New York Stock Exchange (NYSE) chief Richard Grasso. Having the chance to prove one's crisis management mettle is a matter of circumstantial moral luck, and then having the outcomes admired is a matter of resultant moral luck. The story of Richard Grasso's approximately $150m compensation package for heading up what was then a non-profit is often invoked in debates about the ethics of executive compensation in general (Harris 2009, *Knowledge@Wharton* 2004), but the $5 million bonus he received for "sterling leadership" in the aftermath of 9/11 (Boland and Postelnicu 2003) is generally not at the center of the dispute. It is, however, a matter of circumstantial moral

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luck insofar as he would not have had the chance to earn an extra $5 million had it not been for the chance situation that the attacks on World Trade Center and associated impact on the nearby NYSE headquarters came on his watch. It could even be argued that the NYSE had been slow to automate under Grasso, that he would have had to have been less "heroic" had he moved the exchange toward the electronic trading platform—ironically put in place by his successor at the NYSE, *one John Thain*—that now predominates in the equity markets and that already was in place in the bond markets before 9/11.

It seems untoward to describe the 9/11 attacks as "luck," for they were neither good, nor were they purely chance. Had the NYSE, "the fountainhead of capitalism in America" (Thomas 2004, quoting Kenneth Langone), been housed in the tall Twin Towers rather than the comparatively short neoclassical building on Broad Street, all the better for the terrorists' goals of attacking as many symbols of American capitalist strength as possible. Insofar as the attacks were luck, they were bad luck for those surprised by them, including Dick Grasso, though he was the rare individual who came out of the attacks with a modicum of good fortune. (Rudy Giuliani, whose hard-bitten image was transformed into that of a hard-working leader by his post-attack performance, was arguably another.) The attacks occurred on a Tuesday, shutting down major global markets. The electronic bond markets were up and running by Thursday, but Grasso's human zoo that was the NYSE trading floor was covered in dust and mourning. Originally, he was tasked with reopening equity markets by Thursday (Clarke 2004). When that proved overambitious, he worked virtually round the clock, sleeping at the NYSE, to ensure the markets would reopen for business on Monday, rejecting therapy with the tough-guy assertion, "My counseling is this: that Monday morning 9:30 bell" (Stanley 2001). Fearing a steep decline, government officials and the business community were actually relieved by a drop of only 7 percent, and much of the qualitative credit went to those, including Grasso, who proved President Bush's challenge that " the American economy will be open for business" (Bush 2001). Even if we took out a portion of the $5m bonus for overtime pay, there remains a hefty reward for moral heroism that was uniquely available to Grasso in view of the tragic circumstances.

Implications of Moral Luck for Executive Compensation

Lewis. Thain. Vagelos. Grasso. The list continues:

What if the prosecutors in the Galleon Hedge Fund insider trading scandal had been unable to connect Rajat Gupta's sharing of information with Raj Rajaratnam about Goldman Sachs to a particular gain because of unrelated

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aberrations in market behavior. Would then there have been grounds at all to implicate Gupta (Raghavan 2013)?

If the Deepwater Horizon, an exceptionally risky oil-drilling project that led to the largest spill in history, had taken longer—years, or perhaps never—to explode, instead of succumbing to the odds during Tony Hayward's tenure (Krauss 2010)?

If Hurricane Katrina, in the words of then-CEO Lee Scott, had not "changed Wal-Mart forever" by showing "our potential to serve our customers, our Associates and our communities by applying our business model to solve major problems" (Wal-Mart 2007)?

If those reputation boosts, bumps, and benefits that academics, companies, media, and the public all tout as a motivator for moral business conduct, were at all (as I think they undeniably are), buffeted by the winds of fortune?

If there were a reversal of traffic between Wall Street and Main Street, and the 99%, who had not been in the executive position to set off the financial crisis by taking risks with other people's money, had been instead in their driver's seats and "had an opportunity to behave badly" for our own (economic) good at the (moral) expense of others? "Here again one is morally at the mercy of fate. . . . We judge people for what they actually do or fail to do, not just for what they would have done if circumstances had been different" (Nagel 1993: 65–66).[2]

All of these parties, hypothetical and real, lost or gained job security, legacy, reputation, and other forms of business capital, all directly or indirectly related to financial capital—i.e., compensation. All such losses and gains were the result of bad or good moral performance that was influenced in some significant way by luck. There are perhaps many more stories of good or bad moral performance of which we—and more relevant, compensation committees—are unaware, because whether an event or series of events becomes a salient factor in compensation decisions is itself in part a matter of chance, influenced by matters of intentional disclosure and measurement, but also by matters of unintentional timing and measurability, among other factors. Then, if an episode of moral performance does make an impression, the reaction of praise or blame is almost serially an over-reaction. The problem of moral luck impacting executive compensation is not at all rare; yet in the academic and public debate, we have hardly given attention to it at all. Like the problem of moral luck in general, and the problem of moral luck in business ethics, cases "reappear involuntarily" (Nagel 1993: 65) "over and over" again (Michaelson 2008: 785).

We may be put off by the notion that moral performance can be compensated, or we may want to praise moral performance in business. Among other

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things, doing so may even support the association of corporate financial performance with corporate social performance (Margolis and Walsh 2003) while raising the spectre of stigmatization for failure (Wiesenfeld, Wurthmann, and Hambrick 2008). On the other hand, our desire for the moral certitude necessary to reward moral performance is continually challenged by the apparent pervasiveness of moral luck in business. These competing forces of moral responsibility and luck (Athanassoulis 2005) are what make moral luck a seeming contradiction in terms. While prominent commentators (among them, Williams 1995 and Nagel 1993) have claimed that the problem of moral luck is insoluble, even they have been disturbed by the prospect of accepting without resistance the implication that life can be deeply unfair. Therefore, there have been two basic approaches to addressing the problem of moral luck: one has been to accept the problem while attempting to mitigate the magnitude of the unfairness it introduces, and the other has been to deny that there is a problem if we frame moral issues correctly. These different "solutions" to the problem of moral luck suggest analogous solutions to the problem of executive compensation.

Suppose that we *accept* without reservation that our lives, moral and otherwise, are beyond our ability to control (Statman 1993), that "the peculiar beauty of *human* excellence just *is* its vulnerability" to luck, including moral luck (Nussbaum 1986: 2). As Nussbaum explains, though Aristotle is sympathetic to the view that the good state or condition of *eudaimonia* would ideally be internal and impervious to external contingencies, he counters not only that good states are vulnerable to external forces but also that "good states are not by themselves sufficient for good living" (Nussbaum 1986: 322). In this case, we would like to believe that outside forces beyond one's control would not wreck a person's moral fortitude, but Aristotle's worldview about the vulnerability of the good life was shaped by a generation of ancient Greek tragedians who depicted great lives that fell from grace, forced by temptation or circumstances into committing heinous acts because fate left them no choice or they lacked full knowledge of their crimes: Agamemnon, Oedipus, Medea, among others. Indeed, journalistic accounts of John Thain's fall in particular are replete with echoes of Greek tragedy (Creswell and Story 2009, Farrell and Sender 2009). Once on the path toward the helm of Goldman Sachs, he was outmaneuvered by rivals only to land serendipitously at the non-profit New York Stock Exchange, which was itself still reeling from the controversy over Grasso's pay package—a hairless Lex Luthor to Thain's princely Clark Kent—and its antiquated trading platform. Not long before Grasso's name was being removed from a commemorative 9/11 plaque (*Wall Street Journal* 2004), Thain accepted a salary at the

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NYSE that was relatively modest by Grasso's and Goldman's standards, setting up his "Mr. Fix-It" reputation that earned him much more at Merrill. Even after the Merrill sale to Bank of America, he was hailed as a graceful picture in contrast to the villainous Richard Fuld of Lehman, who could not find a buyer for his doomed enterprise. Was it indeed the spectre of compensation itself that suddenly corrupted Thain? To surmise that he was evil all along or to conclude that he became evil at all is perhaps too simple, a conclusion looking for a story to back it up—and self-righteous, a suggestion that in similar circumstances with similar temptations, a person of stronger character would have done otherwise.

Aristotle suggests that good moral character is a characteristic of the good life but that that life also requires help from outside that is not entirely within our control: friendship, intellectual gifts, and, perhaps most relevant to Thain's story, material comforts. Thus does Aristotle controversially accept slavery and servitude as the lot of barbarians and lesser human beings which enable greater human beings to flourish (Richardson Lear 2004). Sustaining a compensation plane that sets financial institution executives apart from ordinary workers requires a tacit acceptance that for some people to live the Wall Street life, there must be others who do not. However, acceptance that moral luck is a necessary part of life does not mean that we cannot try to mitigate its effects to the extent to which we conclude they permit unjust inequity. This leaves us still to decide how many or few should have access to the good life, and how much economic wealth is necessary for those who live it.

Suppose instead that we reject Aristotle's acceptance of moral luck as endemic to the human condition, and we are left with the alternative, to *deny* that there is such a thing as moral luck at all. This challenge to the problem of moral luck seeks to explain it away as rather a framing problem, a failure on our part to apprehend all and only those factors salient to valid moral judgment. On this view, we were wrong when we missed the early signs of lapses in Thain's and Lewis's moral judgment, and we were also wrong to excoriate them as much as we did after the fact, but such are the steep rises and falls of our flawed judgment when we miss the big picture. In keeping with Aristotelian ethics, which assesses moral character as a habit of behaviors that can only fully be ascertained by scrutinizing a complete life, evaluating each moral action as good or bad is akin to paying too much attention to quarterly fluctuations in performance.

Whether we are wont to accept or deny that moral luck exists, either conclusion poses serious challenges to the view that the market for executive compensation could be both efficient and fair. If we accept moral luck, then it complicates decision-making (Barrett 2006), potentially introducing radical

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uncertainty into our judgments about moral performance, which in turn influence our judgments about financial performance, thus impacting financial rewards and sanctions. It thus raises serious doubts about the fairness of market-driven compensation when left in the hands of flawed human judgment. Its potential existence, however, does not preclude us from attempting to mitigate its wanton effects, for one thing by seeking to reduce temptations that might lead any vulnerable human being toward immoral behavior. The fact that a few succumb to those temptations does not mean we all would, but it creates inefficiency in the form of unnecessary moral risk. In addition, the effects of moral luck could be mitigated by seeking to reduce vast differences in wealth that seemingly allow an economically-aided experience of the good life to be experienced by relatively few. This view of moral performance entails the controversial view that pay above certain levels should be capped at an absolute maximum number or at a relative ratio of highest-to-lowest-paid employee.

If we deny that moral luck is a real problem, then we have to admit that moral performance presents a measurement problem. There is no real market pure and efficient enough to measure morality, and since measurement of luck and of morality present complex measurement problems, we are forced to accept that moral luck, real or imagined, has important implications for the ways and means by which executives are compensated. Denying moral luck while supporting fairness in market-driven executive compensation would require accounting for moral performance in the compensation equation, introducing complexity to an equation that already fails adequately to account for non-moral performance. This gives us another reason to be skeptical about the achievability of the pay for performance ideal and about the market's ability to distribute wealth when its outcomes sometimes seem wildly inconsistent with our better moral judgment. This view of moral performance does not necessarily entail caps on compensation. However, it does entail the emerging consensus that financial performance should be measured over long periods of time in order to be fairly assessed, and that clawback provisions should be available should performance in retrospect prove to have been illusory.

Either attitude toward moral luck compels us to conclude that moral performance, to the extent it undeniably influences perceptions of executive performance, introduces inefficiency and thus yet another source of potential unfairness into executive compensation. Recognizing the relevance of moral luck to executive compensation does not help us to achieve the goal of removing luck from the pay equation. Therefore, it provides reasons specifically to intervene in an imperfect market for wealth distribution and to prioritize long-term over

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short-term performance. More generally, the possibility of moral luck should discourage us from too much reliance on market valuation that too often insists on measuring pluralistic value in monolithic, financial terms.

Notes

1. Although casual and specialist readers are likely to recognize these acquiescent sentiments about the presence of luck in executive compensation, no formal references have been cited because the treatment of luck in executive compensation in scholarship and journalism tends to focus on the objective of mitigation rather than on legitimization or justification. Evidence of these sentiments is rather colloquial, as in the willingness of the general populace to support lottery systems that reward luck and the common admiration for speculators who "strike it rich," giving anyone hope that it might happen to them. By contrast, with moral luck, we may with a self-righteous sneer count the reckless driver who got away with it lucky, but we do not celebrate the driver's luck, except to thank fate that nobody was harmed.

2. The quoted passages are from Nagel's discussion of Nazi Germany in which he asserts that some citizens of other countries might have behaved as badly if put in a similar position, yet in general they were not, and so they are not so judged. Nagel means for this point to be generalizable even if the behaviors, such as financial exploitation, are not akin to ethnic cleansing and other heinous war crimes.

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