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AIG RETENTION BONUSES: NOT A PIMPLE, A MALIGNANT TUMOR

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The public outrage over bonuses paid to AIG employees reflects at the gut level some basic ideas of justice governing exchanges between buyer and seller, worker and employer, and others in a market system. Simply put, justice demands that both parties to any exchange are to trade things of equal value and impose equal burdens on one another. This principle applies in all exchanges whether sealed by a written contract or not.

Parents teach this principle to a child who takes a piece of candy off the shelf by insisting that the shopkeeper must be paid or the candy returned. It is violated by price gouging and shoplifting in the marketplace and embezzling and pilfering in the workplace. Nevertheless the fact that these practices and others are condemned as illegal confirms the principle and teaches the importance of compliance. *Let the buyer beware* is no substitute for this commonsense principle.

In the marketplace, justice demands in most cases at the point of sale when the seller transfers the item to buyer that the buyer is obligated to make payment in full. Commonly this transaction involves no written contract. Even so, the demands of justice apply. If the item is defective, the buyer usually can expect to return it to the merchant for a refund or for exchange with an equivalent item. If the buyer pays with a worthless check, the seller has legal options to recover the full amount owed. The rule is that a defect in the exchange voids the contract.

One major exception to the strict application of this principle involves the sale of a big-ticket item such as an automobile or house where the buyer cannot make payment in full at the point of sale, borrows the money, and repays the lender over time. Those payments in the future include interest to cover the lender's risk that the borrower may default and the risk that inflation may erode the value of the money when it is repaid.

In the workplace, the employer is obliged to pay the worker promptly for the work performed. If the employer fails to make payment as agreed, the worker can sue the employer for unpaid wages. If the worker fails to perform as agreed, the employer can adjust the wage downward or fire the worker. Virtually every employment contract, whether written or strictly verbal, calls for performance evaluation as a way of affirming that both parties are being faithful to the terms of the contract. Common sense alone tells us that there must be a tight linkage between performance and pay, that there must be some equivalence between the work done and the wages paid.

This is the nub of the problem, at least the public perception of the problem, regarding Wall Street bonuses which has been brought to a head by the news about \$165 million paid to AIG employees. Is there an equivalence between the work done and the compensation paid these employees? Judging by AIG's collapse as a viable company, there clearly were *serious mistakes in risk management* made by senior AIG executives, notably with credit default swaps, which required AIG to make payments to their clients who purchased this product to insure themselves against the risk of defaulting on their obligations to their debt holders.

Municipalities purchased CDS to insure that they would be able to pay their bondholders in the event of a fiscal crisis. Banks purchased this insurance to protect themselves against defaults on their holdings of mortgage-backed securities. Any default on the financial instruments insured triggered payment by AIG to cover the loss. This work was poorly done because in the end without the government bailout AIG could not make the required payments to its clients facing default.

Ironically AIG actually saw its own collapse on the horizon. In its Form 10-K filed with the Securities and Exchange Commission in February 2008 the company stated that its "procedures may not be fully effective in mitigating risk exposure in all market conditions, some of which change rapidly and severely."

One public commentator trying to dismiss the AIG bonus issue described it as a "pimple" on the face of an enormous bailout package and urged President Obama to apply himself to more important matters. This argument misses the point. The AIG bonus controversy is not about the money so much as it is about the underlying principle which demands equivalence in exchange.

This principle is critical to a properly functioning market economy. Without it all manner of abuses including the ones previously mentioned are tolerated and become commonplace. This in turn weakens compliance with the other principles of justice regarding the relationships between a superior and his/her subordinates and a member and the group to which that person belongs, leading to other abuses such as discrimination, bribery, insider trading, and insurance fraud, and shaking the foundations of a market economy. In the past several day, it has come to light that one prominent U.S. senator lied about his role in changing the language of the stimulus package which allowed AIG to pay retention bonuses.

The Wall Street bonus system needs overhauling because what happened at AIG is not an isolated incident. It is commonplace to pay bonuses even when there is no evidence that the compensation paid to an employee matches that person's own performance or the performance creates no lasting value for the company. The bonus is paid to keep them from leaving and that's why it's called a retention bonus. In strict ethical terms, it really is extortion in which corporate managers, employees, and directors in effect form a conspiracy to fleece the stockholders because they are being paid twice, the first time for work done poorly, the second time for cleaning up their own mess. In the case of AIG they are fleecing the U.S. taxpayers who hold about 80 percent of the shares of the company.

A contract arranged through a conspiracy is not a valid contract and we should not hesitate to set those contracts aside. The bonuses paid under the terms of those contracts are much more than a pimple on the face. They are a malignant tumor.

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