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IS U.S. CEO COMPENSATION INEFFICIENT PAY WITHOUT PERFORMANCE?

John E. Core, Wayne R. Guay** and Randall S. Thomas****

PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION. By *Lucian Bebchuk and Jesse Fried*. Cambridge: Harvard University Press. 2004. Pp. 304. Cloth, \$24.95.

INTRODUCTION

In *Pay Without Performance*, Professors Lucian Bebchuk¹ and Jesse Fried² develop and summarize the leading critiques of current executive compensation practices in the United States. This book, and their highly influential earlier article, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, with David Walker³ offer a negative, if mainstream, assessment of the state of U.S. executive compensation: U.S. executive compensation practices are failing in a widespread manner, and much systemic reform is needed. The purpose of our Review is to summarize the book and to offer some counterarguments to try to balance what is becoming an increasingly one-sided debate.

The book's thesis is that executive compensation practices in the U.S. benefit corporate executives at the expense of shareholders through implicit and explicit corruption of the pay-setting process. It argues that CEO employment contracts are bad for shareholders (not "optimal") because they are the product of managerial power.

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1. Professor of Law, Harvard Law School.
2. Professor of Law, University of California at Berkeley (Boalt Hall).
3. Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

Managerial power arises, the authors claim, because boards of directors at public companies are beholden to the firm's top executives, largely due to management's control over the director nomination process. Weak compensation committees thus do little to protect the firm in its pay negotiations with the CEO, leading to levels of executive pay that are both inappropriately high and have inappropriately low levels of incentives. The only constraint on this process is "outrage," either among the firm's shareholders or the general public. This outrage constraint, however, only polices extreme cases of executive overcompensation.

In support of this claim, the authors offer a four-part analysis of CEO pay. In Part I, they begin with a short description and critique of optimal contracting theory, which posits that executive compensation arrangements are designed to benefit shareholders.⁴ After developing their arguments against the optimal contracting thesis, they go on in Part II to explain their version of managerial power theory, in part through an in-depth analysis of current executive compensation practices. Having claimed to establish the superiority of managerial power theory to optimal contracting, in Part III the authors provide a more detailed critique of the relationship between CEO pay and firm performance. They assert that the managerial power theory provides a superior explanation of current practices to the optimal-contracting perspective. They also draw the strong implication that if such power exists, it means that something is wrong with the contracting process. They conclude in Part IV with their policy recommendations to address what they perceive to be the failings of executive pay practices.

While we agree with some of the analysis offered in *Pay Without Performance*,⁵ we think it is important to put its arguments into perspective. In a nutshell, the key issue is whether the problems Bebchuk and Fried discuss are examples of a few bad apples or are evidence that the whole barrel is rotten.⁶ The essence of their claim that the entire barrel is bad rests on the following assumption: If contracts are optimal, they do not reflect managerial power, and if

4. As we discuss below in Section II, Bebchuk and Fried do not directly critique optimal contracting theory, but instead critique the lack of arm's-length contracts, which are a very restrictive subset of optimal contracts. Because contracts will only be arm's length when there are no contracting costs and no transactions costs, the arm's-length standard is a questionable benchmark, and is not typically used by economists, who prefer to examine whether contracts are optimized to maximize share value net of contracting and transactions costs.

5. For example, we think some of their policy recommendations have merit and deserve careful consideration. See *infra* Part IV for further discussion of some of these points.

6. Bebchuk and Fried introduce their book with the suggestion that the barrel is rotten by quoting Harvard Business School Dean Kim Clark: "Is it a problem of bad apples, or is it the barrel?" P. 1.

contracts reflect managerial power, they are suboptimal. The authors view evidence of managerial power as evidence that the system is failing and that reform is needed.

We agree that it is useful to consider the effect of managerial power on compensation, but disagree with their interpretation of the consequences of such power. It is true that contract structures reflect CEO power, and that CEOs with more power get more pay, but this does not necessarily lead to the conclusion that CEO pay is not optimized for shareholders, nor does it imply that CEO pay needs reform.

More generally, our Review points out that Bebchuk and Fried have missed some important aspects of executive pay and incentives. As a result, they have not shown that there are systematic failures with U.S. CEO compensation, and therefore have not shown that reform is needed.

We try to accomplish this task in the following manner. We begin in Part I by summarizing what we see as the main themes of the book in some detail. This overview sets the stage for us in Part II to define carefully what we understand to be the optimal contract perspective and managerial power perspective. We then show that in many settings where managerial power exists, observed contracts anticipate and try to minimize the costs of this power, and therefore may in fact be written optimally.⁷ As a result, the two perspectives are complementary, not competing, explanations.

In Part III, we examine Bebchuk and Fried's claim that U.S. CEO compensation is inefficient "pay without performance." We note that their analysis focuses primarily on whether CEO annual pay varies with firm performance, and that this perspective ignores the lion's share of CEOs' incentives: the large holdings of stock and options that provide powerful performance incentives and ensure that the wealth of most CEOs varies strongly with their firm's stock price. Thus, we believe that the authors' claim that CEO pay is "pay without performance" is based on a mischaracterization of the structure of U.S. CEO compensation and incentives.

Finally, we conclude by briefly examining some of Bebchuk and Fried's policy recommendations and summarizing our main points.

I. OVERVIEW OF THE BOOK

In *Pay Without Performance*, Professors Lucian Bebchuk and Jesse Fried assert that American executives are vastly overpaid by their overly friendly boards of directors. Bebchuk and Fried argue that

7. As we discuss in detail in Section II.A below, an optimal contract is not a perfect contract, but the best contract that can be achieved given the contracting costs in a given situation.

current executive pay practices are a sign of widespread corporate governance failures, a view that they believe to be supported by scholarly research on executive compensation.

The departure point for their project is the large increases in U.S. CEO pay between 1992 and 2000.⁸ Bebchuk and Fried maintain that current pay arrangements are inefficient and excessive, and are the result of managerial power and a lack of arm's-length bargaining. On the other hand, some financial economists are hesitant to conclude that current pay practices reflect a poorly functioning market for executive labor and question the generalizability of the managerial power perspective.⁹

Bebchuk and Fried argue that the negotiations that take place between boards and CEOs over pay are distinctly one-sided in favor of the executive. Boards do not, and cannot, act as effective monitors of management because their members, even supposedly independent ones, are beholden to CEOs for a host of financial, social, and psychological reasons. Other players in the corporate governance field are either too weak, too unaware of the facts, or too interested in preserving the status quo, to do anything about it. In short, the thesis of the book is that the U.S. executive compensation system is broken and that serious corporate governance reform is needed to fix it.

PART I. THE ARM'S-LENGTH BARGAINING MODEL

Bebchuk and Fried begin with a description of the "official," or "arm's-length bargaining" model, which they claim informs most financial economists' research. This model rests on the widely accepted agency-cost model of the American corporation: diffuse ownership of large corporations leaves substantial discretion in professional managers' hands as to how to run the company, and managers can use this discretion in ways that do not maximize shareholder value. The resulting agency costs can be reduced through a variety of methods, including the use of a monitoring board of directors. Such a board will leave much discretion in the hands of managers, but oversee executives' actions in an attempt to minimize, but not eliminate, the agency costs resulting from the separation of ownership and control.

8. See, e.g., *infra* Table 2.

9. See, e.g., Bengt Holmstrom & Steven N. Kaplan, THE STATE OF CORPORATE GOVERNANCE: WHAT'S RIGHT AND WHAT'S WRONG (Nat'l Bureau of Econ. Research, Working Paper No. 9613, 2003); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002). For two recent surveys of research on executive pay and incentives, see John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, 9 FED. RES. BANK. N.Y. ECON. POL'Y REV. 27 (2003), and Kevin J. Murphy, *Executive Compensation*, in 3 HANDBOOK OF LABOR ECONOMICS 2485 (Orley Ashenfelter & David Card eds., 1999).

As part of the effort to minimize agency costs, executive compensation is designed to provide incentives that reward managers for acting in ways that benefit shareholders. Theory predicts that boards will use schemes that pay each executive their reservation wage, which is the value of the next-best opportunity available to the manager, plus a premium for bearing the risk that comes with incentives that tie the manager's wealth to changes in shareholder value. These incentives induce the executive to exercise his discretion to create more shareholder value. When the firm's success depends heavily upon the decisions and effort level of its executives, then compensation contracts should be highly incentivized. As the amount of incentives is increased, however, so is the risk premium that executives demand, resulting in higher pay. An effective incentive contract maximizes the benefits of increasing shareholder value through incentives net the costs of paying for these higher incentives.

Bebchuk and Fried argue that this model assumes that executive compensation arrangements are the product of "arm's-length bargaining between the executive and a board seeking to maximize shareholder value" (p. 18). They then ask the question of whether this assumption comports with the reality in the marketplace. Here, they contend the answer is a resounding no.

Directors, in Bebchuk and Fried's view, are heavily biased against engaging in arm's-length negotiations for CEO pay. They offer a long list of reasons for this, including: CEOs control, or at least strongly influence, who sits on the board, and board members want to be reelected to continue to enjoy the many benefits of board membership; CEOs can award benefits to directors, directly or indirectly, by hiring their firms, or contributing to their favorite charities; CEOs have significant influence over director compensation, with higher CEO pay being correlated to higher director pay; and a host of social and psychological factors, such as friendship, loyalty, and collegiality. On the other side of the equation, directors have relatively few reasons to oppose higher CEO pay as long as it falls "within the range of what is considered conventional and acceptable" (p. 36). Higher pay, claim Bebchuk and Fried, has little direct financial impact on directors as they usually hold little stock in the company and gain few or no reputational benefits from holding down CEO pay. Furthermore, even well-intentioned and hard-nosed compensation committee members lack the time to do much more than rely on outside consultants for information and advice, with these advisors also having strong incentives to give the CEO what they want.¹⁰

10. Bebchuk and Fried further claim that the same dynamic applies to newly hired outside CEOs because directors have the same incentives to please and get along with them plus a strong interest in insuring that they get the candidate they want to be the new CEO. Pp. 39-41.

Bebchuk and Fried conclude, therefore, that boards are not bargaining at arm's length with CEOs.

If that is true, then what other meaningful checks exist for executive pay? Shareholders lack direct power to set compensation for top managers but do have indirect ways of influencing pay levels through filing law suits, or voting for shareholder resolutions and against management-sponsored option plans. Bebchuk and Fried claim that litigation is a very limited check on excessive executive pay plans. Courts are ill equipped to judge the desirability of compensation levels and practices, so judges typically apply the business judgment rule in evaluating executive pay levels unless there are serious process problems. In fact, Bebchuk and Fried believe that "almost all cases since 1900 have refused to overturn compensation decisions made by the boards of publicly traded firms."¹¹ Nor do they see much hope of that record changing in the future, despite recent Delaware court decisions in favor of shareholders challenging executive compensation.¹²

In the voting arena, NYSE and NASDAQ rules adopted in 2003 require shareholder votes on all stock option plans. Bebchuk and Fried, however, do not believe that this will affect executive compensation levels in a meaningful way, despite research showing that high negative shareholder votes on option plans lead directors to reduce the rate of executive pay increases. They claim that option plans are rarely defeated, that even if such plans are voted down, boards can still substitute other forms of compensation, and that shareholders may be hurting themselves by vetoing these plans. They conclude that "shareholder voting on option plans has been a weak constraint on compensation arrangements" (p. 51).

Markets represent another potential disciplinary force on executive pay levels: the managerial labor market, the market for corporate control, the product market, and the equity capital market

11. P. 46. In support of this claim, Bebchuk and Fried cite a descriptive article by Professor Barris. P. 46 n.1. They do not mention, however, contrary results in an empirical analysis of a large number of executive compensation cases by one of the authors of this review, although they cite the article. This study found that in public company litigation challenging executive compensation, shareholder plaintiffs have obtained favorable judicial opinions in different stages of the litigation in thirty-two percent of the cases in that sample. Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 588, 611 (2001).

12. In particular, two new Delaware Chancery Court decisions place the burden on incumbent managers to insure that their own employment contracts are negotiated "in an adversarial and arm's-length manner." Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. 20228-NC, 2004 Del. Ch. LEXIS 122, at *60 (Aug. 24, 2004) (emphasis omitted); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 290 (Del. Ch. 2003). These decisions make clear that an officer's fiduciary duties to their corporations extend to acting "honestly and in good faith so as not to advantage himself at the expense of the [entity's] shareholders." *Official Comm.*, 2004 Del. Ch. LEXIS 122, at *60 (alteration in original).

may all reduce the likelihood of excessive executive pay. Bebchuk and Fried claim these markets are weak constraints on managers' remuneration, though, for several reasons. First, they argue that the managerial labor market does not reduce, and may actually increase, CEO pay. Their argument runs as follows: although an internal promotion for the current CEO is impossible, CEOs can receive attractive offers from other firms, and may try to behave themselves with respect to excess pay to increase their attractiveness. Bebchuk and Fried assert, however, the primary determinant of being hired by another firm is the executive's performance, not his prior pay level, and hence executives might as well grab all they can from their current firm. Furthermore, if the executive receives an external offer of employment, it will raise the CEO's pay even more as the new firm will at least match the executive's old pay in order to induce him to leave.

The market for corporate control is, in Bebchuk and Fried's eyes, also a weak constraint on executive pay. In theory, high executive compensation levels could lead to a drop in a firm's stock price and make the firm more vulnerable to a potential takeover. The fear of a potential takeover could thus constrain a CEO's demands for higher pay. The authors note, however, that hostile takeovers are rare these days and even if one occurs, departing executives are frequently richly rewarded by "golden parachutes" and other types of payments. Overall, Bebchuk and Fried claim that executives gain far more from pay increases than they lose through the increased likelihood of a takeover that could result from excessive executive pay.

Finally, Bebchuk and Fried deal briefly with the equity and product markets. They believe that capital markets do not effectively check executive pay because firms rarely raise equity capital, and even when they do, high executive pay does not cut off a firm's access to the equity markets, but just raises the cost of equity. Product markets, according to the authors, are rarely competitive and thus high CEO pay merely diverts money away from shareholders into executives' pockets. Furthermore, high pay is unlikely in Bebchuk and Fried's view to adversely affect a firm's operational efficiency, and even if it did, they claim executives would still gain more from higher pay than they would lose from the increased risk of firm failure. Overall, the authors conclude that "market forces are unlikely to impose tight constraints on executive compensation. They may . . . deter managers from deviating extremely far from arm's-length contracting arrangements, but overall they permit substantial departures from that benchmark" (p. 58).

Bebchuk and Fried conclude that the arm's-length bargaining model, as they describe it, does not adequately explain current executive compensation practices. Boards are not negotiating CEO pay using the type of labor negotiating tactics they use with the rank

and file, and other corporate stakeholders do not, and presently cannot, force them to do so.

PART II. MANAGERIAL POWER MODEL

Bebchuk and Fried's version of the managerial power model¹³ begins with the same agency cost model of the corporation used by the arm's-length negotiation model, but differs in that it sees the pay-setting process as just another agency problem. The board does not faithfully represent shareholder interests in this model because they are beholden to the CEO. This gives executives substantial influence over the board for all of the reasons discussed in Part I. Managers use their power to get boards to pay them more than they would receive if there were an arm's-length negotiation. The excess payments, or rents, constitute the "additional value managers obtain beyond what they would get in arm's-length bargaining with a board that had both the inclination to maximize shareholder value and the necessary time and information to perform that task properly" (p. 62).

The difficult problem posed by this claim is how to determine whether such rents are being paid. We can observe actual compensation, but how do we know what amount a shareholder-value-maximizing board would pay? Bebchuk and Fried finesse this point by claiming that all they need to show is that managers with more power over boards will get more pay and that that pay will be in forms that are less performance sensitive.

They do not maintain, however, that managers will receive all of the firm's rents. Market forces and board monitoring limit deviations from the arm's-length pay model. Other stakeholders also have some

13. The managerial power theory is not a new one. In 1932, Berle and Means observed that with the diffusion of stock ownership in modern corporations, executives could exercise great power over others' assets. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 4, 6-7, *passim* (1934). Nor were the implications of managerial power for executive pay unnoticed. Berle and Means recognized that the allocation of rents among the firm's factors of production was affected by the separation of ownership and control. They advocated giving "any surplus which can be made over a satisfactory return to the investor" to management in order to provide "an incentive to action." *Id.* at 343.

While it took other scholars longer to apply managerial power theory to executive compensation practices, at least one early version of the theory surfaced in the 1950s. WILLIAM J. BAUMOL, *BUSINESS BEHAVIOR, VALUE AND GROWTH* (1959) (arguing that managerial pay increases with firm size thereby rewarding managers for engaging in empire building). By the 1990s there were a host of articles applying the managerial power theory to executive compensation practices. For example, in the business school literature, Lambert, Larcker and Weigelt provide a succinct summary, and empirical verification, of the "Managerial Power Model," focusing on many of the same questions being explored by Bebchuk and Fried. Richard A. Lambert et al., *The Structure of Organizational Incentives*, 38 ADMIN. SCI. Q. 438, 441-42 (1993) (defining managerial power as "the ability of managers to influence or exert their will or desires on the remuneration decisions made by the board of directors, or perhaps the compensation committee of the board").

impact on the board's negotiations through what Bebchuk and Fried label as "outrage," which they define as "negative reactions by outsiders" (p. 65). The costs created from this reaction lead the directors to avoid certain compensation packages because strong negative reactions to pay packages can increase support for takeovers, attract negative attention to the board, and harm directors' reputations.

Outsiders will only react adversely to pay packages if they perceive them to be outrageous. If the designers of a compensation scheme can disguise the manager's rent extraction, there will not be substantial opposition to it. Bebchuk and Fried claim that managers indeed camouflage pay packages in order to hide compensation and legitimize the amount of managerial rents paid out (p. 67).

Compensation consultants, they claim, often have an important role to play in this subterfuge. First, the consultant develops and recommends the CEO's pay package, so that directors need only approve it. This protects the directors from judicial challenges as they can point to the outside expert's recommendation as cover for their actions. Second, the compensation consultant is even more vulnerable to pressure from the CEO than the directors, because she knows that displeasing the top executive will mean the end of further employment by the firm. This can cut off the consultant's firm from lucrative assignments with the company's human resource department that pay far more than its much smaller role of advising on the CEO's pay. Third, compensation consultants respond to this pressure by using their discretion to justify pay arrangements that are strongly in the CEO's favor. For example, the surveys of comparable CEOs' pay that are given to compensation committees can be tailored to include favorable comparison groups so as to justify big pay increases for the firm's CEO. Bebchuk and Fried claim that these pay surveys have contributed to the steady increase in CEO pay, as each company ratchets its CEO's pay above the average pay level year after year.

Turning to the predictions of their managerial power model, Bebchuk and Fried focus on the claim that managers with more power will get paid more and have compensation packages that are less sensitive to performance. They argue that CEOs will have more power when boards are weak, when there is no large outside shareholder, when there are fewer institutional shareholders, and when the company has stronger takeover defenses (p. 80). In support of their first claim, Bebchuk and Fried offer five main groups of studies. These studies show that CEOs receive more pay and less performance-sensitive pay when boards: (1) have a greater number of members; (2) have more than three of their directors serving on multiple boards; (3) appoint the CEO as chairman of the board; (4) have a higher percentage of directors appointed by the CEO; and (5) are interlocking. In a related vein, CEOs are better-paid when the CEO

appoints the head of the compensation committee, or there are insiders on the compensation committee. They are paid less as the level of stock ownership of the directors on the compensation committee increases.

Bebchuk and Fried next discuss how better shareholder monitoring can reduce pay. Thus, the presence of large (five percent or more) shareholders is correlated with reduced CEO pay. Similarly, companies with greater institutional shareholder ownership have lower CEO pay and more pay for performance, although this impact is affected by the presence of business relationships between the institutions and the firm.

The authors' final point is that better protection against hostile takeovers correlates with increased executive pay. Their argument is bolstered by a study showing that the adoption of antitakeover defenses is accompanied by CEO pay increases. In a similar manner, CEOs appear to reduce their stockholdings in their firms after the passage of antitakeover legislation that applies to the company.

In Chapters Seven, Eight, and Nine, Bebchuk and Fried seek to illustrate the managerial power thesis with examples of particular corporate pay practices. Chapter Seven focuses on severance payments made to departing CEOs which are not contractually required by their employment contracts, what they call "gratuitous" payments (p. 87). They claim that these payments are frequently made when a CEO is fired, when the firm is acquired, and when the CEO retires. For instance, when a board terminates the company's CEO, it may grant the departing executive substantial monetary and other benefits which are not called for by the CEO's contract. Bebchuk and Fried claim that such payments reflect the need to get some directors to acquiesce in the firing, or to sweeten their action with a gift. But in the authors' view, such payments reflect a generosity not seen in arm's-length bargaining.

Post-acquisition payments to departing executives, either by the target or the acquirer, are common and frequently far in excess of contractually required payments. The authors claim that the best explanation for target-company payments is managerial power over the board: the target's board will only approve the deal if departing management is treated generously, or at least will prefer a deal where managers get special treatment. From the acquirer's side, it may be willing to make such payments as part of a deal to get better terms from target management. Lower acquisition premiums are correlated with higher payments to departing managers, according to recent research.

A similar dynamic exists, Bebchuk and Fried claim, when CEOs retire. Boards agree to large "gratuitous" payments in this situation because of their close personal relationships with the CEO, or out of gratitude for what the CEO has done for them. Since these payments

don't have to be publicly disclosed, they are camouflaged from outsiders and the outrage constraint does not operate.

Excessive retirement benefits are the subject of Chapter Eight. Bebchuk and Fried claim that firms have shifted compensation into post-retirement payments and benefits because there are very weak disclosure obligations for these forms of compensation. Unlike other forms of pay, which must be disclosed in the summary compensation table, the increase in value of an executive's pension plan, or the increase in value of a deferred compensation arrangement, is not disclosed in the summary compensation table. Bebchuk and Fried claim that this permits boards to "camouflage" rent extraction through the use of guaranteed retirement pensions, deferred compensation, post-retirement perks, and guaranteed consulting fees. Each of these four forms of payment is unrelated to firm performance.

Executive pension plans are a form of deferred compensation. They differ from other employees' retirement plans in that they are not tax-qualified. A Supplemental Executive Retirement Plan (SERP) is a plan designed to equalize "reverse discrimination" of retirement programs for executives and highly compensated employees. "Reverse discrimination" happens as a result of the limits put on qualified pension plans such as 401(k) plans and profit-sharing plans, so that highly compensated employees receive or can deposit a much lower percentage of their pay into these plans. Because most executives are paid more than the ERISA limit of \$200,000, boards cannot use tax-advantaged qualified plans, and instead use nonqualified SERPs. As discussed in Scholes et al.,¹⁴ the tax efficiency of deferred compensation plans relative to current compensation depends on the firm's and manager's current and future tax rates. Bebchuk and Fried show assumptions under which these plans seem tax inefficient in that they appear to shift some tax burdens to the employer.¹⁵ The fact that firms offer such plans only to executives confirms, in Bebchuk and Fried's eyes, their inefficiency. Nevertheless, companies use them, the authors claim, because the SEC's poor disclosure rules do not reveal the enormous size of these promised payments in the summary compensation table.

Post-retirement perks are another sign of managerial power over the pay-setting process, according to Bebchuk and Fried. Here, they

14. MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 181-83 (2004).

15. If the deferred plan promises a payout linked to a stock index such as the S&P 500, it is generally more efficient to let the executive save in this index for himself (because he can achieve a lower tax rate on capital gains than the firm can). On the other hand, if the deferred payout is a fixed annuity, as is more common, both the executive and the firm are taxed at ordinary income rates, and the relative efficiency of the firm's saving for the executive is determined by the firm's and the executive's relative income tax rates.

focus on a variety of perks, including retired CEOs' use of corporate aircraft for personal reasons. These types of in-kind benefits are a less efficient way of compensating retired executives than equivalent cash payments, and are never offered to lower-level employees. The authors assert, however, that such benefits have the advantage of not showing up in the firm's disclosures and thus being largely invisible to outsiders.

Consulting contracts are the final post-retirement benefit that Bebchuk and Fried point to in support of the managerial power hypothesis. These contracts pay retired CEOs large sums of money for a relatively small amount of, and sometimes no, consulting with their replacements. Again, the authors argue these contracts are nothing more than camouflaged severance payments that need not be disclosed by the firm and therefore do not risk triggering an adverse reaction from the public or corporate stakeholders.

Chapter Nine discusses the once-widely-used, but now defunct, practice of firms extending below-market rate of interest loans to their top executives. Although this practice was outlawed by the Sarbanes-Oxley Act of 2002, Bebchuk and Fried believe that the former practices provide a "nice illustration of camouflage."¹⁶ Companies provided these loans to executives, the authors say, ostensibly to permit them to purchase the firms' stock. While forty percent of these loans actually assisted executives in purchasing more of their companies' stock, many others were used for purposes unrelated to the executive's job.

Bebchuk and Fried argue that these loans were merely disguised and inefficient compensation payments. Their existence was disclosed but the size of the interest rate subsidy was difficult to calculate. Furthermore, many of these loans were later forgiven by the company, but the value of this benefit was only disclosed after the forgiveness had taken place, usually when the executive left the company, even if there was a prior contractual obligation to do so. Again, the authors claim this minimized any outrage over the payment by postponing it until after the executive was gone.

In summary, Part II makes the case that executive pay arrangements are influenced by the CEO's power, rather than being negotiated on an arm's-length basis. Directors try to hide that fact, Bebchuk and Fried claim, by obscuring the amounts of compensation being paid. This obfuscation minimizes any pressure on them to reduce pay levels and curb abusive practices.

16. P. 112. Furthermore, one billion dollars of loans that were outstanding at the time that Sarbanes-Oxley was passed were exempted so the compensation involved continues to be significant at present. *Id.*

PART III. DECOUPLING PAY FROM PERFORMANCE

In Part III, Bebchuk and Fried try to document their claim that executive compensation is linked only tenuously to managerial performance, which they see as further evidence (and a big cost) of managerial power. Chapter Ten is focused on nonequity compensation, such as salary, bonus plans, acquisition bonuses, signing bonuses, split-dollar life insurance policies, and severance payments. The authors argue that each one of these forms of compensation is not tied, or is only weakly tied, to performance. Bebchuk and Fried see Section 162(m) of the Internal Revenue Code, which is supposed to limit non-performance-based pay, as easily circumvented.

Bebchuk and Fried begin by summarizing research that demonstrates that salary and bonus payments did not correlate with managerial performance in the 1990s, and that executives are sometimes rewarded for stock price increases that are unrelated to the executive's own performance. Similarly, in many cases, bonus plans may pay executives even for poor performance and give boards substantial discretion to make awards, or to lower targets. This is inconsistent, they claim, with tying executive pay to managerial performance.

The delinkage of pay and performance is further illustrated, the authors believe, by the many "gratuitous" payments made to top executives, such as bonuses for acquisitions that are sometimes paid to CEOs at acquiring firms, despite the frequent stock price declines experienced by these firms following the purchase. If acquisitions are value-decreasing events for acquiring firm shareholders, Bebchuk and Fried note, why are boards giving CEOs strong incentives to make them?

The authors also criticize the current form of severance packages for departing executives for being too soft on poor performance. They argue that boards should deny large severance payments to CEOs when their firms perform well below the level of their competitors. Careful contract design could limit this punishment to poor performers and still provide sufficient protections for any CEO terminated despite a strong managerial showing.

Stock options are the subject of the other four chapters in Part III. The main argument Bebchuk and Fried make is that while properly designed stock option plans should be valuable incentives for managers to produce shareholder value, the plans widely used today "have delivered a considerable amount of pay without performance and packaged that pay so that it seems defensible and legitimate" (p. 138). Put slightly differently, they believe that current stock option plans deviate from the plans that would be negotiated at arm's length, and that those deviations systematically favor managers.

In Chapter Eleven, Bebchuk and Fried argue that stock option plans do not filter out windfalls, that is, “substantial gains for managers that do not result from their own performance” (p. 138). They argue options should be designed to reward only firm-specific price movements, not general market conditions. Indexed options, or other similar products, Bebchuk and Fried state, would do a better job than current plans of creating incentives for managers at a lower cost, and those savings could be used to provide managers with more high-powered incentive compensation.

Few companies use indexed options, however, which the authors claim stems from managerial power over the pay-setting process. Managers prefer options that reward them for general market price increases because those generate more compensation for less effort. Furthermore, indexed options might focus attention on poorly performing CEOs, thus embarrassing them in front of directors and peers. Nevertheless, Bebchuk and Fried state, boards can get away with using unindexed options because these options enjoy unwarranted legitimacy in the eyes of outsiders.

In Chapter Twelve, Bebchuk and Fried critique the various justifications offered as to why conventional stock options are used instead of indexed options. One reason for the use of these plans is that they are accorded preferential accounting treatment in comparison with the indexed or performance-conditioned options the authors advocate. Conventional options thereby result in higher reported earnings over their competitors and higher reported earnings can enhance share value if the market for the company's stock is not informationally efficient.

Though conceding this claim might be true, Bebchuk and Fried contend that it does not lead to the conclusion that the lack of indexed options is the result of arm's-length contracting. First of all, even if there would be a short-term share price drop from adopting indexed options, there could be substantial offsetting benefits as executives' incentives are sharpened. Second, Bebchuk and Fried assert that institutional investors favor indexed options despite their potential adverse impact on reported earnings, which suggests to the authors that shareholders are not concerned about the accounting effect. Third, in the past few years many firms have begun to voluntarily expense options, yet they continue to use conventional options, suggesting that the accounting rationale is not the real reason they have not adopted indexed options. Finally, many managers have lobbied to stop the FASB from requiring firms to expense conventional options. The authors claim that managers want to stop the FASB because expensing would make the size of their option payments more salient and would eliminate their justification for not switching to indexed options. Bebchuk and Fried find it unsurprising that these same executives have not tried to convince the FASB to

change the accounting treatment for indexed options to level the playing field.

The remaining chapters in Part III of *Pay Without Performance* discuss various aspects of equity-based compensation that Bebchuk and Fried feel further demonstrate managerial power over the pay-setting process: the widespread use of at-the-money options, option repricing, reload options, restricted stock in lieu of options, and executives' ability to unwind their equity positions. Beginning with at-the-money options, the authors observe that they are used by virtually every public company in the U.S., even though out-of-the-money options "generate much higher pay-for-performance sensitivity per dollar of expected value... [a]nd there is empirical evidence suggesting that giving managers out-of-the-money options rather than at-the-money options does, on average, boost firm value" (p. 161). According to Bebchuk and Fried, this pattern would not be observed in an arm's-length setting, but rather only exists because at-the-money options give managers the greatest amount of "rents" without creating much "outrage." Moreover, managers can manipulate the timing of corporate disclosures and option grants to increase the options' value.

Repricing of stock options is another area where managers use their power over boards to get more for themselves, say the authors. Repricings occur when firms either drop the exercise price for existing options or alternatively issue new options at a lower exercise price to replace existing ones. Although proponents frequently maintain that such changes are needed to retain existing managers or to protect option holders from adverse stock price movements unrelated to managerial performance, Bebchuk and Fried assert that neither justification holds up well under scrutiny. They find the managerial power explanation a more logical one — managers want conventional options that get repriced when stock prices fall, rather than indexed options, because the former generate bigger gains for them. The superficially plausible justifications of improved retention and protection from unrelated adverse stock price movements serve to minimize any dissent by outsiders.

Bebchuk and Fried offer a related critique of reload options. Reload options permit executives to lock in the benefits from increases in their company's stock price even when the long-term returns of holding the firm's stock are flat. Proponents of these options claim they encourage early exercise of options and greater stock holdings by executives. The authors say this is just a pretext for paying executives more money because nothing prevents executives from selling the additional shares they get when they exercise these options and that managers, in fact, do just that. Bebchuk and Fried assert that firms could increase managers' stock ownership much more cheaply by simply requiring them to hold those shares they get from exercising options.

Chapter Thirteen concludes with a strong critique of the current movement toward replacing conventional stock options with restricted stock. Bebchuk and Fried believe this amounts to replacing an at-the-money option with a zero-price option, increasing executive windfalls even when the stock price falls below its grant-date price (p. 171). They are unpersuaded by claims that restricted stock is particularly valuable because it requires executives to hold shares longer, since that holding requirement could be easily included in a conventional option plan. They also believe restricted stock is an expensive method of preserving managerial incentives (in comparison to indexed options) in the face of declining stock prices.

The concluding chapter in Part III analyzes executives' freedom to sell their company stock and options. Bebchuk and Fried state that managers have almost unfettered discretion to sell their vested stock and options, which weakens their incentives to maximize shareholder value or provides them a windfall if firms try to maintain these incentives by granting additional equity. Even with respect to unvested stock and options, the authors assert that executives "generally have been allowed to hedge away their equity exposure before these instruments vest" (p. 177). While managers benefit greatly from this freedom, Bebchuk and Fried believe that firms should, in many instances, prohibit managers from selling their shares and options so as to preserve their beneficial incentive effects.

A second aspect of this problem, the authors argue, is that managers have almost total control over when they unload their stock and options. This freedom gives managers the opportunity to engage in insider trading through their informational advantage over outsiders. Although many companies have insider-trading policies that limit when executives can trade their shares, Bebchuk and Fried claim, "these trading windows and blackout periods have not been designed to effectively prevent managers from trading profitably on their inside information" (p. 181). This pattern is consistent, in the authors' eyes, with the managerial-power hypothesis because insider trading benefits executives in a way outsiders are unlikely to notice. They do acknowledge that the improved disclosure rules of Sarbanes-Oxley will reduce the profitability of this form of insider trading, but claim that the historical practice still supports their overall view of executive pay practices as skewed sharply in managers' favor. Since firms could prohibit all such abuses by contract, the authors argue, this is another illustration of the perverse effects of managerial power. Finally, Bebchuk and Fried note that executives' freedom to unwind their equity positions with the company could give them incentives to manipulate their company's stock price to maximize the short-term value of their holdings.

In short, Part III of *Pay Without Performance* makes the case that equity-based compensation in its current form is too costly and often

fails to generate the proper incentives to maximize shareholder value — both because of the decoupling of pay and performance, and because of the creation of perverse incentives to misreport results, to suppress bad news, and to choose projects that are not transparent.

PART IV. POLICY IMPLICATIONS

The concluding section of *Pay Without Performance* focuses on the policy implications of Bebchuk and Fried's analysis. They divide their recommendations into two chapters: Chapter Fifteen proposes changes to current executive-compensation arrangements and Chapter Sixteen broadens the inquiry to cover the relationship between shareholders and boards. The former chapter is partly a summary of proposals sprinkled throughout the earlier parts of the book: institutional investors should push firms: (1) to index options, (2) to eliminate restricted stock grants and generous severance packages that are not tied to managers' performance, and (3) to limit managers' freedom to unload equity incentives. There are also several other policy interventions, however, brought forward for the first time.

Increased transparency in executive pay disclosures would, in Bebchuk and Fried's view, help outsiders understand corporate executives' compensation arrangements and thereby check the use of their less-desirable elements. The authors propose four mandatory rules: option expensing, monetary valuation of all forms of compensation, disclosure on how market movements affect option values recognized by executives, and restrictions on managers' sale of options and stock. In each case, the authors stress that adopting the rule would make it easier for shareholders and other outsiders to determine the size of executive pay packages or the effect of managers' performance on their pay.

Compensation committee practices are very briefly considered as a second, albeit limited, source for improving the executive pay system. The authors believe that while current practices can be improved, these changes can only address carelessness and insufficient attention, which are not the main problems today.

The final proposal Bebchuk and Fried make in Chapter Fifteen is to require shareholder approval of equity-based plans and of specific "suspect" compensation arrangements. NYSE and NASDAQ rule changes in 2003 required listed companies to put option plans up for a shareholder vote, thereby implementing the first of these two ideas. Shareholder approval of "suspect" practices, such as option repricing, has been proposed by some institutional investors, but has yet to be mandated. In both instances, the authors acknowledge that these changes will have only a limited effect on executive pay.

Yet, in the end, Bebchuk and Fried conclude that none of these changes is likely to fix the system. Rather, executive compensation

problems arise because, under current arrangements, boards cannot be relied upon to effectively scrutinize and monitor the decisions and activities of their CEOs. They see Sarbanes-Oxley's emphasis on director independence and paying directors with stock as steps in the right direction, but ones that can never provide sufficient affirmative incentives for directors to maximize shareholder value. They hold out more hope for the SEC's proposal to permit shareholders to nominate candidates for the board in limited circumstances, although they say it does not go far enough (p. 208-10).

Instead, Bebchuk and Fried argue that recent corporate-governance reforms need to be augmented by making directors directly accountable to shareholders. They believe that only by reducing takeover defenses, giving shareholders more power to change corporate rules, and opening up the nomination process to facilitate direct shareholder nomination of whole slates of directors, will the fundamental problems of the executive pay system be cured. In their view, none of the problems identified by defenders of the current nomination system — distraction of corporate management, increased influence for special interests such as labor unions, shareholder myopia, and paternalistic protection of shareholders from themselves — justify maintaining the current system with all of its flaws. In short, Bebchuk and Fried conclude that directors' insulation from shareholders is the root of all of the problems in executive compensation.

II. THE EXISTENCE OF MANAGERIAL POWER DOES NOT IMPLY THAT CONTRACTS ARE SUBOPTIMAL

Bebchuk and Fried's central claim is that the managerial power perspective explains executive pay arrangements better than what they term "the official 'view' of executive compensation — that boards, bargaining at arm's length with CEOs, negotiate pay arrangements designed to serve shareholder interests" (p. 15). The main problem with this claim is that in no sense is arm's-length contracting an official view among scholars. Arm's-length contracting amounts to a standard of theoretical perfection, and such a contract would only exist in a perfect world without frictions such as contracting costs and transactions costs. As such, it is not a relevant benchmark. Saying that there is something wrong with a contract because it is not arm's length is akin to saying that there is something wrong with a tank that does not perform well on a racetrack (where there are small frictions) because it has been designed to operate in the desert (where there are large frictions).

As recognized and discussed by Bebchuk, Fried, and Walker (2002) and Bebchuk and Fried (2003), what a large body of mainstream scholars espouse instead, and what may be fairly termed

an “official view,” is optimal contracting theory, which posits that contracts are designed to maximize shareholder value net of contracting costs and transactions costs. This is a reasonable alternative hypothesis with which to compare the predictions of managerial power theory. As we show below, in many settings where managerial power exists, observed contracts anticipate and try to minimize the costs of this power, and therefore may in fact be written optimally. As a result, the optimal contracting and managerial power perspectives are not competing explanations. It is true that contract structures reflect CEO power, and that CEOs with more power get more pay, but this fact does not mean that CEO pay is not optimized for shareholders, nor does it imply that CEO pay needs reform. The first step is to define optimal contracts, managerial power, and related terms.

A. *What Is an Optimal Contract?*

In this review, and similar to Bebchuk and Fried, we use the terms “optimal contracts” and “efficient contracts” as synonyms. We follow Core, Guay, and Larcker, and define an “optimal contract” or “efficient contract” as “one that maximizes the net expected economic value to shareholders after transactions costs (such as contracting costs) and payments to employees. An equivalent way of saying this is that . . . contracts minimize agency costs.”¹⁷ Bebchuk, Fried, and Walker similarly define an “optimal contract” as “one that minimizes agency costs (that is, the sum of contracting costs, monitoring costs, other costs incurred in achieving a certain level of compliance with the principal’s interest) and the costs of the residual divergence.”¹⁸ These definitions highlight the key role contracting costs play in determining what governance systems are optimal.

The use of the word “optimal,” while standard in the literature, can cause confusion. Optimal does not mean perfect, but the best contract that can be achieved to maximize shareholder value given the contracting costs in a given situation. This perspective is well-summarized by Jensen and Meckling:

[F]inding that agency costs are non-zero (i.e., that there are costs associated with the separation of ownership and control in the corporation) and concluding therefrom that the agency relationship is non-optimal, wasteful or inefficient is equivalent in every sense to comparing a world in which iron ore is a scarce commodity (and therefore costly) to a world in which it is freely available at zero resource cost, and concluding that the first world is “non-optimal” — a perfect

17. Core et al., *supra* note 9, at 27.

18. Bebchuk, et al., *supra* note 3, at 761-62.

example of the fallacy criticized by Coase and what Demsetz characterizes as the “Nirvana” form of analysis.¹⁹

Consistent with this view, when we argue below that many contracts with managers may in fact be optimal, we are not claiming that U.S. corporate governance is perfect, or as economists sometimes say, “first best efficient.” Nor are we claiming that contracts meet Bebchuk and Fried’s standard of arm’s-length contracting. What we mean is that U.S. corporate governance may in fact be extremely good given the existence of information costs, transactions costs, and the existing U.S. legal and regulatory system. Conceivably, improved regulation or other changes to the contracting environment could lower contracting costs and improve overall governance by, for example, making boards more independent and effective monitors. This is an important point, to which we will return when we discuss in Part IV how any changes to macro-level governance features (such as a regulation that all directors must be independent) must consider the costs of these changes (such as the fact that there is a limited pool of well-qualified independent directors) as well as the benefits. For this Section and next two Sections, however, we hold the existing U.S. contracting environment fixed and address the question of whether compensation structures are written optimally within our current system. This means that, for the moment, we address optimality at the firm level, not at the overall domestic or global economy level. In Section II.D, we turn to the question of optimality at the global economy level.

As an example of the importance of contracting costs, consider the differences in contracting in the U.S. and in Italy.²⁰ As discussed by Shleifer and Vishny,²¹ and by Bebchuk in other work,²² Italy’s weaker legal system makes it easier for insiders to “expropriate” or steal from outside shareholders. This systemic weakness increases contracting costs in Italy. These greater costs result from the fact that the contract needs to be written to prevent expropriation, because the legal system does not. As a consequence of these higher contracting costs, optimal

19. Michael C. Jensen & William H. Meckling, *Agency Costs and the Theory of the Firm*, 3 J. FIN. ECON. 305, 328 (1976) (citations omitted).

20. This is an example of the general phenomenon that weaker legal and political systems are associated with higher contracting costs and different contracting outcomes. See, e.g., Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997). When contracting costs are high, the type of contracts that will be used is different; moreover, high contracting costs mean that the optimal contract will permit higher agency costs, and higher agency costs mean that less net value is given to outside shareholders.

21. Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 742 (1997).

22. LUCIAN ARYE BEBCHUK, A RENT PROTECTION THEORY OF CORPORATE OWNERSHIP AND CONTROL 3, 24 (Nat’l Bureau of Econ. Research, Working Paper No. 7203, 1999).

ownership structures in Italy leave much more control in the hands of insiders than do those in the U.S. Greater insider ownership forces Italian managers to internalize the costs of their private benefits. An interpretation of the greater agency costs stemming from this weak legal system is that the Italian contracting environment is less efficient than the U.S. contracting environment. Because outside shareholders in Italy fear expropriation, they are less willing to provide capital, and the Italian stock market is much smaller on a per capita basis than the U.S. stock market.

The assumption that the Italian contracting environment is less efficient than the U.S. system, however, does not imply that Italian firms are writing suboptimal contracts or that managers in Italy are extracting *unexpected* private benefits. Italian firms may be contracting optimally given the high costs imposed by their suboptimal legal system. If the Italian legal system could be improved at low cost, or if an Italian company could move to the U.S. at low cost, shareholder wealth would go up because contracting costs go down. The fact that neither of these adjustments have occurred (at least for most Italian firms) suggests that the adjustments are very costly, and the persistence of these costs does not imply that Italian firms are operating or contracting inefficiently within their environment.

B. *A Contract Does Not Need to Be Arm's Length to Be Optimal*

Although Bebchuk and Fried suggest that if a contract is not an arm's-length contract, then it is not an optimal contract, this inference is not correct.²³ By arm's-length contract, the authors mean a contract that is written by a completely independent board (or equivalently, a board that is completely dependent on shareholder interests). An independent board, however, is not necessary for an optimal contract.

As Bebchuk and Fried note, in most cases, a corporate board is not completely independent of the CEO (e.g., internally promoted CEOs will know the board members, and even externally hired CEOs are likely to know at least some of the board members). It may be too costly and therefore not optimal for the board to be completely independent because the board has many other responsibilities besides contracting with executives about compensation, and these responsibilities are often best fulfilled by a nonindependent board.²⁴

23. For an example of this suggestion, see p. 20 under the heading "Efficient Contracting and Paying for Performance," where Bebchuk and Fried suggest that a contract not consistent with the arm's-length model is inefficient or not optimal.

24. In the extreme, the independence of directors could be enhanced by requiring that directors serve only one one-year term at a given firm, and at the end of the year the entire board would be replaced. While this would make it very difficult for the CEO to gain power over and compromise the independence of directors, it would likely come at a very high cost.

For example, the board provides input into project selection and investments. A board that is optimized for project selection and investment decisions may contain insiders and thus not be independent of the CEO. Fama and Jensen make this point by noting that since the board is to be comprised of experts, it is natural that the most influential members are internal managers with valuable firm-specific information about the organization.²⁵ A board that is optimized for making compensation decisions could destroy value by making bad decisions on more crucial items.²⁶ Thus, the board structure that maximizes overall share value may not be comprised entirely of independent directors. In this case, the optimal compensation contract with the CEO is not the one that results from the arm's-length bargaining of an independent board: it is the one that maximizes net shareholder value given that the board is optimized to perform several functions.

Just as in our Italian example, a contract can maximize net shareholder value, even in the absence of arm's-length contracting, given market and legal constraints. One cannot determine whether a compensation contract is optimal by examining the contracting environment in isolation. It is also necessary to consider whether the board of directors has been optimized over parameters beyond independence from the manager. The key point Bebchuk and Fried ignore is that an optimal board structure minimizes overall agency costs, not just the cost of compensating managers.

C. *The Existence of Managerial Power Does Not Show That Contracts Are Suboptimal*

Bebchuk and Fried introduce and describe the managerial power perspective as follows:

After analyzing the shortcomings of *the arm's-length contracting view*, we turn . . . to the managerial power perspective on executive compensation. The same factors *that limit the usefulness of the arm's-length model* suggest that executives have had substantial influence over their own pay. Compensation arrangements have often deviated from *arm's-length contracting* because directors have been influenced by management, sympathetic to directors, insufficiently motivated to bargain over compensation, or simply ineffectual in overseeing compensation. Executives' influence over directors has enabled them to obtain "rents"

25. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. FIN. ECON. 301, 314 (1983).

26. For a discussion of the idea that the board is structured to optimize competing objectives, see Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, 9 FED. RES. BANK N.Y. ECON. POL'Y REV. 7 (2003).

— benefits greater than those obtainable under true *arm's-length bargaining*.. (pp. 4-5; emphasis added)

In short, they view managerial power as equivalent to contracting that deviates from arm's-length bargaining, and therefore imply that managerial power necessarily results in suboptimal contracting and excess pay. In the prior Section, we explained why the lack of an independent board and the resulting managerial power does not imply suboptimal contracting. In this Section, we further argue that just because a CEO attains managerial power does not imply that the CEO receives excess pay.

In many contracting settings, managerial power is unavoidable. Before hiring a manager, the shareholders and board know that a successful executive will grow powerful and exert more influence on the board over time (indeed, it may well be optimal to yield power and discretion over time to talented managers that demonstrate a valuable understanding of the firm's business environment).²⁷ Ex post growth in managerial power, however, says nothing about whether contracting with this manager is suboptimal, ex ante. That is, when a new CEO is hired, optimal contracts are expected to be structured ex ante to take into consideration that the CEO will ex post build managerial power over time. Such contracts will ensure that, in expectation, the CEO does not earn excess pay.²⁸ For example, shareholders may place limits on shares reserved for stock options and restricted stock grants, place limits on the magnitude and form of perquisite consumption, or carefully structure board-selection rules or shareholder-approval rules to slow the growth in managerial power. The key point here is that simply showing, at a given point in time, that a manager has power says little about whether a firm has contracted optimally with the manager, or whether the manager earns excess pay in expectation over his or her tenure as manager. To show that the power is suboptimal, one must take the further step to show that it leads to bad outcomes for shareholders.

Returning to our example of Italy, their weak legal system makes it impossible ex post to stop insiders from gaining power and using this power to expropriate wealth from outside shareholders. But this need

27. Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96 (1998).

28. As noted in the previous Section, the manager may already have power at the time of his initial employment. This initial power will allow the manager to earn pay greater than he could with arm's-length bargaining. An optimal contract in this setting will minimize the cost of this power and the costs of anticipated growth in power over time. Thus it will take into account the fact that the initial contract will have a limited life of say three to five years. See Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?* (Oct. 21, 2004) (unpublished working paper) (documenting length of CEO employment contracts and finding that the most common lengths are three and five years).

not stop Italian firms from writing *ex ante* optimal contracts with insiders that anticipate expropriation and minimize its expected cost. Under the assumption that the residual agency problems and deadweight losses from the contracting process are greater in Italy than in the U.S., contracting and governance are more efficient in the U.S. The existence of larger residual agency problems and managerial power in Italy, however, does not imply that Italian managers receive greater excess pay than U.S. managers. Assuming shareholders in Italian firms recognize these greater agency costs, they will structure contracts optimally to constrain excess pay. Of course, some firms may contract suboptimally with managers, and for these firms, agency costs will not be minimized and managers will receive excess pay. But the critical point is that the existence of large residual agency problems does not imply that contracts are suboptimal; equivalently, there can be large residual agency problems and substantial managerial power in settings where there is no excess pay.

D. *How Does One Distinguish Between Costly Contracting and Suboptimal Contracting?*

If one wishes to claim that regulation is necessary because the U.S. governance system is suboptimal, as do Bebchuk and Fried, it is important to be able to distinguish between: (1) contracts that are optimal in the presence of contracting costs and (2) suboptimal contracts. Because managerial power will be greater in both cases, it is important to define appropriate benchmarks to establish whether observed managerial power is evidence of suboptimal contracting or not. One benchmark we have discussed is governance systems in other countries. If a governance system is less efficient in one country than another, then economic indicators such as market valuation and productivity are expected to be lower in the country with less efficient governance.

Holmstrom and Kaplan use stock returns and productivity growth as a benchmark to evaluate U.S. governance and executive pay, and conclude that U.S. shareholders should be very pleased about corporate performance over the recent decade.²⁹ There is no evidence from stock returns (which is the performance measure shareholders care about) that U.S. corporate governance in general, or U.S. executive pay in particular, has substantially declined in competitiveness relative to other countries over the last two decades. As Holmstrom and Kaplan emphasize:

Although the U.S. stock market has had negative returns over the last several years, it has performed well relative to other stock markets, both

29. Holmstrom & Kaplan, *supra* note 9.

recently and over the longer term. In fact, the U.S. market has generated returns at least as high as those of the European and Pacific markets during each of the five time periods considered — since 2001, since 1997, since 1992, since 1987, and since 1982. . . . [Stock returns] reflect publicly available information about executive compensation. Returns, therefore, are measured *net* of executive compensation payments. The fact that shareholders of U.S. companies earned higher returns *even after* payments to management does not support the claim that the U.S. executive pay system is designed inefficiently; if anything, shareholders appear better off with the U.S. system of executive pay than with the systems that prevail in other countries.³⁰

So, when other countries are used as the benchmark, there is no evidence that contracting costs have increased in the U.S., that U.S. executives as a group have taken advantage of suboptimal contracts, or that they have extracted rents through excess compensation.

Another approach to assess whether individual executives are earning excess pay is to use within-country (as well as within-industry, within-firm-size, etc.) average compensation as a benchmark. The idea here is that a subset of firms contract more or less optimally than the average firm, and one can estimate the magnitude of rents accruing to managers, and the governance characteristics of firms where these rents appear large. Note that this is an attempt to focus on variation in the optimality of contracts as opposed to variation in contracting costs. If contracting is costly, residual agency problems will be large and managers will be expected to gain power over time. If this *ex post* situation is considered in the *ex ante* structuring of contracts, one does not expect the manager to reap rents through excess compensation over his tenure. If some contracts are written suboptimally, however, some managers will reap rents through excess compensation. It is not sufficient to show that a governance feature is associated with excess pay, unless one can also show that this compensation is the product of suboptimal governance. Showing suboptimal governance can be accomplished by observing whether firms with higher excess compensation show worse performance, as is shown by Core, Holthausen, and Larcker for a sample of U.S. firms in the 1980s.³¹ This cross-firm approach is designed to identify bad apples within an economy. It does not tell us, however, whether a given economy suffers from systematic governance problems as does the cross-country approach discussed above.

In contrast to these approaches that compare markets and market outcomes, Bebchuk and Fried argue that pay structures must be measured by the standard of arm's-length bargaining:

30. *Id.* at 2-4.

31. John E. Core et al., *Corporate Governance, CEO Compensation, and Firm Performance*, 51 J. FIN. ECON. 371 (1999).

The absence of arm's-length bargaining could still mean that managers are paid too much or paid in inefficient ways. In such a market, compensation levels could be higher than those that would prevail if arm's-length bargaining shaped the market. Thus, when the market as a whole is distorted by the absence of arm's-length bargaining, general conformity to market terms cannot allay concerns about the amount and structure of compensation.

In the end, then, the validity of the arguments for deference to market outcomes depends on whether those outcomes are largely generated by arm's-length negotiations between executives and self-interested purchase[r]s of their services. (p. 22)

Essentially, they maintain that unless U.S. CEO compensation is the product of arm's-length bargaining, it is suboptimal.

As we have discussed above, there are three problems with this conclusion. First, it is not necessary for a contract to be the product of arm's-length negotiations for it to be optimal. Requiring a contract to be at arm's-length amounts to using a standard of theoretical perfection as the benchmark, or to requiring that the world be perfect or first-best efficient. In the eyes of Jensen and Meckling, this could be viewed as a complaint that Nirvana does not exist.³² A second problem is that there is no empirical evidence to suggest that the U.S. contracting environment (as it is) is not as good as any in the world. Third, it seems dangerous to regulate behavior according to a standard of theoretical perfection, especially when one cannot demonstrate that the current system is not working well. If arm's-length contracts do not exist in the U.S., they seem unlikely to exist elsewhere in the world. If we force firms to a standard of arm's-length contracting, how do we know if the benefits of achieving this standard will be less than the costs?

III. U.S. CEOs HAVE SUBSTANTIAL PERFORMANCE INCENTIVES

We next examine Bebchuk and Fried's second major claim: that U.S. CEO compensation is inefficient "pay without performance." If "pay without performance" in fact exists, it would provide evidence that contracts are suboptimal. In this Section, we show that U.S. compensation in fact exhibits much pay for performance, and that the authors' claims stem from not giving sufficient weight to important sources of incentives in U.S. CEOs' compensation contracts. Specifically, they focus exclusively on the performance component of annual pay (including grants of options), and fail to consider the vastly stronger incentives provided by CEOs' equity portfolios.³³

32. Jensen & Meckling, *supra* note 19.

33. For instance, Bebchuk and Fried devote Chapters 11 to 14 to what they consider to be shortcomings of what can be broadly termed grants of options and stock (i.e., that

Bebchuk and Fried offer four main and interrelated critiques of U.S. pay practices: (1) executive pay is too high; (2) CEO contracts do not provide enough incentives (there is too little pay for performance); (3) options and other equity-based pay provide “windfalls” in the sense that they increase in value when the stock price increases, due to market-wide factors, rather than managerial performance; and (4) CEOs have too much freedom to unwind their incentives. As we will make clear below, these critiques are interrelated in the sense that for a given level of pay, if incentives are too low, then pay is too high.

As Bebchuk and Fried recognize, there are benefits and costs to imposing incentives (pp. 19-20). The optimal contract imposes the precise amount of incentives that maximizes net benefits. The benefits of incentives are that they encourage the CEO to make the right choices. The costs of these incentives are that the CEO must be paid for his work, and because he is risk averse, he will demand more compensation as the amount of incentives imposed is increased. If the CEO's contract imposes too many incentives and offers too little pay, the CEO will quit and work elsewhere. Conversely, if the contract offers too much pay and imposes too few incentives, pay could be cut or incentives could be increased or both. This is the essence of the authors' call for “windfalls” to be removed from options: their assumption is that by not removing the market component of options, pay is too high, and that reducing the “windfall” market component could reduce pay without causing the executive to quit.

A. *There Are Two Equivalent Ways of Providing Incentives*

In this Section, we show there are two ways of providing incentives: (1) by making managers' pay vary with performance, and (2) by requiring managers to hold stock and options that vary with performance. We will show that these two methods can provide identical incentives, even though the observed pay is different.

Suppose that a firm is contracting optimally, and that the firm wants to provide incentives based on market-adjusted stock returns (the market-adjusted return is the difference between the return on the firm's stock return and the market return). Assume that the expected return on the firm's stock is the same as the expected return on the market. Suppose further that the CEO has outside wealth of \$20 million. Also, assume that the optimal amount of incentives for this CEO requires that the CEO's wealth increases (decreases) by

because these securities contain a “windfall” component, they give CEOs an unnecessarily large compensation grant). They do not, however, balance this critique of equity grants with a discussion of the incentive benefits that occur when CEOs hold large portfolios of stock and options (where this portfolio comes from the accumulation of past grants of unexercised options and unsold investments in firm stock).

\$100,000 for every percentage point that the firm's stock return outperforms (underperforms) the market return. For example, if the firm's stock return is 5% and the market return is 10%, the contract requires that the CEO's wealth decrease by \$500,000. This optimal contract only rewards the CEO when firm performance exceeds market performance, and thus is consistent with Bebchuk and Fried's call for incentives based on peer-adjusted performance. Finally, assume that this CEO requires \$2 million in annual compensation for him to agree to this contract.

Consider two different contracts to achieve these incentive requirements, "Pay Incentives" and "Portfolio Incentives". The first contract, "Pay Incentives", is a contract that consists of a salary of \$2 million and a bonus that is equal to the product of \$10 million and the firm's market-adjusted return. This bonus meets the requirement that the CEO's wealth changes by \$100,000 for each 1% deviation between the stock return and the market return (i.e., \$10 million times 1% = \$100,000). Note that the expected bonus is \$0 (because the expected return on the firm's stock is the same as the expected return on the market). Let us further assume, in the spirit of Bebchuk and Fried's call for incentives based on peer-adjusted performance, that if the firm's stock return is less than the market return (that is, the market-adjusted return is negative), the bonus is negative. For example, as shown in Table One, if the market-adjusted return is -50%, the CEO will have to pay the firm \$5 million. The CEO's expected pay from this contract is \$2 million (= \$2 million salary plus an expected bonus of \$0).

The second contract, "Portfolio Incentives", requires the CEO to use half of his outside wealth to purchase \$10 million in stock and pays the CEO a salary of \$2 million, but does not have a bonus plan. Because this contract requires the CEO to purchase \$10 million in firm stock while selling \$10 million in the market portfolio, it effectively creates a security that has a payoff of \$100,000 for each 1% deviation between the firm return and the market return (i.e., \$10 million times the market-indexed return). Again, under the assumption that the expected returns are the same for the firm and the market, the expected pay from this plan is \$2 million (= \$2 million salary).

Table 1

COMPARISON OF "PAY INCENTIVES"
AND "PORTFOLIO INCENTIVES" CONTRACTS

"Pay Incentives" — CEO receives salary of \$2 million, a bonus that is equal to the product of \$10 million and the firm's market-adjusted return, and has \$20 million of wealth invested in the market portfolio.

Firm and market stock returns

Firm return	-50%	0%	50%
Market return	0%	0%	0%
Market-adjusted return	-50%	0%	50%

CEO compensation and incentives

Salary	\$ 2	\$ 2	\$ 2
Bonus	\$ (5.0)	\$-	\$ 5.0
Change in Firm Stock Value	\$-	\$-	\$-
Change in market holdings	\$-	\$-	\$-
Total wealth change	\$ (3.0)	\$ 2	\$ 7.0

"Portfolio Incentives" — CEO receives salary of \$2 million, invests \$10 million of wealth in firm stock, and has \$10 million of wealth invested in market.

Firm and market stock returns

Firm return	-50%	0%	50%
Market return	0%	0%	0%
Market-adjusted return	-50%	0%	50%

CEO compensation and incentives

Salary	\$ 2	\$ 2	\$ 2
Bonus	\$-	\$-	\$-
Change in Firm Stock Value	\$ (5.0)	\$-	\$ 5.0
Change in market holdings	\$-	\$-	\$-
Total wealth change	\$ (3.0)	\$ 2	\$ 7.0

Table One shows that these two contracts provide identical incentives as measured by the change in CEO wealth for each 1% difference between the return on the firm's stock return and the market return. The table displays payments and CEO wealth changes associated with these contracts in three scenarios: a firm stock return of -50%, 0%, and 50%. To make the example more straightforward, we assume that the market return for the year was 0%, and so the market-adjusted returns are -50%, 0%, and 50%. The "Pay Incentives" contract shown in the upper panel delivers these wealth changes through a bonus, and the "Portfolio Incentives" contract shown in the lower panel delivers these wealth changes through changes in stock value. As illustrated in Table One, the two contracts deliver identical CEO total wealth changes.³⁴ The "Pay Incentives" contract and the "Portfolio Incentives" contract result in identical risk exposures and therefore identical incentives.³⁵

In spite of identical compensation and incentives, the observed payment stream from the two plans is quite different. Under "Pay Incentives," the CEO's bonus will cause pay to vary with firm performance. Under "Portfolio Incentives," the CEO will be paid \$2 million no matter how bad or good firm performance is. If a shareholder did not see the CEO's stock ownership in the proxy statement, he might conclude that the CEO had no pay-performance incentives. If the firm's market-adjusted return fell by 50%, however, the CEO's wealth would be lower by \$5 million, the same as in "Pay Incentives", which would require the CEO to pay the firm \$5 million.

34. This occurs because these two contracts provide identical exposure to the market-adjusted return. In the "Portfolio Incentives" contract, the manager's exposure consists of his \$10 million market portfolio and his \$10 million stock portfolio. To see that the exposure in the "Pay Incentives" contract is identical, note that the bonus is equal to the product of \$10 million and the firm's market-adjusted return. This bonus is equivalent to simultaneously holding \$10 million in firm stock and a \$10 million short position in the market portfolio, which gives a payout of \$10 million times the firm return minus \$10 million times the market return, or \$10 million times the market-adjusted return. Thus, the manager's overall exposure is implicitly equivalent to a net \$10 million exposure to the market return (the manager's \$20 million market portfolio less the \$10 million short position embedded in the bonus) plus a \$10 million exposure to the firm's return. This is the same as the "Portfolio Incentives" contract, in which the manager's exposure explicitly consists of his \$10 million market portfolio and his \$10 million stock portfolio.

35. Although the incentives provided are the same, assuming that both the firm and the CEO observe the terms of the contract, the "Pay Incentives" contract requires an ex post commitment and therefore is more difficult to enforce. It requires the ability of both the firm and the executive to commit to making cash transfers in the future when the price changes. The executive can be tempted to renege after large price declines (when he would owe a large bonus to the firm), and the firm can be tempted to renege after large price run-ups (when it would owe a large bonus to the manager). Because the "Portfolio Incentives" contract is fulfilled once the manager purchases the stock, it is simple to enforce: the executives directly benefits from (is punished by) any stock price increases (decreases). These contracting-enforcement difficulties may account for why most CEO contracts (at least in the U.S.) are more consistent with the "Portfolio Incentives" contract than the "Pay Incentives" contract. We discuss the evidence to support this claim below.

“Pay Incentives”, though, would show highly variable total CEO pay, and a naïve analysis might conclude that pay-performance incentives for “Pay Incentives” were much greater than “Portfolio Incentives,” even though they are identical.

B. *Most U.S. CEOs’ Incentives Are Provided by Their Stock and Option Portfolios*

U.S. executive incentives are designed much more like “Portfolio Incentives” than “Pay Incentives.” In other words, pay for performance is provided primarily through executive stock and option holdings. This fact has been established in the literature at least since Jensen and Murphy’s study in 1990.³⁶ Bebchuk and Fried do not consider this point and assert that U.S. executive incentives should follow “Pay Incentives,” which predicts much variation in flow pay when performance varies. This perspective ignores the fact, however, that executives’ stock and option portfolios are the primary source of incentives. Hall and Liebman summarize this common misperception in the abstract to their 1998 paper:

A common view is that there is little correlation between firm performance and CEO pay. Using a new fifteen-year panel data set of CEOs in the largest, publicly traded U.S. companies, we document a strong relationship between firm performance and CEO compensation. This relationship is generated almost entirely by changes in the value of CEO holdings of stock and stock options.³⁷

Thus, the fact that CEO pay does not vary much with performance does not mean that CEOs have no incentives or that CEO pay is inappropriate. Rather, equity portfolios, which are structured similarly to our “Portfolio Incentives” example, provide U.S. CEOs with strong incentives.

36. Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990).

37. Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 653 (1998).

TABLE 2
 MEDIAN CEO PAY, PORTFOLIO VALUE, AND
 INCENTIVES FOR S&P 500 FIRMS: 1993 TO 2003³⁸

Year	(1) Total Annual Pay	(2) Beginning- of-Year Portfolio Value	(3) Beginning- of-Year Incentives	(4) Fraction of Value Vested
1993	\$1,983,000	\$9,275,000	\$125,000	76.7%
1994	2,444,000	10,306,000	152,000	75.6%
1995	2,765,000	10,623,000	157,000	70.8%
1996	3,257,000	13,220,000	191,000	72.8%
1997	3,989,000	19,574,000	286,000	71.3%
1998	4,578,000	27,563,000	403,000	69.2%
1999	5,470,000	37,041,000	492,000	65.9%
2000	6,947,000	43,484,000	567,000	63.8%
2001	7,351,000	50,215,000	647,000	60.1%
2002	6,585,000	38,105,000	552,000	58.8%
2003	6,578,000	30,137,000	430,000	52.8%
Ten- year growth rate	12.7%	12.5%	13.2%	-3.7%

Total Annual Pay is the median CEO salary, bonus, stock and option grants, and other pay for the year shown.

Beginning-of-Year Portfolio Value is the median total value of stock exercisable and unexercisable options held by the CEO at the beginning of the year shown.

Beginning-of-Year Incentives is an estimate of the change in the beginning-of-year value of CEO stock and option holdings for a 1% change in stock price.

Fraction of Value Vested is the fraction of beginning-of-year portfolio value that the CEO could obtain if all vested stock was sold and all vested in-the-money options were exercised (for options, the value vested is the

38. For details of sample selection and variable measurement, see appendix, *infra* pp. 143-44.

intrinsic value, which is equal to the beginning-of-year stock price less the exercise price times the number of options).

Table Two illustrates the magnitude of equity incentives held by U.S. CEOs relative to their pay. The Table shows data on annual compensation and beginning-of-year portfolio value and incentive data for S&P 500 CEOs from 1993-2003 (the data and computations are described in greater detail in the appendix). Column One shows total annual pay for the median CEO. The second column shows the beginning-of-year market value of the median CEO's stock and option portfolio. The third column shows a measure of the median CEO's beginning-of-year incentives. Following the method developed by Jensen and Murphy,³⁹ we measure incentives as the increase (decrease) in the value of the CEO's stock and option portfolio that occurs when the stock price increases (decreases) by 1%. For an example of the interpretation of this measure, consider the median CEO in 1993. Suppose that this CEO's firm experienced a return of -20% during the year. Then the CEO's portfolio would decrease in value by \$8.6 million (= -20 times \$430,000 in incentives). Thus, as discussed by Hall and Liebman, these CEOs can lose large amounts of their wealth when prices fall. Note that this \$8.6 million decrease is larger than the median CEO's pay for 2003 of \$6.6 million.

Table Two illustrates the Hall and Liebman point that because of their large stock and option portfolios, U.S. CEOs experience very large wealth changes when the stock price changes. In other words, U.S. CEO compensation is structured very much like the "Portfolio Incentives" example above: large stock prices will cause large changes in the value of the CEO's portfolio and wealth even though changes in annual pay may be fairly small. Consequently, U.S. CEOs have very large pay-performance incentives, and an assertion that U.S. CEOs receive "pay without performance" is clearly inconsistent with the evidence. However, it is easy to see why this is what Hall and Liebman call a "common view" and a common mistake. If one does not consider the very large incentives delivered by CEO equity portfolios, one could come to the false conclusion that CEOs have low incentives because their pay does not vary strongly with performance.

In a related vein, one must consider executive incentive levels in any analysis of whether executive pay levels are appropriate, because ignoring the very large incentives delivered by U.S. CEO equity portfolios could lead one to the false conclusion that U.S. CEOs are overpaid. It is widely agreed, and accepted by Bebchuk and Fried, that firms should provide incentives that link managerial wealth to firm performance. Imposing incentives on the CEO benefits the firm

39. Jensen & Murphy, *supra* note 36.

because it aligns the CEO's and the shareholders' objectives: when shareholders' wealth increases or decreases, so does the CEO's. At the same time, however, greater incentives come at a cost because executives require greater pay to bear the risks associated with greater incentive levels.⁴⁰ An executive who is required to bear \$10 million in incentives will require more pay than if she was required to bear only \$5 million in incentives.

Many misconceptions about the magnitude of U.S. CEO pay arise because the observer did not consider (1) the magnitude of U.S. CEO incentives, and (2) that higher pay is necessary when incentives are higher. For example, U.S. CEOs have higher pay than their European and Japanese counterparts, which could lead the naïve observer to conclude that U.S. CEOs are overpaid. Yet, U.S. CEOs' incentives are much higher as well, suggesting that their compensation needs to be higher to account for the additional risk they bear. Conyon and Murphy's study of executive compensation in the U.K. illustrates this point: they found that U.S. CEOs in 1997 made about 2.7 times more than their British counterparts, but that U.S. CEOs also held 4.2 times more stock.⁴¹ Given the larger incentives held by U.S. CEOs, it is not clear that U.S. CEOs are overpaid relative to their British counterparts.

This predicted economic relation between incentives and pay can also be applied to the growth in CEO pay over the last decade, the same growth that Bebchuk and Fried use to motivate their book:

During the extended bull market of the 1990s, executive compensation at public companies — companies whose shares are traded on stock exchanges — soared to unprecedented levels. (p. 1)

Bebchuk and Fried want to use this pay growth as *prima facie* evidence of a problem with pay. What is wrong with this approach is the following: if efficient contracts call for an increase in CEO incentives over time, this increases the amount of risk that these executives bear, and make it optimal for pay to rise with the increased incentives. Accordingly, it is not correct to point to the growth in pay as a problem without considering the growth in incentives. If there is a large growth in pay without a corresponding growth in incentives, this is stronger evidence of problems with pay. If, however, pay and

40. Bebchuk and Fried recognize that efficient contracting predicts that pay will be higher when incentives are higher: "Linking compensation to performance may require a company to increase an executive's level of compensation because pay that is sensitive to performance is less valuable to managers than fixed pay with the same expected value." P. 19.

41. Martin J. Conyon & Kevin J. Murphy, *The Prince and the Pauper? CEO Pay in the United States and the United Kingdom*, 110 *ECON. J. F.* 640 (2000). The study is a comparison of median data for CEOs in 1997 that run companies with 200 to 500 million pounds of sales.

incentives grow simultaneously, this growth is consistent with efficient contracting.

Table Two shows that during the period from 1993 to 2003, high pay growth went hand-in-hand with high growth in incentives. Column One illustrates that the median CEO's total pay increased from \$2 million in 1993 to \$6.6 million in 2003, an annual increase of 12.7% over the ten-year period. Over this same period, however, the market value of the median CEO's beginning-of-year stock and option portfolio grew at almost exactly the same rate, from \$9.3 million at the beginning of 1993 to \$30.1 million at the beginning of 2003, or an annual increase of 12.5% (see Column Two).⁴² Similarly, Column Three of Table Two shows that the median incentives provided by the CEOs' beginning-of-year stock and option portfolios increased from \$125,000 for each 1% increase in the stock price in 1993 to \$430,000 for each 1% increase in the stock price in 2003, or an annual growth of 13.2%. These statistics are consistent with efficient contracts that pay more as: (1) incentives grow, and (2) the size and complexity of the organization grows.

We want to emphasize that the fact that pay and incentives grow at the same rate does not imply that pay is necessarily optimal. For example, CEOs could have been overpaid both in 1993 and in 2003. In addition, pay growth is optimal only if the incentive growth is optimal. While Bebchuk and Fried take the position that due to their power, executives hold *too few* incentives, one could imagine a recasting of the "outrage cost" argument to yield a result that executives hold *too many* incentives. For example, if shareholders got outraged when executives sold stock, powerful executives might agree to hold excess incentives in exchange for excess pay.⁴³

We do not claim that U.S. pay packages are optimal, but we instead point out that one can make no claim about the optimality of pay packages if one ignores the major source of incentives in those packages. Pay and incentives must be considered together. Second, as discussed above, even with a correct understanding of pay and the structure of incentives, it is not possible to show that pay is suboptimal without comparing it across firms or countries. It is correct that U.S. CEO incentives and pay are large both by recent historical standards and relative to other countries, and that they have grown during the 1990s. However, there is little if any empirical evidence that shows

42. During this time, the size of the median S&P 500 firm also increased substantially: the market value of the median S&P 500 company increased from \$3.6 billion in 1993 to \$9.1 billion in 2003, or an annual increase of 9.6% over the ten years ended 2003.

43. As evidenced by their claim that executives have "[b]road freedom to unwind equity incentives," Bebchuk and Fried do not seem to think that share sales are a source of outrage. P. 178. See, for example, their discussion that suggests low outrage because stock sales are not salient. *Id.*

that U.S. CEO pay, or its growth, is suboptimal. As discussed above, Holmstrom and Kaplan find that U.S. stock market performance and productivity growth through 2002 are as good as those in any other country, offering no evidence that U. S. compensation practices have grown worse relative to those in the rest of the world.

C. *Do U.S. CEOs Receive “Windfalls”?*

We turn next to Bebchuk and Fried’s claim that executives are gaining “windfalls,” especially in their equity-based pay. They state, “[w]hen managers are rewarded for market- and sector-wide price movements unrelated to their efforts, shareholders’ money is not well spent” (p. 139). Their complaint about stock and options is that the market component reflects pay that does not increase incentives. If these “windfalls” were removed, they go on to say, “the same amount of incentives can be provided at a lower cost, or more incentives can be provided at the same cost” (p. 190). Embedded in this statement is an assumption that the CEO is being paid too much, which the authors have not demonstrated. If the CEO is being paid too much, the statement is true for any component of compensation. For example, if the CEO has too much cash pay, his pay can be cut or his incentives increased without causing him to quit.

In this Section, though, we want to focus on why this is an unfair criticism of the design of equity compensation. To see why this is wrong in general, consider the “Portfolio Incentives” compensation arrangement discussed previously, which imposed the optimal level of incentives by requiring the executive to hold \$10 million of his wealth in firm stock. Recall that in this example, the executive was being paid the least amount that would cause him to agree to the contract, and that the cost-minimizing contract also required a compensation payment of \$2 million to the executive. Suppose that instead of paying this amount in cash, the firm paid the executive in stock worth \$2 million. The executive could sell this stock for cash and obtain \$2 million (under the simplifying assumption of no trading costs). Stock is an option with an exercise price of \$0, so this stock grant is conceptually the same as an option grant, and we use this stock grant to illustrate our point.

Bebchuk and Fried claim that firms could use market-indexed equity to either create “the same amount of incentives . . . at a lower cost, or more incentives . . . at the same cost.”⁴⁴ Our example shows that this claim is not generally correct. Suppose the example firm continues to impose \$10 million in stock price risk on the executive,

44. P. 190. Although not true in general, the claim will be true when the executive is overpaid. In this case, the claim amounts to a statement that it is efficient to cut pay when the executive is overpaid.

but tries to pay less money by giving indexed stock instead of straight stock. This indexed stock would be worth less than \$2 million, and the executive would quit because his pay was lower than that required under the contract. Alternatively, suppose that the firm tried to impose more incentives on the executive for the same amount of money by paying the executive \$2 million in stock but not allowing the executive to sell stock in response. Now the executive holds \$12 million in stock. These increased incentives would raise the risk premium required by the executive, and he would quit unless his compensation was increased as well.

The example above illustrates that so long as an executive is not overpaid, incentives and pay must move together, and firms cannot unilaterally increase incentives without increasing pay, or vice versa. To show that there is something wrong with option plans requires showing that the manager is overpaid. To this point, as we showed earlier, although U.S. CEOs receive high pay relative to CEOs in other countries, they also hold substantially more incentives than CEOs in other countries. As a result, there is no conclusive evidence that U.S. CEO pay is inappropriately high given the incentive risk these individuals are required to bear. Further, the fact that stock and options have a market component does not imply that a manager is overpaid, nor does it imply that a contract is suboptimal. As described above, the purpose of the market component is not to provide incentives, but to deliver pay.

A further criticism of the authors' "windfall" argument is that it presumes that CEO contracts exhibit "too much" exposure to market performance, and that market-adjusting stock and options is necessary to remove this excess market exposure. To see the flaw in this argument, it is again important to recognize that U.S. CEOs get nearly all of their incentives from their stock and option portfolios, as in the "Portfolio Incentives" plan. A naïve analysis will call these stock and option portfolios "puzzling" because they increase in value when the market portfolio increases in value. The "Portfolio Incentives" plan contract, however, increases the manager's exposure to firm-specific performance, without changing his market exposure.

To see this, remember that the CEO in Table One with the "Portfolio Incentives" plan has \$20 million in outside wealth that he prefers to invest in the market portfolio. The CEO's "Portfolio Incentives" contract requires him to place \$10 million of that wealth in firm stock. Note that the stock return R_{firm} is the sum of the market return R_{market} and the firm-specific net-of-market return $R_{\text{firm}} - R_{\text{market}}$:

$$R_{\text{firm}} = R_{\text{market}} + (R_{\text{firm}} - R_{\text{market}}).$$

Therefore, when the executive holds \$10 million in firm stock, it is the same as if he held \$10 million in the market index and \$10 million in an indexed security with return $R_{\text{firm}} - R_{\text{market}}$. The executive's actual

portfolio is no more correlated with market movements than the “Pay Incentives” contract.⁴⁵

Bebchuk and Fried accept this point:

Some economists, however, have argued that executives might in fact be interested in investing in a market-wide portfolio and, if given cash, would invest it in such a portfolio. On this view, giving executives conventional options is not more puzzling than giving them indexed options plus a large amount of cash. Indeed, assuming that the managers are likely to invest the cash in a market-wide portfolio, giving compensation to them in the form of conventional options might be simpler.

We have no quarrel with this analysis. Conventional options may well be no more puzzling than a combination of indexed options and a very large amount of cash. . . . Our point, simply, is that a large portion of the value of conventional options — which have been widely considered to be “performance-based pay” — is in fact decoupled from performance. (p. 157; citations omitted)

In other words, there is no “puzzle” about the fact that stock and options are not indexed. This practice is completely consistent with optimal contracting, and calling it “windfalls” is misleading and wrong. The point “that a large portion of the value of conventional options — which have been widely considered to be ‘performance-based pay’ — is in fact decoupled from performance” simply restates the fact that U.S. firms have “Portfolio Incentives” pay schemes: it is well known that most CEOs’ incentives come from their portfolios and that their annual pay varies little with performance.

D. *Do U.S. CEOs Unwind Their Incentives?*

Bebchuk and Fried further claim that CEOs have broad “freedom to unwind incentives,” and that they use this freedom to exercise options and sell stock that the shareholders would prefer the CEOs to hold. If a CEO could unwind his equity holdings at will, one would expect CEOs to hold little if any unrestricted firm stock, and to exercise their options as soon as they became exercisable and far enough in-the-money to reap a reasonable fraction of the options’ value.

This claim is not well supported, however, by empirical evidence. CEO equity holdings are not low in the U.S., but instead are in general larger than in any other country. Further, CEO equity

45. The idea that nonindexed grants of stock and options do not impose excess market risk on executives is becoming well-recognized. Core et al., *supra* note 9; Gerald Garvey & Todd Milbourn, *Executive Compensation When Executives Can Hedge the Market: Evidence of Relative Performance Evaluation in the Cross Section*, 58 J. FIN. 1557 (2003); Li Jin, *CEO Compensation, Diversification, and Incentives*, 66 J. FIN. ECON. (2002).

holdings are not in decline but, as documented by Hall and Liebman and in the data we presented above, have in fact risen substantially over the last twenty years. This increase in value over time shows the authors have overstated their claim that managers have almost unfettered discretion to sell their vested stock and options. As shown in the Column Four of Table Two, empirically in 2003, the median CEO could realize about 53% of the value of his portfolio by exercising and selling vested stock and options. These CEOs, however, did not do so.⁴⁶

Further, Table Two shows a declining trend in the fraction of the CEOs' portfolio that is vested and realizable. This decline stems from the fact that a greater fraction of CEOs' equity portfolios in 2003 is due to option holdings. The value of an option consists of the realizable intrinsic value, which is equal to the beginning-of-year stock price less the exercise price, plus the time value that comes from expected stock price increases over the term of the option. The early exercise of options destroys the time value of the options, thereby encouraging the executive to hold options even after vesting. In 2003, many CEOs' options were out-of-the-money, in which case all of the options' value is due to time value. This evidence suggests that an increasing use of options has likely reduced CEOs' ability to unwind their incentives and has contributed to the observed growth in CEO equity incentives.⁴⁷

One might also ask, if CEOs knew that they had bad incentives and would conduct future "rent-extraction" activities and make decisions that would destroy value, why would they not sell their stock today to avoid these future costs?⁴⁸ Why would they own any stock at all? After all, if the CEO takes an action to destroy shareholder value, that action destroys the value of his or her portfolio as well. If CEOs were extracting rents and could sell stock at will, one would expect the

46. Although there is a declining trend in the percentage of value vested during this time period, executives are holding much more equity now than in 1993. Thus, the dollar value of their vested holdings is far greater today than it was ten years ago, even though the fraction of value vested is lower.

47. Some of these CEOs could be hedging the firm-specific risk in their equity portfolios through derivative securities such as caps and collars that are negatively correlated with firm-specific price changes. These instruments can reduce the CEO's exposure to the firm's stock price and the price-based incentives provided by their portfolios. Recent research by Bettis, Bizjak, and Lemmon indicates that some CEOs use these techniques, but the small sample size suggests that this behavior is limited. J. Carr Bettis et al., *Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders*, 36 J. FIN. & QUANTITATIVE ANALYSIS 345 (2001). Although it is possible that some CEOs engage in this behavior and do not file required SEC disclosures, the fact that secret hedging activities violate SEC disclosure and insider trading rules reduces the likelihood that this behavior is widespread.

48. Even though rational shareholders in equilibrium price-protect against the probability that value destruction will occur, the price will still fall at the time the value destruction becomes certain.

median CEO to own no stock and to exercise his options as soon as they became exercisable and far enough in-the-money to reap a reasonable fraction of the options' value. To summarize, if in fact a CEO could sell without constraints, one would expect that CEO to own no stock.

A final point on unwinding incentives is that, in some cases, it is optimal for the firm to allow and even encourage the CEO to sell equity. For example, restricted stock and options are sometimes used as a substitute for cash pay. In these cases, the reason for granting equity to the CEO is not to increase incentives. As highlighted above, it is costly for a firm to impose greater incentives on the CEO than is optimal. Therefore, when equity pay is used as a substitute for cash pay, the CEO should be allowed to rebalance his portfolio. As another example, consider the case where the stock price has risen substantially faster than the market over a number of years. As the CEO's portfolio of stock and options becomes a greater proportion of his overall wealth, incentives could increase beyond the optimal level. In addition to the higher risk premiums the CEO will demand, unnecessarily high incentives can also cause the CEO to behave in an overly risk-averse manner, thereby shunning valuable, but risky, projects. Again, in these settings, it is optimal to allow the CEO to exercise options and sell stock to rebalance his portfolio.

IV. CONCLUDING REMARKS: DOES U.S. CORPORATE GOVERNANCE NEED TO BE FIXED?

To conclude, we briefly summarize our main points and discuss a few of Bebchuk and Fried's policy conclusions. First, the authors have offered no persuasive evidence that CEO pay contracts are systematically suboptimal. In other words, they have provided some interesting examples of bad apples, but have not offered evidence or a theory to show that the entire barrel is bad. As we discussed in Part II, in many settings where managerial power exists, observed contracts anticipate and try to minimize its costs and therefore may in fact be optimal. The optimal contract and managerial power perspectives are not competing explanations of executive pay. It is true that contract structures reflect CEO power, and that CEOs with more power get more pay, but this fact does not mean that CEO pay is not optimized for shareholders, nor does it imply that CEO pay needs reform.

Second, when Bebchuk and Fried advance their central argument that U.S. executives' compensation is inefficient "pay without performance," they ignore executives' stock and option portfolios, which are the primary source of their incentives. Once we factor in these very large stock and option portfolios, it becomes apparent that corporate executives have very large pay-performance incentives. Without considering the very large incentives delivered by CEO

equity portfolios, one could come to the false conclusions that CEOs have low incentives because their annual pay does not vary strongly with performance, or that CEOs are overpaid. We do not claim that U.S. pay packages are optimal, but we instead point out that one can make no claim about the optimality of annual pay packages if one ignores the major source of incentives in executives' portfolios.

Bebchuk and Fried's policy recommendations for government intervention are based on their assessment that executive pay practices are failing, which we do not believe to be true. Therefore, we see no broad justification for the policy recommendations they give. Holding this aside, some of their proposals seem sensible. For example, we agree that better disclosure on the value of executive pensions and the exercise and sale of options and shares would be beneficial. We also agree that we see no reason that stock options should not be expensed for accounting purposes.

With regards to their more sweeping proposals, however, Bebchuk and Fried have not provided evidence of why more needs to be done. They have shown some potential benefits from changing governance practices, but have not provided a thorough discussion of the costs of these changes, and therefore no means of assessing whether the proposed changes have net benefits. For example, it is conceivable that corporate governance practices would be improved by increasing director independence through implementation of the shareholder nomination rule. Yet, as we pointed out in Section II.B, it may be too costly and therefore not optimal for a board to be completely independent. In addition, there is a limited pool of qualified outside directors, and increasing the demand for talent from that pool is likely to be very costly. The focus should not be on maximizing board independence, but on selecting a board structure that maximizes share value, which may include having inside directors and which likely will differ from a board structure optimized solely for making compensation decisions.

Finally, a number of their specific proposals for reforming pay ignore the role played by stock and option portfolios. Because these proposals are based on incomplete analysis, or false premises, their merit is questionable. First, as discussed above, their proposal that stock and stock options should be indexed to filter out any general market increases is ignores key aspects of how equity portfolios provide incentives. The objective of requiring executives to hold options is to force the executive to hold less than the desired level of some diversified portfolio, and more than the desired level of firm-specific equity. Traditional stock and options without indexing achieve this objective: executives would prefer to liquidate their stock and option portfolio and invest it in a diversified portfolio. Any argument for indexed stock and options must show that the benefits of creating these new securities exceed their costs, and that the resulting securities

are more efficient than the existing simple securities currently used to achieve the contracting objective. Second, they propose that more stringent stock- and option-holding requirements should be imposed on top executives. This proposal is based on their claim that it is easy for executives to unload stock and that executives hold too few incentives. We show that executive equity holdings are large and growing even though most of the value of executives' holdings is vested and tradeable. While it may be useful to impose additional restrictions on executive portfolios, it is important to determine whether additional incentives are necessary and to consider the costs of the additional incentives. As we have discussed throughout this Review, a cost of higher incentives is higher pay. Finally, their recommendation that pay be made more sensitive to performance stems from a failure to adequately consider the primary source of U.S. CEOs' incentives. U.S. CEOs do in fact have very strong pay-for-performance equity incentives (more than in any other country in the world) through their stock and option portfolios.

Overall though, we emphasize that Professors Bebchuk and Fried have written a provocative book that is at the center of the current debate about executive compensation. Any scholar who wishes to participate in and advance this debate must understand the arguments in *Pay Without Performance* as well as their limitations.

APPENDIX — DATA ON U.S. CEO PAY AND INCENTIVES

The data we show in Table Two are annual compensation and incentives of S&P 500 CEOs from 1993 to 2003. We use the S&P 500 as a comparison group over time because the index is comprised of the largest and most successful companies in the U.S.⁴⁹ We use Execucomp as our source for compensation data, and we obtain data on the S&P 500 composition and on firm market value from Compustat. We require data on CEO tenure, and we exclude CEOs who are not in office for a full year. We also require data on the CEOs' stock and option ownership at the beginning of the year. As shown in the first column of the Table, these data requirements yield an annual sample of about 400 CEOs (out of 500 companies).

The numbers shown are in actual dollars and are not inflation-adjusted. We examine medians, not means.⁵⁰ There are some CEOs in our sample who are paid nothing in a year and others who are paid huge amounts. These outliers distort the average as a summary measure, but have no effect on the median. We therefore use medians to avoid the influence of extreme cases in our data, and instead examine what is typical for the largest and most successful firms in the world.

Stock and option portfolios provide CEOs with incentives because they change in value with the stock price, an important performance measure over which the CEO exerts some control. Following the method developed by Jensen and Murphy,⁵¹ we measure incentives as the increase (decrease) in the value of the CEO's stock and option portfolio that occurs when the stock price increases (decreases) by 1%. Stock holdings increase one-for-one with the stock price. In other words, if the firm has a stock return of 1%, the CEO's stock portfolio increases in value by 1%. If the median CEO in 1993 held all stock, his portfolio, which has a value of \$9.3 million, would provide \$93,000 in incentives by this measure. In other words, when the stock price decreases by 1%, \$9.3 million in stock falls in value by \$93,000. But these CEOs own a combination of stock and options, and a given dollar amount of options increases (decreases) in value more than the

49. The S&P 500 "includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large-cap segment of the market, with over 80% coverage of U.S. equities it is also an ideal proxy for the total market." S&P 500 Factsheet, at <http://www2.standardandpoors.com/spf/pdf/index/500factsheet.pdf> (last visited Mar. 6, 2005).

50. The trend in median data is quite similar to the trend in average data documented by Hall and Murphy, and others, and we see the same trend when we look at averages in our data. Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49 (2003).

51. Jensen & Murphy, *supra* note 36.

same dollar amount of stock. In other words, if the firm has a stock return of 1%, the CEO's option portfolio increases in value by more than 1%. To estimate the value and incentives provided by the CEO's option portfolio at the end of a year t , we use the method developed by Core and Guay.⁵² We modify this method by assuming times-to-exercise equal to 70% of the Core and Guay assumed times-to-maturity.

52. John E. Core & Wayne R. Guay, *Estimating the Value of Employee Stock Option Portfolios and Their Sensitivities to Price and Volatility*, 40 J. ACCT. RES. 613 (2002).