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Pay without Performance: The Unfulfilled Promise of Executive Compensation, Part I: The Official View and its Limits

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This paper contains a draft of the introduction and Part I of our forthcoming book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004). The book provides a detailed account of how structural flaws in corporate governance have enabled managers to influence their own pay and produced widespread distortions in pay arrangements. The book also examines how these flaws and distortions can best be addressed.

Part I of the book critically examines the arm's length contracting view, which underlies much of the academic research on executive compensation as well as the law's approach to it. We show that boards have not been operating at arm's length from the executives whose pay they set. While recent reforms can improve matters, they cannot be expected to eliminate significant deviations from arm's length contracting. We also show that the constraints imposed by market forces and shareholders' power to intervene are not tight enough to prevent such deviations.

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Pay without Performance: The Unfulfilled Promise of Executive Compensation

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INTRODUCTION

“Is it a problem of bad apples, or is it the barrel?”

- Kim Clark, Dean of the Harvard Business School, 2003

During the extended bull market of the 1990s, executive compensation at public companies soared to unprecedented levels. Between 1992 and 2000, the average real (inflation-adjusted) pay of chief executive officers (CEOs) of S&P 500 firms more than quadrupled, climbing from \$3.5 million to \$14.7 million.¹ Increases in option-based compensation accounted for the lion’s share of the gains, with the value of stock options granted to CEOs jumping nine-fold during this period.² And despite the bursting of the stock market bubble, executive compensation remained at the end of 2002 at levels close to its 2000 peaks.³ The growth of executive compensation far outstripped that of compensation for other employees. In the past two decades, in inflation-adjusted terms, the average CEO pay increased by nearly 600 percent, whereas average pay increased by only about 15 percent.⁴

Executive pay has long attracted much attention from investors, financial economists, regulators, the media, and the public at large, and the higher CEO salaries have climbed, the keener that interest has become. Indeed, one economist has calculated that the dramatic growth in executive pay during the 1990s was outpaced by at least one thing: increases in the volume of research papers on the subject.⁵

¹ See Brian J. Hall and Kevin J. Murphy, “The Trouble with Stock Options,” *Journal of Economic Perspectives* 17 (2003): 51.

² *Ibid.*

³ See Lucian Bebchuk and Yaniv Grinstein, “The Growth of Executive Pay,” working paper, Harvard Law School and Cornell University, 2003.

⁴ Brian J. Hall and Jeffrey B. Liebman, “The Taxation of Executive Compensation,” in *Tax Policy and the Economy*, ed. James Poterba, vol. 14 (Cambridge, MA.: MIT Press, 2000).

⁵ Kevin J. Murphy, “Executive Compensation,” in *Handbook of Labor Economics*, ed. Orley Ashenfelter and David Card (New York: Elsevier, 1999), p. 2487. He demonstrates graphically that the increase in academic papers on the subject of CEO pay outpaced the increase in total CEO pay during the late 1980s and early 1990s.

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Executive compensation has also long been the subject of heated debate. The rise in pay has been the subject of much public criticism, which was further intensified following the corporate governance scandals of 2002 and 2003. But the changes in executive compensation in the past two decades have also had powerful defenders. On their view, despite some lapses, imperfections and cases of abuse, executive arrangements have been shaped by market forces and the growing recognition by loyal boards that providing managers with powerful pay incentives operates to the benefits of shareholders.

Our goal in this book is to provide a full account of how managerial power and influence have shaped the executive compensation landscape. The dominant paradigm for the study of executive compensation by financial economists has assumed that compensation arrangements are the product of arm's length bargaining between boards and executives. This assumption of arm's length bargaining has also been the basis for the basic corporate law rules governing the subject. We aim to show that managerial power has caused the pay-setting process in publicly traded companies to stray far from the arm's length model.

Our analysis indicates that managerial power has played a key role in the setting of managers' own pay. The pervasive role of managerial power can explain much of the contemporary landscape of executive compensation. Indeed, it can explain practices and patterns that have long puzzled financial economists researching executive compensation.

By identifying the causes and consequences of executives' influence on their own pay, we seek to contribute to a better understanding of past and current flaws in the design of compensation arrangements and in the corporate governance processes generating them. Having a clear picture of what has gone wrong is essential for effectively addressing these problems. We conclude that recent corporate governance reforms, which are designed to increase board independence, would likely improve matters but much would to be done. And we put forward reforms that, by making directors more accountable to shareholders, would reduce the forces that have in the past distorted compensation arrangements.

The Official View and Its Shortcomings

Part I of the book discusses the shortcomings of the “official” view of executive compensation. According to this view, which underlies existing corporate governance arrangements, corporate boards that set compensation schemes operate at arm’s length from the executives whose compensation they set. Accordingly, having shareholder interest in mind, boards seek to design cost-effective compensation arrangements that serve shareholders by providing executives with incentives.

The premise that boards negotiate pay arrangements at arm’s length with executives has long been and remains a central tenet in the corporate world and in research on executive compensation. Holders of the official view believe it provides a good approximation of reality. When faced with practices that are hard to reconcile with arm’s length contracting, they seek to explain these “deviant” examples as “rotten apples” that do not represent the entire barrel, or as the result of temporary lapses, mistakes, or misperceptions which, once identified, will promptly be corrected by boards.

In the corporate world, the official view serves as the practical basis for legal rules and public policy. It is used to justify directors’ compensation decisions to shareholders, policymakers, and courts. These decisions are viewed as being made largely with shareholders’ interests at heart and therefore deserving of deference.

Most research on executive compensation has also been based on the premise of arm’s length bargaining. Recognition of the influence managers have over their own pay has been at the heart of the criticism of executive compensation in the media and by shareholder activists.⁶ This influence also has been recognized by those writing on executive compensation from a legal, organizational, or sociological perspective.⁷ But most of the systematic

⁶ See, for example, Graef S. Crystal, *In Search of Excess: The Overcompensation of American Executives* (New York: Norton, 1991); Robert A. G. Monks and Nell Minow, “Corporate Governance” (Cambridge, MA: Blackwell Publishing, 2001), 221-225.

⁷ For writings by legal scholars that recognizes See, e.g., Linda J. Barris, “The Overcompensation Problem: A Collective Approach to Controlling Executive Pay,” *Indiana Law Journal* 68 (1992): 59; Mark J. Loewenstein, “Reflections on Executive Compensation and a Modest Proposal for (Further) Reform,” *Southern Methodist University Law Review* 50 (1996): 201; Carl T. Bogus, “Excessive Executive

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research on executive compensation (especially empirical research) has been done by financial economists, and the premise of arm's length bargaining has guided most of the work by financial economists. Some financial economists, whose studies we discuss later in this book, have reported findings they viewed as inconsistent with arm's length contracting.⁸ However, the majority of work in the field has assumed arm's length contracting.

In the paradigm that has dominated financial economics, which we label the "arm's length bargaining" approach, the board of directors is viewed as operating at arm's length and seeking to maximize shareholder value. Rational parties transacting at arm's length have powerful incentives

Compensation and the Failure of Corporate Democracy," *Buffalo Law Review* 41 (1993): 1; Eric W. Orts, "Shirking and Sharking: A Legal Theory of the Firm," *Yale Law and Policy Review* 16 (1996): 265-329; Charles M. Yablon, "Bonus Questions—Executive Compensation in the Era of Pay for Performance," *Notre Dame Law Review* 75 (1999): 271.

For writings from an organizational or sociological perspective that recognize the significance of managerial power in the setting of executive pay, see, e.g., Michael Patrick Allen, "Power and Privilege in the Large Corporation: Corporate Control and Managerial Compensation," *American Journal of Sociology* 86 (1981): 1112-1123; Richard A. Lambert, David F. Larcker, Keith Weigelt, "The Structure of Organizational Incentives," *Administrative Science Quarterly* 38 (1993): 438-461; Sydney Finkelstein and Donald C. Hambrick, "Chief Executive Compensation: A Study of the Intersection of Markets and Political Processes," *Strategic Management Journal* 10 (1989): 121-134; Sydney Finkelstein and Donald C. Hambrick, "Chief Executive Compensation: A synthesis and Reconciliation," *Strategic Management Journal* 9 (1988): 543-558; Charles A. O'Reilly, Brian G. Main, and Graef S. Crystall, "CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories," *Administrative Science Quarterly* 33 (1988): 257-274; Sydney Finkelstein, Power in Top Management Teams, *The Academy of Management Journal* 35 (1992): 505-538; James Wade, Charles A. O'Reilly, III, and Ike Chandarat, "Golden Parachutes: CEOs and the Exercise of Social Influence," *Administrative Science Quarterly* 35 (1990): 587-603; Mayer N. Zald, "The power and functions of boards of directors: A theoretical synthesis," *American Journal of Sociology* 75 (1969): 97-111.

⁸ See, e.g., Olivier Jean Blanchard, Florencio Lopez-de-Silanes, and Andrei Shleifer, "What Do Firms Do with Cash Windfalls?" *Journal of Financial Economics* 36 (1994): 337-360; David Yermack, "Good Timing: CEO Stock Option Awards and Company News Announcements," *Journal of Finance* 52 (1997): 449-476; Marianne Bertrand and Sendhil Mullainathan, "Are CEO's Rewarded for Luck? The Ones without Principals Are," *Quarterly Journal of Economics* 116 (August 2001): 901-932.

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not to include inefficient provisions that reduce the pie produced by the contractual arrangements. The arm's length contracting approach has thus led researchers to believe that executive compensation arrangements will tend to be efficient, which is why used "efficient contracting" or 'optimal contracting" to label this approach in some of our earlier work.

Financial economists, both theorists and empiricists, have largely worked within the arm's length model in attempting to explain the various features of executive compensation arrangements as well as the variation in compensation practices among firms.⁹ In fact, upon discovering practices that appear inconsistent with the cost-effective provision of incentives, financial economists have often labored to come up with clever explanations for why such practices might be consistent with arm's length contracting after all. Practices for which no explanation has been found have been considered "anomalies" or "puzzles" that can be expected ultimately to be explained within the paradigm or disappear.

The official arm's length story is neat, tractable, and reassuring. However, as we explain in part I of this book, this model has failed to account for the realities of executive compensation. Directors have had various economic incentives to support, or at least go along with, arrangements favorable to their senior executives. Various social and psychological factors – collegiality, team spirit, sometimes friendship and loyalty, and a natural desire to avoid conflict within the board team – have also often pulled directors that way. Although many directors own shares in their firms, their financial incentives to seek arrangements favorable to shareholders have been too weak to induce them to take the personally

⁹ For surveys of the work from this perspective in the finance and economics literature, see for example, John M. Abowd and David S. Kaplan, "Executive Compensation: Six Questions that Need Answering," *Journal of Economic Perspectives* 13 (1999): 145-168; Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, ed. Orley Ashenfelter and David Card (New York: Elsevier 1999); John E. Core, Wayne Guay, and David F. Larcker, "Executive Equity Compensation and Incentives: A Survey," *Economic Policy Review* 9 (April 2003).

The arm's length contracting view is also held by an important line of legal scholarship. For early and well-known discussion of executive compensation by legal scholars, see Frank H. Easterbrook, "Managers' Discretion and Investors' Welfare: Theories and Evidence," *Delaware Journal of Corporate Law* 9 (1984): 540-571; Daniel R. Fischel, "The Corporate Governance Movement," *Vanderbilt Law Review* 35 (November 1982): 1259-1292.

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costly or, at the very least, unpleasant route of haggling with their CEO. Finally, limitations on time and resources have made it difficult for even well-intentioned directors to do their job properly.

Some writers have argued that, even if directors are subject to considerable influence from corporate executives, market forces can be relied upon to force boards to negotiate efficient compensation arrangements with managers. Our analysis, however, finds that market forces are neither sufficiently finely tuned nor sufficiently powerful to eliminate substantial deviations from arm's length contracting. The markets for capital, corporate control, and managerial labor do impose *some* constraints on whatever agreements directors and managers are willing to make. However, these constraints are hardly stringent, and they permit substantial deviations from arm's length contracting.

A realistic picture of the incentives and circumstances of board members, then, reveals a myriad of incentives and tendencies that have led directors to behave very differently than expected under the arm's length model. Although recent reforms may weaken some of these factors in the future, they do not at all eliminate them. Thus, without additional changes, the arm's length model will continue to provide an inadequate account of the pay-setting process.

Power and Pay

After analyzing the shortcomings of the arm's length contracting view, we turn in part II 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 subjected to influence by management, sympathetic to executives, insufficiently motivated to bargain over compensation, or simply ineffectual in overseeing compensation.

Of course, there are limits to what directors will accept and what markets will permit. But these constraints have not prevented senior executives from routinely receiving "rents" - benefits greater than those obtainable under true arm's length bargaining.

The managerial power approach predicts that executives who have more power vis-à-vis their boards should receive higher pay, or pay that is

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less sensitive to performance, than their less powerful counterparts. Although top executives generally have some degree of influence over their board, the extent of their influence depends upon various features of the firm's governance structure. A substantial body of evidence indicates that pay has indeed been higher, or less sensitive to performance, when executives have been more powerful vis-à-vis the board.

One important building block of the managerial power approach is that of "outrage" costs and constraints. Managers' and directors' choices of executive compensation arrangements have depended, in part, on how much "outrage" a proposed arrangement was expected to generate among those outsiders whose views they care about. Outrage might reduce shareholders' willingness to support incumbents in proxy contests or takeover bids. Outrage might lead to more shareholder pressure on managers and directors. It also might embarrass directors and managers or harm their reputations. The more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve it and the more hesitant managers will be to propose it in the first place. Thus, the adoption of a compensation arrangement that favors executives depends on how it is perceived by outsiders.

The critical role of outsiders' perception of executives' compensation, and the significance of outrage costs, explain the importance of yet another component of the managerial power approach - "camouflage." The desire to minimize outrage gives designers of compensation arrangements a strong incentive to obscure and try to legitimize—or, more generally, to camouflage—the amount of managerial rents. Camouflage thus allows executives to get more rents. Perhaps more importantly, the strong desire to camouflage can lead to the adoption of inefficient compensation structures that harm both managers' incentives and firm performance.

We present evidence that compensation arrangements have often been designed with an eye to camouflaging rent and minimizing outrage. Firms have systematically taken steps that make less transparent both the total amount of executive compensation and the extent to which managers' compensation is decoupled from their own performance. Managers' interests in reduced transparency have been served by the design and use of numerous compensation practices, such as post-retirement perks and consulting arrangements, deferred compensation, pension plans, and executive loans. Overall, the camouflage motive turns out to be quite useful

in explaining many otherwise puzzling features of the executive compensation landscape.

Paying for Performance and the Unfulfilled Promise of Executive Pay

Those applauding the rise in executive compensation have stressed the benefits to shareholders from strengthening managers' incentives. Indeed, in the beginning of the 1990s, prominent financial economists urged shareholders to be more accepting of large pay packages to make it possible to provide high-powered incentives.¹⁰ Shareholders, it was argued, should care much more about providing managers with sufficiently strong incentives than about the amounts spent on executive pay.

Indeed, throughout the past decade, shareholders have often accepted the increase in pay as the price of improving managers' incentives. The increase in pay has been presented as necessary, and thus worth paying, for this important purpose. Unfortunately, however, shareholders have not received a pay-for-performance sensitivity commensurate with what they have been paying.

As we describe in Part III of the book, managers have used their influence to channel the increase in pay to compensation arrangements that have been substantially decoupled from pay. Shareholders have not received as much bang for the buck as possible. Firms could have provided them same increase in incentives with a much lower spending, or they could have used the amount spent to obtain more powerful incentives. Current executive pay is less sensitive to performance than has been commonly recognized.

Although equity-based compensation has drawn most of the recent attention, much of senior managers' pay is in forms other than equity such as salary and bonus. The evidence indicates that cash compensation – including bonuses – has been weakly correlated, if at all, with firms' industry-adjusted performance. Such compensation has been generously rewarded even managers whose performance is mediocre relative to other executives in their industry. Furthermore, financial economists have paid little attention to the other forms of non-equity compensation that managers

¹⁰ Michael Jensen and Kevin Murphy, "Performance Pay and Top-Management Incentives," *Journal of Political Economy* 98 (1990): 225-264.

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frequently receive, such as favorable loans, pension and deferred benefits, and various perks. These less-noticed forms of compensation, which can be substantial, tend to be insensitive to managerial performance.

In light of the historically weak link between non-equity compensation and managerial performance, shareholders and regulators wishing to make pay more sensitive to performance have increasingly looked to, and encouraged, equity-based compensation. We strongly support equity-based compensation, which in principle can provide managers with desirable incentives. Unfortunately, managers have been able to use their influence to obtain option plans that have deviated substantially from arm's length contracting in ways that favor the managers. Our analysis indicates that equity-based plans have enabled executives to reap substantial rewards even when their performance has been merely passable or even poor.

For instance, firms have failed to filter out stock price rises that are due largely to industry and general market trends and thus unrelated to the managers' own contribution to shareholder value. Although there is a whole range of ways in which such windfalls could be filtered out, a large majority of firms have continued to stick to conventional option plans under which most of the equity-based compensation made by managers is not due to their own performance. In addition, firms have given executives broad freedom to unload options and shares, a practice that has been beneficial to executives but costly to shareholders. Interestingly, most of the firms now changing their equity-based compensation plans in response to outside pressure are still avoiding plans that would effectively eliminate such windfalls. Rather, they are moving to plans, such as those based on restricted stock, that involve only a limited reduction, and sometimes even an increase, in these windfalls.

Different Critiques of Executive Compensation

Criticisms of executive compensation practices can come from different methodological and ideological perspectives. And it is important to make clear at the outset the difference between our approach and certain other types of criticism. Indeed, on some dimensions, our positions are closer to those of supporters of current pay arrangements than to those of other critics of these arrangements.

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To begin, there is the “moral,” “fairness-based” – and some might call “populist” – opposition to large amounts of pay. On this view, putting aside practical consequences, paying executives hundreds of times what other employees get is inherently unfair and unacceptable.

Our own critique does not come from this moral or fairness-based perspective. Our approach is completely pragmatic and consequential. We care about shareholder value and the performance of corporations and in turn of the economy as a whole. We would readily accept compensation at current or even higher levels so long as such compensation, through its incentive effects, actually served shareholders. We are concerned, however, that the compensation arrangements that have been in place do not in fact meet this standard.

It is also important to distinguish our position from that of those who believe that enhancing shareholder value does not call for large pay packages simply because financial incentives are not all that important in motivating top executives. At least since the first half of the past century, some industrial psychologists and others have believed that corporate executives, who are all well off anyway, are primarily moved by such factors as need for esteem, self-actualization, and so forth.¹¹ On this view, “[t]he real driving force which motivates the typical executive ... is not money, but the deep inner satisfaction that he is doing a tough job well.”¹² Accordingly, increasing the pay of already well-paid managers, it is argued, will not affect performance and will simply be a waste of shareholder money.

In contrast to this view, we do share the assumption of defenders of current pay arrangements that executives are influenced by financial incentives. We do believe that paying generously to provide incentives could be, if well designed, a good compensation strategy. Our concern is simply that, as it were, executives have partly taken over the compensation machine. That executives (as well as directors) are influenced by financial incentives, and that they have an interest in increasing pay, play an important role in our analysis. And a main concern we have about current

¹¹ For a classic statement of the view that such psychological motivations are critical, see Abraham H. Maslow, “A Theory of Human Motivation, 50 *Psychology Review* (1943): 370-xxx.

¹² See C.B. Randall, *The Executive in Transition* (1967), p. 26.

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compensation arrangements is that they fail to provide managers with desirable incentives.

Finally, it is worth stressing that our critique pays much less attention to absolute levels of pay than critics of current pay arrangements commonly do. In our view, it is difficult to infer from absolute levels of pay that pay arrangements deviate from arm's length contracting. Our conclusion that they have done so is based primarily on examination of both the processes that have produced pay arrangements and the inefficient, distorted, and nontransparent structure of these arrangements. For us, the "smoking gun" of managerial influence on pay is found not in pay levels but rather in evidence about matters such as the relationship between power and pay, the showering of gratuitous benefits on departing executives, the systematic use of designs that obscure the amount and performance insensitivity of pay,

The Stakes

How important is the subject of executive pay? Why should one read a full book on the subject? Some might wonder whether executive compensation has a significant economic impact on the corporate sector. The problems existing in the area of executive compensation, it might be argued, have little effect on shareholders' bottom line and are thus mainly symbolic. important primarily for symbolic reasons.

Even if symbolism were unimportant, however, the subject of executive compensation is of substantial practical importance for shareholders and policy makers. The existing flaws of compensation arrangements impose substantial costs on shareholders. To begin with, there is the excess pay managers receive as a result of their power, the difference between what managers' influence enables them to obtain and what they would get under an arm's-length arrangement. The amounts involved are much more than mere pocket change for shareholders: they have a significant effect on shareholder returns.

In 2000, the mean annual compensation of CEOs was \$8.5 million, and CEO compensation amounted to an average of 7.89 percent of corporate profits.¹³ Furthermore, CEO compensation in that year amounted to an

¹³ Steven Balsam, *An Introduction to Executive Compensation* (San Diego: Academic Press, 2002), p. 262.

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average of 17.19 percent of dividends.¹⁴ The compensation figures reflect only the compensation reported in the compensation tables filed by firms, and it does not include the substantial “stealth compensation” we will discuss in Part II, whose dollar amount never appears in the reported compensation tables. Thus, if compensation could be cut without weakening managerial incentives, the gain to investors would not be merely symbolic but would have real practical significance.

Furthermore, and perhaps more importantly, manager-influenced compensation arrangements fail to generate incentives to enhance value that are as strong as those produced under arm’s length contracting. In our view, the reduction in shareholder value caused by these inefficiencies—rather than that caused by excessive managerial pay—could be the biggest cost arising from managerial influence over compensation.

We discuss two incentive problems pay arrangements have been producing. First, compensation arrangements have been providing weaker incentives to reduce managerial slack and increase shareholder value than would be the case under arm’s length contracting. Both the non-equity and equity components of managerial compensation have been more severely decoupled from managers’ contribution to firm performance than superficial appearances might suggest. Making pay more sensitive to performance may well benefit shareholders substantially.

Second, prevailing compensation practices have also created perverse incentives. For example, managers’ ability to unload options has provided them with incentive to misreport results, suppress bad news, and choose projects and strategies that are less transparent to the market. Improving compensation schemes could thus considerably benefit shareholders by reducing the costs resulting from such distorted behavior.

Going Forward

In part IV of the book we turn to some of the implications of our analysis, both for executive compensation and for corporate governance more generally. Given the difficulty of achieving an arm’s length relationship between boards and managers, it is important that shareholders

¹⁴ Steven Balsam, *An Introduction to Executive Compensation* (San Diego: Academic Press, 2002), p. 264.

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scrutinize executive compensation for inefficient pay structures. Our analysis highlights the kinds of schemes institutional investors should seek. They might do well, for example, to push firms to use equity-based schemes that filter out windfalls, that tie pay tightly to management's own performance, and that substantially limit managers' freedom to unload equity incentives.

Because outside monitoring and pressure can serve as a check on rent extraction, our analysis implies that compensation arrangements should be highly transparent to those observers whose views executives and directors care about. It is not enough for information to be in the public domain and fully accessible and understood by a limited number of market professionals. Given the importance of outrage—outsiders' perceptions in limiting the extent to which executives can extract rents—transparency is critical for reducing the extent to which managers' influence distorts compensation arrangements.

Getting compensation arrangements to be more consistent with arm's length contracting, and getting boards to be more effective monitors of managers generally, is likely to be more difficult than many expect. Recent reforms require NYSE and NASDAQ companies to have a majority of independent directors, to staff compensation and nominating committees with such directors, and to submit equity compensation plans to a shareholder vote. Our analysis indicates that even though these reforms are likely to be beneficial, they cannot be relied on to lead to the kind of arm's length relationship between directors and executives on which our corporate governance system relies. What else should be done? To induce boards to perform their critical role well, we should focus not only on insulating directors from the influence of executives, but also on reducing their current insulation from shareholders. While we should guard against excessive dependence of directors on executives, we should seek greater dependence of directors on shareholders.

Even in the wake of poor performance and shareholder dissatisfaction, directors have thus far run very little risk of being ousted in a proxy contest or a hostile takeover. This state of affairs should not continue. To improve the performance of corporate boards, arrangements that insulate directors from removal by either a proxy fight or a takeover should be removed or reduced. Additionally, boards should not have veto power – which current corporate law rules grant them – over changes in corporate

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rules that could increase shareholder value and that shareholders would approve if given the opportunity.

Although we do sketch out some of the implications of our analysis, our aim in this book is not to offer a fully detailed blueprint for changes in pay arrangements and corporate governance. Rather, we focus on some prior and crucial steps: demonstrating that, contrary to the official story of executive compensation, boards have not been bargaining at arm's length with managers over their pay; explaining how managerial power and rent-seeking have played important roles in shaping executive compensation; and providing a full account of the range of deviations from arm's length bargaining and their adverse consequences.

This is an area in which the very recognition of problems might help to alleviate them. Managers' ability to influence their pay structures depends upon the extent to which their influence remains somewhat hidden to market participants—especially institutional investors. Thus, recognition of how managerial influence can produce substantial deviations from efficient contracts might serve as a useful check simply by reducing managers' ability to camouflage their rents.

To address the problems in corporate governance that we examine, additional structural reforms in the allocation of power between boards and shareholders are necessary. To make such reforms possible, shareholders and public officials must have a fuller understanding of how pervasive, systemic, and costly the current flaws have been for our economy. Helping to bring about such an understanding is a main aim of this book.

Chapter 1: The Official Story

“[T]he board of directors is the oversight mechanism charged with monitoring management and providing shareholders with accountability.”

Ira Millstein, “The Professional Board,” 1995

We should start by describing briefly the “official” view of executive compensation – that boards, bargaining at arm’s length with CEOs, negotiate pay arrangements designed to serve shareholders’ interests. This view underlies corporate law’s approach to executive compensation, helps legitimize compensation arrangements, and informs much of the large body of research on executive compensation carried out by financial economists.

The Agency Problem

Our focus in this book is on publicly traded American companies without a controlling shareholder. This diffuse ownership structure is the norm in the United States, though not in other countries.¹⁵ The dispersion of shareholder interests was first documented in 1932 by Adolph Berle and Gardiner Means in their classic study, *The Modern Corporation and Private Property*, and remains dominant among publicly traded companies in the United States.

The dispersed owners of a typical publicly traded company cannot monitor or direct managers’ actions, so the executives who exert day-to-day control in such firms tend to have substantial discretion. In such a situation, ownership and control are separated. Shareholders own the company, but the managers exercise a substantial amount of effective control over how it is run.

The separation of ownership and control creates what financial economists call an “agency relationship:” a firm’s managers act as agents of its shareholders. The principals—the shareholders—cannot directly ensure that the agents—the managers—will always act in the principals’ best interest. As a result, the manager-agents, whose interests do not fully

¹⁵ Rafael LaPorta, , Florencio Lopez-de-Silanes, and Andrei Shleifer, “Corporate Ownership around the World,” *Journal of Finance* 54 (1999): 471-517.

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overlap with those of the shareholder-principals, may deviate from the best course of action for shareholders. This is called the “agency problem.”¹⁶ Managers’ departures from shareholder-regarding strategies in turn may involve “inefficient” behavior – behavior that reduces the size of the corporate pie. The reductions in aggregate firm value accompanying such deviations are called “agency costs.”

The agency problem can affect a wide variety of managerial choices: how much effort to exert, how many perks to consume, which strategic and business choices to make for the company. In each instance, managers’ interests may not overlap with those of shareholders. Consider, for example, decisions about how much effort to exert. Because managers will bear the entire cost of such effort, but will not fully enjoy its benefit, they will tend to exert less effort than is optimal from shareholders’ viewpoint. On the other hand, because managers *will* fully enjoy the perks they consume while not bearing their entire cost, they will have an incentive to consume too much.

Managers’ private interests may also distort their business decisions that affect firm size. CEOs are likely to have a tendency to engage in empire building,¹⁷ which can increase their prestige, perks, compensation, and other private benefits. Because managers derive more private benefits from being at the helm of a larger firm, they may make acquisitions and additional investments that do not serve shareholder value. They might also fail to reorganize and reduce the scope of operations when downsizing is called for. Moreover, to avoid firm contraction and perhaps also to facilitate future empire building, managers may retain too much cash, failing to distribute excess funds to shareholders even when their firms do not have profitable investment opportunities.¹⁸

Agency problems are likely to affect other business decisions as well. Overall, managers may run firms in ways that are personally more

¹⁶ The standard reference is to Michael Jensen and William Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,” *Journal of Financial Economics* 3 (1976): 305-360.

¹⁷ Michael Jensen and William Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,” *Journal of Financial Economics* 3 (1976): 305-360; Oliver Williamson, *The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm* (Englewood Cliffs, N.J.: Prentice Hall, 1964).

¹⁸ Michael Jensen, “Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers,” *American Economic Review* 76 (1986): 323-329.

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satisfying or convenient even if they come at the expense of shareholders. They may be tempted to pursue pet projects, for example, or they may fail to take actions that are personally costly, such as firing mediocre subordinates who also happen to be their friends.

Finally, managers may prefer to continue to run their firms even when they are no longer the best people for the job.¹⁹ They may turn down even very attractive acquisition offers or attempt to block takeover attempts that would increase shareholder value but cost them their jobs. And they have an incentive to take entrenching actions (such as adopting antitakeover measures) that make it more difficult to replace them.

The Board as Guardian of Shareholder Interests

The official theory of executive compensation recognizes that there is an agency problem in publicly traded companies with separation of ownership and control. However, under both the legal and financial economics models of executive compensation, this agency problem is supposed to be addressed by the board's supervision and monitoring of managers. Under corporate law rules, the power to manage the company is not given to the CEO and other officers. Rather, this power is vested in the board, under whose direction the business and affairs of the corporation must be managed.²⁰

Although the board has formal authority and control, directors are not expected to manage the company themselves. The directors of publicly traded companies have other primary careers – as executives, professionals, or academics – and thus do not perform their board roles full-time. In addition, many directors sit on more than one board. Hence directors are generally expected to delegate ongoing management to the company's officers and especially to the CEO. But the board's power to intervene is supposed to keep managers in line. The threat of board intervention is expected to curb managers' tendency toward self-serving behavior, thereby reducing agency costs.²¹

¹⁹ Andrei Shleifer and Robert Vishny, "Management Entrenchment: The Case of Manager-Specific Investments," *Journal of Financial Economics* 25 (1989): 123-140.

²⁰ See, for example, Delaware General Corporate Law, sec. 141.

²¹ John E. Core, Wayne Guay, and David Larcker, "Executive Equity Compensation and Incentives: A Survey," *Economic Policy Review* 9 (April 2003): 27-50.

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After selecting and hiring executives, directors are thus supposed to monitor their performance, replacing them as necessary. Major corporate decisions, such as how to respond to an acquisition offer, are ultimately reviewed by the board, which has the full power to accept or reject management's recommendations.

In carrying out its supervisory duties, the board is generally must be guided solely by the interests of the corporation and its shareholders. The directors are elected by shareholders and have a fiduciary duty to protect the latter's interests. In addition to their legal duty to serve shareholders, the directors are assumed to have an incentive to focus on shareholder interests. Failure to do so, it is widely believed, may lead shareholders to replace the board by voting in a different slate of directors or by selling their shares to a hostile acquirer.

Arm's Length Bargaining over Compensation

Given executives' natural interest in being paid more and working less, permitting them to set their own pay would clearly produce severe agency problems. Therefore, the board is directly entrusted with these decisions. Under the official theory of executive compensation, the board is assumed to bargain at arm's length with executives, solely with the interests of the corporation and its shareholders in mind.

Courts assume that directors in fact negotiate compensation arrangements solely with shareholders' benefit in mind. That premise underlies corporate law's treatment of board compensation decisions. Courts routinely defer to boards' decisions on compensation issues, reflecting a strong presumption that directors exercise their business judgment to serve shareholders. As the Delaware Supreme Court recently wrote, "...the size and structure of executive compensation are inherently matters of judgment" entitled to "great deference" by the courts.²²

The same premise also underlies most of the large volume of research that financial economists have done on executive compensation. The dominant model in the economic literature assumes that, in negotiating compensation, directors take an independent, if not adversarial, position vis-à-vis the executives. The board is viewed as bargaining with management at arm's length with the exclusive goal of serving shareholder interests. Such

²² See *Brehm v. Eisner*, Delaware Supreme Court, 746 A.2d 244, 262-263 (2000).

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bargaining is expected to yield “efficient” compensation contracts – contracts that cost-effectively provide executives with incentives to generate shareholder value. Financial economists have done substantial work within this model, which we label the “arm’s length contracting approach,” in an effort to understand executive compensation practices.²³ Even after the corporate scandals of 2002 and 2003, financial economists have continued to use arm’s length contracting as the main lens through which to view compensation arrangements.

Efficient Contracting and Paying for Performance

What would characterize an executive compensation arrangement produced by arm’s length bargaining between the executive and a board seeking to maximize shareholder value? To begin, the contract must provide enough value to induce the executive to accept and remain in the position being offered. Thus, the contract must provide benefits whose value meets or exceeds the value of the other opportunities available to the candidate (the executive’s “reservation value”).

In addition, when rational, self-interested buyers and sellers transact, their contracting practices tend to avoid inefficient terms, i.e., terms that reduce the size of the pie produced by the contractual arrangement and shared by the transacting parties. Thus, for example, employers tend to take advantage of ways of compensating employees that enjoy a tax subsidy and to avoid ways that impose a tax loss. For this reason, when studying compensation arrangements from the perspective of the arm’s length model, financial economists viewed terms that seemed inefficient as puzzling and sought to show that they might be efficient after all.

Economists have long believed that a key feature of efficient compensation contracts involves linking pay with performance to provide executives with incentives. Indeed, according to the standard view, the compensation arrangement can be a major instrument for combating the

²³ Recent surveys of this work on executive compensation from an arm’s length contracting perspective include Kevin J. Murphy, “Executive Compensation,” in *Handbook of Labor Economics*, vol. 3, bk. 2, ed. Orley Ashenfelter and David Card (New York: Elsevier, 1999), 2485-2563; and John E. Core, Wayne Guay, and David Larcker, “Executive Equity Compensation and Incentives: A Survey,” *Economic Policy Review* 9 (April 2003): 27-50.

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agency problem. And the significance of the agency problem makes it important to use this instrument effectively is important.

Directors have neither the time nor the information necessary to monitor all managerial actions to ensure that they benefit shareholders. Given the considerable discretion inherent in a CEO's position, inducing the CEO to focus on shareholder interests and avoid self-serving choices is important. The board can influence these actions by designing compensation arrangements that provide managers with incentive to increase shareholder value. Thus, by designing the compensation scheme well, it is argued, directors can to a substantial "make up" for the fact that they cannot directly monitor or scrutinize many actions and decisions by their top executives.

If well designed, then, a compensation arrangement can substantially reduce agency costs. To do so, it is widely believed that an efficient contract must link managers' compensation to the value they generate for shareholders.²⁴ Paying for performance can improve performance.

Creating a link between pay and performance is believed to be beneficial for shareholders even though pay that is sensitive to performance is less valuable for managers than a cash pay with the same expected value. Because managers cannot know in advance how much value they will create, tying managers' compensation to their own performance creates uncertainty for them. Managers are generally risk-averse - meaning they value a dollar paid with certainty more than they value variable pay with an expected value of a dollar (e.g., a 50 percent chance of receiving two dollars). For this reason, compensation that is uncertain imposes "risk-bearing" costs on the executive. Everything equal, it would take more performance-based compensation than cash salary to meet an executive's reservation value.

As long as managers' incentives are important, however, an efficient contract can be expected to provide a major part of its compensation in ways that induce and reward performance. Even if the total amount of

²⁴ Classic works on the subject include J. A. Mirrlees, "The Optimal Structure of Incentives and Authority within an Organization," *Bell Journal of Economics* 7 (1976): 105-131; Bengt Holmstrom, "Moral Hazard and Observability," *Bell Journal of Economics* 10 (1979): 74-91; Steven Shavell, "Risk Sharing and Incentives in the Principal and Agent Relationship," *Bell Journal of Economics* 10 (1979) 55-73. For a recent survey of the application of principal-agent theory to CEO compensation, see Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, vol. 3, bk. 2, ed. Orley Ashenfelter and David Card (New York: Elsevier, 1999).

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compensation must be increased to make up for the risk-bearing costs that performance-based compensation imposes on the CEO, this additional expense may be worthwhile for shareholders in order to provide managers with desirable incentives. For this reason, economists have long stressed the importance of increasing the sensitivity of compensation to performance.²⁵

Indeed, as economists have long recognized, the incentives of performance-based pay might be so substantial as to make it desirable for shareholders to pay their top executives more than the “reservation wage” needed to induce them to hire and retain them. That is, directors that seek to maximize shareholder value might elect to provide an additional compensation beyond the level that they assume to be sufficient to hire and retain the executive. It would be worth granting, say, an additional \$1,000,000 of performance-based compensation if doing would give the executive incentives expected to increase the value of the firm by more than \$1,000,000. Importantly, however, such an increase in compensation beyond the executive’s reservation wage level could serve shareholders only if it were given in a performance-based form.

In examining whether the empirical reality has been consistent with arm’s length contracting, it will be useful to focus on the structure of executive compensation. Because a board seeking to maximize shareholder value may set high levels of compensation, such levels do not by themselves demonstrate a departure from arm’s length contracting. However, under the arm’s length contracting view, there is little reason to expect the widespread persistence of arrangements that, by distorting incentives or otherwise, compensate managers in an inefficient way. Thus, evidence about that such arrangements are widespread and persistent will be a more telling sign of departures from the arm’s length model than absolute amounts could be.

It’s the Market

Defenders of existing compensation practices often try to base their case on analogies to other markets for talent. For example, while testifying before a Senate committee, noted compensation expert Ira Kay asserted: “The CEO labor market meets all of the criteria of any market.”²⁶ On this

²⁵ See, e.g., Michael Jensen and Kevin J. Murphy, “Performance Pay and Top-Management Incentives,” *Journal of Political Economy* 98 (1990): 225-264.

²⁶ Ira Kay, Testimony before the Senate Finance Committee, April 2002.

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view, compensation arrangements are the outcome of market interactions, a product of the combined forces of the demand and supply managerial talent. Executive compensation arrangements produced by this process, it is argued, are not more problematic, and should not be questioned more, than the compensation arrangements obtained by other highly-paid individuals, such as star athletes or movie stars.

Are CEOs Like Star Athletes?

The analogy to star athletes or movie stars is one that defenders of existing pay practices often seek to invoke.²⁷ After, star athletes are a rather popular and admired group, and reports about their high salaries are more commonly accepted with awe and approval rather than with outrage. Furthermore, the compensation of players has also escalated in the past two decades. Thus, defenders of current executive pay practices can assert that the meteoric rise in executive pay is simply part of a broader phenomenon of the rise in the value of special talent, which has manifested itself in other markets. The rise in executive pay, so the argument goes, is not more problematic than the fact that Shaquille O'Neal, the current top basketball center, is being paid many times the compensation in the past of such great centers as Bill Russell or Wilt Chamberlain.

But the market processes generating the compensation of, say, O'Neal are quite different from those producing the compensation arrangements of, say, Michael Eisner, Disney's CEO. Those making the market analogy are implicitly relying on the premise of arm's length bargaining, which is valid for athletes but not executives. When an athlete's compensation arrangements are set, there is little doubt that the manager of the club is negotiating at arm's length. The manager is seeking to serve the club's interests, not those of the individual player. And when transactions occur between independent buyers and sellers, the invisible hand of the market tends to produce efficient arrangements.

Indeed, it is worth noting that, although star athletes are highly paid, some more than the average S&P 500 CEO, their compensation arrangements do not exhibit some of the common features of executive pay arrangements that managerial influence produces. After owners negotiate

²⁷ See, e.g., Franklin Snyder, *More Pieces of the Compensation Puzzle*, *Delaware Journal of Corporate Law* (2003): 129-183.

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with their star athletes their compensation arrangements, they have little reason to try to camouflage the amount of pay and to channel pay to forms that are less visible. While clubs pay athletes generously during the period of the contract, they generally do not provide them with a large amount of compensation in the form of post-retirement perks and payments. Clubs do not provide athletes with complex deferred compensation arrangements that serve to obscure total pay but do not enjoy tax subsidy. And when clubs get rid of players, they do not generally provide them with gratuitous large payments beyond the contractual payments to which the players are entitled. As we shall see, these are all common practices in the area of executive compensation. Executives are not like star athletes.

Is it Possible for Most Executives to be Over-Paid?

Defenders of current pay arrangements also argue that the only way to judge whether an individual is overly paid is by reference to the compensation based to others hired in the same market. One cannot judge a compensation arrangement, it is argued, outside the context of the equilibrium in the market at the time the arrangement is made. On this view, it is not possible by definition for most executives to be paid excessively. Furthermore, on this view, compensation arrangements should not be viewed as problematic as long as they are boards use market surveys to set compensation in line with that paid to other executives of publicly traded companies.

It is true that, by definition, most CEO cannot be compensation above the median compensation of their peer group. But boards acting at arm's length should be doing more than ensuring that the compensation they set can be defended as being in line with market levels. Boards acting at arm's length are supposed to try to get, against the background of market outcome, the best outcome for shareholders. Furthermore, in the absence of an arm's length process, concerns about executive compensation arrangements would not be addressed by a finding that all executives are getting the same packages. The absence of arm's length bargaining would still provide a basis for concerns that managers are paid too much or paid in inefficient forms. When the market as a whole is distorted by the absence of arm's length bargaining, general conformity to market terms is not a particularly good yardstick. In such a market, compensation levels could be

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generally higher relative to the outcomes that would be generated if arms' length bargaining shaped the market.

In the end, then, the validity of the arguments for deference to market outcome depends on whether those outcomes are largely generated by arm's length negotiations between executives and self-interested purchasers of their services. The critical question is whether the arm's length model is a sufficiently accurate reflection of reality. This is the question to which we will now turn.

CHAPTER 2: HAVE BOARDS BEEN BARGAINING AT ARM'S LENGTH?

“The directors of [joint stock] companies, however, being the managers rather of other people’s money than of their own ... cannot well be expected ... [to] watch over it with the same anxious vigilance [as the owners themselves]....”

Adam Smith (1776)

The arm’s length contracting assumption that underpins the official view of corporate governance recognizes that we cannot rely on executives to serve shareholders. Once in their positions, managers are likely to act in ways that serve their own interests – a tendency that board oversight and proper incentives are supposed to curb. But the arm’s length model implicitly assumes that, unlike corporate executives, corporate directors can be relied on to serve shareholders.

Given that executives do not automatically seek to maximize shareholder value, however, there is no reason to expect *a priori* that directors will do so. Directors’ incentives and preferences do matter. Directors have financial and non-financial incentives to favor or at least to get along with executives. A variety of psychological and social factors reinforce these incentives. Because directors hold only a tiny fraction of the firm’s shares, their holdings have been insufficient to outweigh the incentives and tendencies to side with executives. And, in any event, directors have thus far had neither the time nor the information necessary to serve shareholder interests effectively in setting pay arrangements.

The pay-setting process is, of course, better in some firms than in others. However, significant deviations from arm’s length contracting have been common in widely held public companies. And while recently adopted stock exchange requirements will probably produce some improvement in pay setting processes, they are unlikely to eliminate substantial and widespread deviations from arm’s length contracting.

The Pay-Setting Process

We begin our exploration of the limitations of the arm’s length model with a brief description of the pay-setting process in large public

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corporations. The board of directors is responsible for determining the compensation of the CEO and other top executives. To be sure, shareholders have often been asked to approve option plans that provide an upper limit on stock-based awards to senior executives and to lower-level employees. But shareholder ratification has generally been a foregone conclusion for reasons to be discussed in the next chapter. Operating within the broad parameters of the plan, the board has full authority to award any compensation package it wishes to the CEO or to any other executive.²⁸

Boards of large public companies delegate to compensation committees the task of working out the critical details of executive compensation arrangements. The compensation committee is typically composed of three or four directors.²⁹ For some time now, most directors serving on compensation committees have been “independent.” The Investor Responsibility Research Center reported that 73 percent of the S&P 1,500 compensation committees surveyed during 2002 were fully independent.³⁰ Directors are generally considered independent if they are not current or former employees of the firm and are not affiliated with the firm other than through their directorship. (Below we will discuss in detail the definitions of independent directors adopted by the NYSE, NASDAQ, and AMEX in their listing requirements.)

Tax rules and court decisions have contributed to the widespread use of compensation committees staffed exclusively with independent directors. Since 1994, the U.S. tax code has penalized corporations lacking such committees; publicly traded corporations have not been permitted to deduct pay in excess of \$1 million annually per executive unless the excess compensation either consists of options or is based upon the achievement of performance goals that have been established by a compensation committee composed solely of independent directors.³¹ And, as will be detailed in the

²⁸ Stacey R. Kole, “The Complexity of Compensation Contracts,” *Journal of Financial Economics* 43 (1997): 101.

²⁹ Stacey Burke, Glenn Davis, Chris Loayza, Conor Murphy, and Sergio Schuchner, “The Structure and Compensation of Boards of Directors at S&P Super 1500 Companies,” in *Board Practices/Board Pay 2002* (Washington D.C.: Investor Responsibility Research Center, 2002), p. 43.

³⁰ *Ibid*, p. 41.

³¹ See *Internal Revenue Code*, § 162(m), codified at 26 *USC* § 162 (Supp 2001). The employees whose compensation is covered by this rule include the CEO or the

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next chapter, courts have generally upheld compensation arrangements recommended to the board by a compensation committee composed of independent directors. Thus, the use of such a committee has largely insulated board compensation decisions from judicial review.³²

Although already very common, the presence of independent directors on boards and on compensation committees in particular is becoming even more widespread because of the listing requirements adopted by the NYSE, NASDAQ, and AMEX and approved by the SEC in the fall of 2003.³³ These new provisions require the boards of most publicly traded companies to have a majority of independent directors.³⁴ Under the NYSE rules, each company must have a compensation committee composed only of independent directors. Under the rules of the two other exchanges, the CEO's compensation must be determined or recommended to the board by a majority of independent directors or a compensation committee composed solely of such directors. These requirements also establish standards for judging independence.

Although these new requirements have attracted a great deal of attention, it is important to keep in mind that they merely make mandatory a practice that most public companies have been following for some time anyway. Thus, it is unlikely that these new requirements, by themselves, will greatly change the relationship between executives and their boards. Indeed, as we shall see below, there are good reasons to doubt that the mere presence of independent directors on the board and on the compensation

individual acting in that capacity and the four most highly compensated officers other than the CEO, whose compensation must be reported under the Securities Exchange Act of 1934. See 26 CFR § 1.162-27(c)(2) (2002) (defining the employees covered under IRC § 162(m)). Non-employee directors who serve as consultants or who otherwise receive direct or indirect remuneration from the firm in a capacity other than that of directorship do not qualify as outside directors for the purposes of Section 162(m). See 26 CFR § 1.162-27(e)(3).

³² Robert Charles Clark, *Corporate Law*, section 6.1 (Boston: Little, Brown and Company, 1986): 194.

³³ NASD Rule 4350; NYSE Listed Company Manual Rule 303A; American Stock Exchange Company Guide Sections 121, 801-809; SEC Release No. 34-48745 (November 4, 2003); SEC Release No. 34-48863 (December 1, 2003).

³⁴ AMEX creates an exception for "small business issuers", which are required only to have a board comprised of at least 50 percent independent directors. American Stock Exchange Company Guide Section 121B(2)(c).

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committee can ensure a pay-setting process that approximates arm's length bargaining.

Directors' Desire to be Re-elected to the Board

A director receives a number of benefits from serving on a board. First, a board seat provides direct financial benefits. In most cases, these benefits are likely to be economically significant to the director. Like executive pay, director pay rose dramatically with the stock market. In 2002, director compensation averaged \$152,000 in the largest 200 companies and \$116,000 in the largest 1000 companies.³⁵ There are often additional perks and indirect benefits. For example, directors of UAL Corp. (which owns United Airlines) can fly United for free, and directors of Starwood Hotels get 18 free nights in Starwood hotels.³⁶ Moreover, and importantly, a board seat often provides directors with prestige and with valuable business and social connections. The financial and non-financial benefits of holding a board seat give directors a compelling interest in keeping their positions.

That directors have an interest in being re-elected is clear. The question, then, is what incentives does this desire provide. According to the official view, the desire to be re-elected by shareholders should make directors attentive to shareholder interests: the better their performance, so the official argument goes, the more likely they are to win re-election.

In reality, however, candidates placed by the board on the company's slate have been virtually assured of being re-elected. Dissident shareholders contemplating putting forward their own director slate have confronted substantial obstacles.³⁷ As a result, the director slate proposed by the company is the only one on the ballot. In an empirical study of the seven-year period 1996-2002, one of us finds that, outside of the context of hostile takeovers, the incidence of electoral challenges to the board's slate was

³⁵ See Pearl Meyers & Partners, "Executive Pay Trends: Looking Forward and Looking Back" (2002), p. 3; Garry Strauss, Companies Pony Up to Keep Directors: Boards Seats Have Become Hot Seats, U.S.A. Today, Nov. 21, 2002, at B1.

³⁶ See UAL Corp Form 10-K (filed March 28, 2003); Starwood Hotels & Resorts Worldwide Inc Form 10-K (filed July 7, 2003)

³⁷ Lucian A. Bebchuk and Marcel Kahan, "A Framework for Analyzing Legal Policy Towards Proxy Contests," *California Law Review* 78 (1990): 1071-1135.

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practically non-existent – no more than two a year among firms with a market capitalization exceeding 200 million dollars.³⁸

The key to a board position is therefore getting one's name on the company slate. And, at least thus far, CEOs have had considerable and sometimes decisive influence over the nomination process.³⁹ Most boards have had a nominating committee. However, while compensation committees have for some time been largely composed of independent directors, that has not been the case with respect to nominating committees. Indeed, CEOs have often served on this committee.⁴⁰ A 2002 survey found that among those S&P 1500 firms that had a nominating committee, only 50 percent were fully independent.⁴¹

Even CEOs not formally serving on the nominating committee have had a significant influence on the nomination process.⁴² Boards and nominating committees have been unlikely to nominate a director clearly

³⁸ See Lucian Bebchuk, "The Case for Shareholder Access to the Ballot," *The Business Lawyer* 59 (2003): 43-66.

³⁹ Brian G. M. Main, Charles A. O'Reilly III, and James Wade, "The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives," *Industrial and Corporate Change* 11 (1995): 302-303; Victor Brudney, "The Independent Director—Heavenly City or Potemkin Village?" *Harvard Law Review* 95 (1982): 610, n. 39; Benjamin E. Hermalin and Michael S. Weisbach, "Endogenously Chosen Boards of Directors and Their Monitoring of the CEO," *American Economic Law Review* 88 (1998): 96-97. For a review of the economic literature on boards of directors, see Benjamin E. Hermalin and Michael S. Weisbach, "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature," *Federal Reserve Bank of New York Economic Policy Review* 9 (2003): 10-12.

⁴⁰ Shivdasani and Yermack report that in 1994 78 percent of 341 publicly traded Fortune 500 firms had a nominating committee, and that in 33 percent of those firms the CEO was a member of the nominating committee. Anil Shivdasani and David Yermack, "CEO Involvement in the Selection of New Board Members: An Empirical Analysis," *Journal of Finance* 54 (1999): 1834.

⁴¹ Stacey Burke, Glenn Davis, Chris Loayza, Conor Murphy, and Sergio Schuchner, "The Structure and Compensation of Boards of Directors at S&P Super 1500 Companies," in *Board Practices/Board Pay 2002* (Washington D.C.: Investor Responsibility Research Center, 2002), p. 49.

⁴² Brian G. M. Main, Charles A. O'Reilly III, and James Wade, "The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives," *Industrial and Corporate Change* 11 (1995): 302-303; Cynthia A. Montgomery and Rhonda Kaufman, "The Board's Missing Link," *Harvard Business Review* (March 2003): 89.

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opposed by the CEO. At a minimum, CEOs have had a considerable power to block nominations. Thus, sparring with the CEO over executive compensation could only have hurt their chances of being re-nominated to the board. "Going along" with the CEO's pay arrangement has been a much safer bet. Directors thus have had an incentive to do so, at least as long as the compensation package remains within the bounds of what can be defended and justified should challenges arise.

Under the NYSE's new listing requirements, the firm must have a nominating committee staffed solely with independent directors. NASDAQ's new listing provisions require that director nominees be selected or recommended either by a majority of the independent directors or a nominating committee composed solely of such directors.⁴³ These requirements might significantly reduce CEOs' influence over the nomination process - and hence over the directors themselves. But not upsetting the compensation apple cart may well remain the best bet for remaining on the company's slate.

The CEO's wishes can be expected to continue to influence the decisions of the nominating committee; after all, the directors appointed to the board will have to work with the CEO. Thus, even if CEOs power over director nomination decreases, CEOs will continue to have some influence over who is placed on the company slate and who is not. Indeed, experts interviewed by the Wall Street Journal have advised boards to consult with management on the independent nominating committee's choices. And as a lawyer who has served on the boards of several public companies said, "I think as a practical matter, few new directors would accept without knowing that the CEO is enthusiastic about the decision... No one likes to go to the boardroom thinking they've been imposed on the CEO..."⁴⁴

Even if the CEO had no influence over nominations, challenging the CEO over her compensation might be viewed unfavorably by some of the independent directors on the nominating committee. These directors might not wish to have on the board a director whose bad relationship with the CEO might undermine board collegiality. They might also wish to avoid the

⁴³ NASD Rule 4350; NYSE Listed Company Manual Rule 303A; American Stock Exchange Company Guide Section 804; SEC Release No. 34-48745 (November 4, 2003).

⁴⁴ Daniel Nasaw, "Opening the Board: The Fight is on to Determine who will Guide the Selection of Directors in the Future," *Wall Street Journal*, 27 October 2003, p. R8.

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friction and unpleasantness that is likely to accompany disputes over the CEO's compensation. Finally, the directors also might side with the CEO for some of the reasons to be discussed below.

To be sure, the impact of the new requirements concerning nominating committees will become clear only with time. At this stage, however, it appears likely that, as long as the key to board appointment remains being on the company's slate, not challenging CEO compensation would be the safest strategy for a director who wants to keep her board seat. This state of affairs would be likely to change, we believe, only under reforms that would give shareholders a much more meaningful role in the selection of directors, an issue to which we shall return in our concluding chapter.

CEOs' Power to Benefit Directors

Putting aside the issue of re-election to the board, directors, including independent directors, have other economic incentives to be on good terms with the CEO. CEOs have a great deal of power apart from their influence over board nominations. They have substantial control over the firm's resources and their position sometimes gives them significant influence outside the firm. CEOs can use this power, if they so choose, to directly or indirectly benefit individual directors. In the past, CEOs have displayed considerable willingness to use their power to reward friendly directors in a myriad of ways. While the new stock exchange listing requirements place limits on the benefits that independent directors can get from the company, they still permit directors to receive meaningful benefits while still retaining their independent director status.

Current and Past Practices

In the wake of the high-profile corporate scandals involving Tyco, Worldcom, and other large firms, evidence emerged suggesting that some CEOs had effectively bought off directors by providing them individually with special perks or monetary benefits.⁴⁵ While the practice of business

⁴⁵ The Tyco CEO paid one director, Frank Walsh, a \$20 million "finder's fee" for helping to arranging a deal. Jeffrey Kranser, "Tyco Sues 2 Former Executives Accused of Pay Impropriety, a Coverup," *Boston Globe*, 18 June 2002, p. D1. Worldcom CEO

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dealings with independent directors has received much attention in the case of companies tainted by scandals, it has hardly been limited to such companies. Many other firms have also engaged directly and indirectly in such business dealings. ⁴⁶ For example, Verizon's 2001 board included an executive director of Boston Consulting Group which received \$3.5 million from Verizon for services in 2000; the CEO of a railroad that was paid by Verizon \$650,000 for services and products; and two attorneys from law firms that provide Verizon with legal services. Bank of America's 2001 board included high-ranking officials from three property businesses that received from the bank \$3.47 million in rental fees the previous year.

Companies expend billions of dollars annually on charitable contributions,⁴⁷ and CEOs have used their power to direct contributions to benefit some of their directors. It has been common practice for companies to make charitable contributions to non-profit organizations that employ or are headed by a director. Verizon contributed hundreds of thousands of dollars annually to the National Urban League whose head sat on Verizon's board.⁴⁸ Oracle, which has on its board three Stanford University professors and a Stanford alumnus who is involved in the university's affairs, has been making large contributions to Stanford.⁴⁹

Bernard Ebbers allowed Stiles A. Kellet Jr, the director who chaired the compensation committee, to rent a Falcon 20 jet for \$1 a month plus \$400 per hour plus minor expenses, when the standard rate for renting a corporate jet is at least several thousand per hour. Susan Pulliam, Jared Sandberg, and Deborah Solomon, "Worldcom Board Will Consider Rescinding Ebbers's Severance," *Wall Street Journal*, 10 September 2002, p. A1. The value of the lease was between \$1.4 million and \$3.4 million, and WorldCom's court-appointed monitor, Richard Breeden, recommended that Kellet repay at least \$1.4 million. Christopher Stern, "WorldCom Director Urged to Leave," *Washington Post*, 13 September 2002, pE01. Kellett eventually agreed to reimburse Worldcom at a rate of \$3000/hour, requiring him to pay Worldcom \$156,000 and to give up directors' fees and other amounts owed to him by Worldcom.

⁴⁶ The examples in this paragraph are described in Gary Strauss, "Do Conflicts Cloud the Objectivity of Boards?" *USA Today*, 5 March 2002, p. A1.

⁴⁷ See Victor Brudney and Allen Ferrell, Corporate Speech and Citizenship: Corporate Charitable Giving," *University of Chicago Law Review* 69 (2002): 1197.

⁴⁸ Gary Strauss, "Do Conflicts Cloud the Objectivity of Boards?" *USA Today*, 5 March 2002, p. A1.

⁴⁹ *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917, 920-921 (Del. Ch. 2003).

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There are reasons to believe that executives and directors place value on the firm giving money to favored charitable causes.⁵⁰ To reward a director, a CEO can also use her power to direct charitable contributions to a charitable organization that a director favors but does not work for. Enron donated millions of dollars to some of its directors' favorite charities.⁵¹ Although there is little empirical evidence on the subject, we suspect that a significant amount of corporate charitable contributions is given to causes recommended by directors, and that this practice gives CEOs yet another mechanism for rewarding friendly directors.

The New Independence Standards and their Limits

The listing standards adopted by the stock exchanges in 2003 will in the future place some limits CEOs' ability to reward independent directors.⁵² However, these standards leave CEOs with substantial power in this area. To begin, the rules do not prohibit a firm from giving a particular director compensation on top of his director fees. Rather, they only limit the amount of such compensation. Under the NYSE listing standards, for example, a director can still be considered independent even if she receives up to \$100,000 a year in such additional compensation, hardly a negligible amount for many directors.⁵³ Moreover, under the NYSE requirements, compensation given to an immediate family member who is a non-executive employee of the company would not count toward this \$100,000 limit.⁵⁴

⁵⁰ For example, the departing CEO of Ford, Jacques Nasser, extracted a commitment from Ford to endow a scholarship in his name at a school of his choice. See Joann S. Lublin, "Many Former Chief Executives Get Lush Perks and Fat Fees for Limited 'Consulting' Work," *Wall Street Journal*, 13 September 2002, p. B1.

⁵¹ Richard A. Oppel, Jr., "Senate Panel Says Enron's Board could have Stopped High Risk Practices," *New York Times*, 7 July 2002, p. 1.

⁵² NYSE Listed Company Manual Rule 303A; NASD Rule 4350; American Stock Exchange Company Guide Section 121. In the discussion below, we focus on the NYSE requirements because of the importance and prominence of this exchange.

⁵³ NYSE Listed Company Manual Rule 303A.02(b)(ii). The NASDAQ and AMEX limit is \$60,000. NASD Manual 4200(a)(14)(B); American Stock Exchange Company Guide Section 121A(b).

⁵⁴ See commentary to NYSE Listed Company Manual Rule 303A.02(b)(ii). NASDAQ's standard's is stricter with respect to this issue. Directors whose immediate family members are employees of the company, who may qualify as directors under the

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Similarly, the requirements would limit but not prohibit business dealings between a company and a firm associated with one of its independent directors. Under the NYSE standards, a director who is an officer or an employee of another business is presumed to be independent as long as the other business receives from the company less than \$1,000,000 annually (and less than 2 percent of the other firm's gross revenues).⁵⁵ Business dealings below this ceiling might well be economically significant for many directors. Consider a partner in a large New York firm who is both a director of the firm and one of its outside lawyers, for which his law firm receives \$900,000 each year. This amount of business is likely to matter to the director.

Now consider a lawyer who sits on a corporation's board but is not currently providing services to the firm. This lawyer still has an economic incentive to remain on good terms with the CEO because the firm could be a future client. Fighting with the CEO over compensation is hardly a good way to get the firm's legal business. To be sure, if the company ends up giving a large amount of business to the lawyer's firm -- say, work on acquisitions with many millions in fees -- then the partner will no longer be able to qualify as an independent director. The point, however, is that the possibility of such future business might affect the lawyer's economic incentives even while he still is an independent director. This point also highlights how difficult it is to prevent the CEO from rewarding directors who have ties to other businesses.

As for charitable contributions, the NYSE standards make it clear that the \$1,000,000 limit on business dealings does not apply to charitable contributions. A director who is an officer or employee of a charitable organization still can be considered independent even if the firm on whose board she sits contributes more than \$1 million to that organization. The only requirement is that the contributions be disclosed.⁵⁶ When the firm contributes to a charitable organization recommended by a director who is

NYSE standards, may not be counted as independent under the NASDAQ standards. NASD Manual 4200(a)(14)(C).

⁵⁵ NYSE Listed Company Manual Rule 303A(2)(b)(v). The figures used by AMEX and NASDAQ are \$200,000 or 5 percent of gross revenues. American Stock Exchange Company Guide, Section 121A(d); NASD Manual 4200(a)(14)(D).

⁵⁶ See commentary to NYSE Listed Company Manual Rule 303A(2)(b)(v).

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not an officer or an employee of this organization, not even disclosure is required.

Should the above problems be addressed by tightening the tests of director independence? When we examine the subject of future reforms, we argue that director independence would in any event be insufficient to ensure board accountability to shareholders; some dependence on shareholders is essential for this purpose. For the purpose of trying to understand the current landscape of executive compensation, however, it is important to recognize that director independence has been compromised by CEOs's ability to confer significant rewards on directors, that recent reforms diminish but hardly eliminate their ability to do so.

Interlocks

When a director is himself an executive at a firm on whose board the CEO sits, the CEO has another channel for rewarding the director. In this case, the CEO can benefit the director not by using the CEO's power in the company managed by the CEO but rather by using whatever influence the CEO has sitting on the other company's board.

The considered case - usually referred to as "interlocking directors" - is not as rare as one might imagine. According to one study, in approximately one out of every twelve publicly-traded firms, the board is "current CEO-interlocked" - that is, the CEO of Firm A sits on the board of Firm B, and the CEO of Firm B sits on the board of Firm A.⁵⁷ The study also finds that, as might be expected, CEO pay has been larger in companies with interlocking directors.

The new stock exchange requirements reduce but do not eliminate the potential influence of interlocks on independent directors. Under these requirements, a director of company A who is an executive of company B cannot be considered independent if A's CEO (or any other of its executives) serves on B's compensation committee. However, the director of company

⁵⁷ Kevin Hallock, "Dual Agency: Corporate Boards with Reciprocally Interlocking Relationships," in *Executive Compensation and Shareholder Value: Theory and Evidence*, ed. Jennifer Carpenter and David Yermack (Boston: Kluwer Academic Publishers, 1999), 58. For an examination of the factors that make reciprocal CEO board membership more likely, see Eliezer M. Fich and Lawrence J. White, "Why Do CEO's Reciprocally Sit on Each Other's Boards?" *Journal of Corporate Finance*, forthcoming..

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A can be considered independent if A's CEO serves on B's board but not on B's compensation committee. The presence of A's CEO on B's board might well still have an effect on the director's interests; A's CEO could be an important voice on B's board either for or against decisions favored by the director. For this reason, we expect that the practice of interlocking directors will continue to provide CEO's with another source of influence over certain directors.

Director Compensation

Lastly, directors have a natural economic interest in their own compensation, which CEOs might be able to influence. As the company leader, usually as a board member, and often as board chairman, the CEO has some say over director compensation. Although recommendations concerning director compensation are usually made by a compensation committee composed of independent directors, the CEO can choose to either discourage or encourage director pay increases. Independent directors who are generous with the CEO might reasonably expect the CEO to use his bully pulpit to push for higher director compensation. At a minimum, generous treatment of the CEO contributes to an atmosphere that is conducive to generous treatment of directors.

In fact, Ivan Brick, Oded Palmon and John Wald report that companies with higher CEO compensation have had higher director compensation as well.⁵⁸ To be sure, high CEO and director compensation might reflect the fact that a firm is particularly difficult to run, or that there is a shortage of people capable of running it, or that the firm is doing so well that the board believes both the CEO and its own members should be rewarded. But the considered study rejects these alternative explanations. It reports that excess CEO and director compensation have been negatively associated with firm performance; thus, lower director and CEO compensation has been associated with better performance. The authors conclude that collusion between directors and CEOs (what they call "cronyism") has driven the link between high director pay and high CEO pay.

⁵⁸ Ivan E. Brick, Oded Palmon, and John K. Wald, "CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism," working paper, Rutgers University Business School, September 2002, p.29.

Social and Psychological Factors

Putting aside economic incentives and the desire to be renominated to the board, there are various social and psychological factors that encourage directors to go along with compensation arrangements that favor the company's CEO and other senior executives. These social and psychological factors reinforce the economic incentives to favor executives discussed above, and they can also affect directors who are not influenced by economic considerations. Indeed, most directors are subject to at least some of the social and psychological factors discussed below.

Friendship and Loyalty

Let us start with social and psychological factors that operate on directors as soon as they begin serving on the board. Many independent directors have some prior social connection to, or are even friends with, the CEO or some other senior executives.⁵⁹

Even directors who did not know the CEO prior to their appointment might well have begun their service with a sense of obligation and loyalty to the CEO. The CEO usually will have been involved in bringing the director onto the board -- even if only by not blocking her. With such a background, directors often start serving with a reservoir of good will toward the CEO, which will contribute to a tendency not to bargain aggressively with the CEO over her pay. This kind of reciprocity is expected and observed in many contexts. For example, if our book were discussed by a particular commentator at a conference, that commentator would less likely be harsh in his criticisms of the book if we were the ones who had invited him to the conference. Not surprisingly, Brian Main, Charles O'Reilly, and James Wade find that compensation committee chairmen who have been appointed after the CEO takes office have tended to reciprocate by awarding higher CEO compensation.⁶⁰

⁵⁹ XXX Give the example of Circon – from Hall Subramanian case study.

⁶⁰ Brian G. M. Main, Charles A. O'Reilly III, and James Wade, "The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives," *Industrial and Corporate Change* 11 (1995): 302-303. Similarly, CEO pay tends to be higher and the CEO is more likely to have a golden parachute when a higher of percentage of

Collegiality and Team Spirit

The directors who negotiate with the CEO over his compensation simultaneously work closely with the CEO, who is generally a fellow member of the board and, at least in the past, has often been its chairman. Whether or not a particular director was appointed during the CEO's reign, that director is likely to develop a personal relationship with the CEO, as well as with the other directors who might be even more close to the CEO.

In addition, except perhaps in times of crisis, the members of the board are expected to act collegially towards one another. According to a director who has served on the boards of several public companies, including Marriott Corporation, "It is hard to explain to a person who is not a director. It is in many ways a club."⁶¹ While each board might have slightly different social rules, these norms tend to foster board cohesion. As Rakesh Khurana observed in his study of CEO hiring, there is on boards, "...a strong emphasis on politeness and courtesy and an avoidance of direct conflict and confrontation."⁶²

Perhaps once or twice a year, members of the compensation committee must take off their hats as colleagues of the CEO and put on their hats as arm's length bargainers with the CEO over his or her compensation. This change is likely to be difficult even for well-meaning directors attempting to represent shareholders' interests in these negotiations. The evidence indicates that individuals working within a group feel pressure to placate group members, often at the expense of interests that are not directly represented at the table.⁶³ There is no reason to believe that the members of the compensation committee are immune to such pressure.

the outside directors have been appointed by the CEO.

⁶¹ Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs* (Princeton, N.J.: Princeton University Press, 2002), p.83.

⁶² *Ibid.*, p.84

⁶³ Melvin A. Eisenberg, "The Compensation of Chief Executive Officers and Directors of Publicly Held Corporations," 7th Annual Corporate Governance Institute, SE39 ALI-ABA (1999): 117-118.

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Authority

The CEO is not merely a colleague of the directors. The CEO is the most important figure in the corporation. She is the leader whose decisions and vision have the most influence on the future direction of the firm. Thus, directors naturally tend to treat the CEO with respect. They accept the CEO's authority on many corporate matters. They may even look up to the CEO.

Furthermore, on many decisions for the company, board members tend to defer to the CEO, rather than overrule her, even when they have a different view. On many issues, the directors' role is to provide strategic advice and serve as a sounding board but not to overrule and make decisions for the CEO. As long as the board wishes the CEO to remain, it makes sense not to force its positions on the CEO but rather to let the CEO be in the driver's seat. And when some directors cannot in good faith continue to support a CEO who has the support of the rest of the board, they are expected to step down.⁶⁴

Again, switching hats to bargain with the CEO over compensation is difficult. Directors who otherwise tend to treat the CEO with respect and defer to her authority will find it difficult to assume a true arm's length bargaining position when negotiating the CEO's pay.

Cognitive dissonance

In 2002, 20 percent of all compensation committee members were current CEOs themselves.⁶⁵ An outside CEO's compensation decisions are likely to be affected by cognitive dissonance.⁶⁶ Individuals are known to develop beliefs that support positions consistent with their self-interest.

⁶⁴ Brian G. M. Main, Charles A. O'Reilly III, and James Wade, "The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives," *Industrial and Corporate Change* 11 (1995): 304.

⁶⁵ Stacey Burke, Glenn Davis, Chris Loayza, Conor Murphy, and Sergio Schuchner, "The Structure and Compensation of Boards of Directors at S&P Super 1500 Companies," in *Board Practices/Board Pay 2002* (Washington D.C.: Investor Responsibility Research Center, 2002), p. 47.

⁶⁶ Graef S. Crystal, *In Search of Excess: The Overcompensation of American Executives*. (New York: Norton, 1991).

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These beliefs enable individuals to avoid the discomfort of enjoying benefits that they believe to be undeserved.

A CEO who herself benefits from generous and favorable pay arrangements is thus likely to have formed a belief that such arrangements are desirable and serve shareholders. For example, a CEO who benefits herself from, say, a conventional option plan is likely to support the view that such plans are an efficient form of compensation. Similarly, a CEO who has or had a compensation agreement with generous severance provisions is unlikely to support the view that such provisions are undesirable or even counter-productive. Thus, the presence of a well-paid outside CEO is likely to lead to higher pay. Indeed, Brian Main, Charles O'Reilly and James Wade find a significant association between the compensation level of outsiders who serve on the compensation committee and CEO pay.⁶⁷

Finally, cognitive dissonance might lead even independent directors who are not CEOs themselves to hold beliefs that are conducive to granting generous executive compensation. Directors will tend to err on the positive side in assessing how well the company is doing relative to its industry peers, how good and well qualified their selected CEO is relative to her CEO peers, and so forth. To be sure, cognitive dissonance might impair not only the thinking of public company directors but also employers who are, say, the sole owners of their firm. But such employers – as 100 percent owners of their own firms -- will bear significant personal costs if they let themselves be influenced too much by cognitive dissonance. In contrast, for most independent directors of public companies, the personal cost of favoring executives is rather small, as we now explain.

The Small Cost of Favoring Executives

Economic incentives as well as psychological and social factors, we have seen, lead independent directors to favor executives. The question, then, is whether there are countervailing forces that make favoring

⁶⁷ Brian G. M. Main, Charles A. O'Reilly III, and James Wade, "The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives," *Industrial and Corporate Change* 11 (1995): 319-320; Charles A. O'Reilly, James Wade, and Tim Pollock, "Overpaid CEO's and Underpaid Managers: Equity and Executive Compensation," working paper, Stanford University and the University of Illinois at Urbana-Champaign (2004).

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executives prohibitively costly for directors. Unfortunately, the potential personal costs to most directors of favoring executives are negligible. These costs can take two forms: (1) reduction in the value of any shares the directors own in the corporation and (2) reputational costs to the directors. We will consider each in turn.

Reduction in the Value of Directors' Holdings

Although stock-based compensation for independent directors is on the rise – 81 percent of S&P 500 firms awarded directors stock or options in 1997⁶⁸ -- the fraction of the company's shares held by the typical independent director remains insignificant.⁶⁹ John Core, Robert Holthausen, and David Larcker found that half of directors in their study owned 0.005 percent or less of the companies on whose boards they sit.⁷⁰ While these figures might go up in the future,⁷¹ most directors are likely to remain holding only a very tiny fraction of the company's shares. One reason for these small magnitudes is that managers prefer it this way. There is evidence that CEOs actually try to reduce the portion of director compensation that is equity-based, in order to further reduce the board's incentive to monitor the CEO's performance.⁷²

As a result, directors commonly bear only a negligible fraction of the cost imposed by distorted compensation arrangements. Consider, for example, a director who owns .005 percent of the company's shares (the

⁶⁸ Charles A. O'Reilly, James Wade, and Tim Pollock, "Overpaid CEO's and Underpaid Managers: Equity and Executive Compensation," working paper, Stanford University and the University of Illinois at Urbana-Champaign (2004) ???

⁶⁹ George P. Baker, Michael C. Jensen, and Kevin J. Murphy, "Compensation and Incentives: Practice vs. Theory," *Journal of Finance* 63 (1998): 614.

⁷⁰ Core, John E., Robert W. Holthausen, and David F. Larcker, "Corporate Governance, Chief Executive Officer Compensation, and Firm Performance," *Journal of Financial Economics* 51 (1999): 371-406.

⁷¹ A case for increasing stock grants to independent directors is presented in Charles M. Elson, "Executive Over-Compensation – A Board-Based Solution," *Boston College Law Review* 34 (1993): 981-983.

⁷² Harley E. Ryan, Jr. and Roy A. Wiggins, III, "Who is in Whose Pocket? Director Compensation, Bargaining Power and Board Independence." *Journal Of Financial Economics*, forthcoming..

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median ownership for directors in the Core-Holthausen-Larcker study). And suppose that the director considers whether to approve a compensation arrangement requested by the CEO that would reduce shareholder value by \$10 million. Given the director's fraction of total shares, the reduction in the value of holdings of the director from going along with the CEO request would be only \$500. Such a cost, or even one that would be many times larger, is highly unlikely to overcome the various factors exerting pressure on the director to go along with the CEO's request.

Note that, although the cost of favoring executives is negligible for most independent directors, it might not be so trivial for independent directors who own (or are appointed by those owning) a large block of shares. Such directors will bear more of the cost associated with inefficient compensation arrangements and will be more likely to oppose them. This fact likely accounts for the findings, to be discussed in chapter 5, that CEO pay is lower, and the sensitivity of CEO pay to firm performance is higher, when the compensation committee members hold a large amount of stock.⁷³

Reputational Costs

In theory, directors who approve compensation arrangements that benefit managers at the expense of shareholders could suffer a reputational cost. Two prominent financial economists, Eugene Fama and Michael Jensen, have argued that independent directors have an incentive to safeguard shareholder interests in order to preserve and enhance their reputations as experts in decision control.⁷⁴ Fama and Jensen have in mind those independent directors who are CEOs or hold other decision-making positions. For such directors, the value of their human capital would depend on their decision-management reputation. According to the Fama-Jensen view, by being effective guardians of shareholder value, independent directors can signal their expertise in decision control and boost the value of their human capital in their primary career. Furthermore, it can be argued

⁷³ Richard M. Cyert, Sok-Hyon Kang, and Praveen Kumar, "Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence," *Management Science* 48 (2002): 453-469.

⁷⁴ Eugene F. Fama and Michael C. Jensen, "Separation of Ownership and Control," *Journal of Law and Economics* 26 (1983): 301-325.

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that developing reputation as effective guardians of shareholder interests will improve directors' chances of landing directorships in other companies.

We agree that directors' reputations and human capital, both in their primary positions and in the market for directors, could suffer should the board approve compensation arrangements that are subsequently be regarded as egregious. For example, following the Enron scandal, outrage was directed against certain members of the Enron board.⁷⁵ Some Lockheed Martin shareholders opposed the re-election to their board of one former Enron board member, Frank Savage, and there were calls for Dr. John Mendelsohn, another former Enron director, to step down from his position as head of the M.D. Anderson Cancer Center. In the end, Savage was re-elected to the Lockheed Board, and Mendelsohn remained head of M.D. Anderson Cancer Center. Still, outrage undoubtedly did impose some costs on these two directors. Indeed, anticipation of such costs may explain why Enron directors Wendy Gramm, Robert Jaedicke, and Herbert Winokur Jr. resigned from other board positions.⁷⁶ As we will discuss in chapter five, concerns about reputational costs arising from egregious compensation arrangements might place some limit on how far directors will be willing to go in favoring executives.

However, as long as pay arrangements are within the range of what is considered conventional and acceptable, directors who have gone along with arrangements favorable to executive have been unlikely to bear reputational costs. To begin, with respect to a director who is a CEO or executive of another firm, the compensation decisions of the board on which she served as a director are unlikely to influence, or even be noticed by, those who might in the future seek to her as an executive of another firm. Prospective employers are unlikely to have much information about the contribution of a particular independent director to a company's compensation arrangements. More importantly, prospective employers would likely focus on the director's performance in her primary, full-time positions rather than on her performance in an independent directorship.

The performance of an individual independent director would probably be of most interest to those considering appointing the director to

⁷⁵ See, e.g., Geeta Anand, "Double Trouble: Ties to Two Firms Tainted by Scandal Haunt Top Doctor," *Wall Street Journal*, 24 December 2002, p. A1.

⁷⁶ See, e.g., Joshua Green, "Savage Business," *American Prospect* 13 (June 2002): 14-15.

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the board of another corporation. Here, however, earning a reputation for challenging CEO compensation has been unlikely to help, and if anything has been likely to hurt, the director's prospects of securing appointments to other boards. Recall that the key to a board seat is in being included on company's slate, which is put together by the board and its nominating committee. As discussed, a reputation for challenging CEO compensation has been viewed as a minus, not as a plus, by nominating committees.

The absence of reputational incentives to guard shareholder interests in the compensation context is thus a product of the director selection process. We support reform that would give shareholders meaningful opportunities to select directors. Such reform could create incentives for directors to serve shareholders rather than executives. For now, however, we cannot count on the reputational mechanism to counter directors' personal incentives and natural inclinations to side with executives.

Insufficient Time and Information

Even independent directors who for some reason wished to serve shareholders' interests in bargaining over the CEO's pay have usually lacked the time and information to do so.⁷⁷ Being an independent director is a part-time job. Most independent directors have had their own full-time careers. They have spent little time focusing on the performance of the corporations on whose boards they sit. Surveys of board practices prior to the recent wave of corporate scandals indicated that they spent only about 100 hours per year performing work for each board.⁷⁸ Indeed, as Rakesh Khurana documents in his book on CEO hiring, boards have spent surprisingly little time even when confronted with the critical task of selecting a new CEO.⁷⁹

The time that independent directors devote to their directorship has been increasing. But one should keep in mind that the Sarbanes-Oxley Act,

⁷⁷ See, for example, Brian G. M. Main, Charles A. O'Reilly III, and James Wade, "The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives," *Industrial and Corporate Change* 11 (1995): 302-303.

⁷⁸ Jay W. Lorsch and Krishna G. Palepu, "Limits to Board Effectiveness," working paper, Harvard Business School, 2003, p.3.

⁷⁹ Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs* (Princeton, N.J.: Princeton University Press, 2002), pp. 81-118.

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and the increased formalization of board processes, have also created additional demands on directors' time. Due to these demands, part-time independent directors will still be expected to spend a rather limited amount of time on the design and approval of complex compensation arrangements. In a "best practices calendar" that one prominent law firm issued to its clients for corporate boards that the compensation committee meet three days during the year, twice during January and once in November.⁸⁰

In addition to facing time constraints, many directors often do not have the knowledge and expertise that is needed to properly evaluate the compensation arrangements they are asked to approve. According to Jeffrey Sonnenfeld, Associate Dean of Yale's School of Management, "I work with several compensation committees, and I know that a lot of time board members don't understand the complexity of the documents they're reviewing. People don't want to look foolish by asking how some of the instruments work."⁸¹

In reaching compensation decisions, independent directors have thus generally had to rely on information and advice provided by the firm's human resources department and by compensation consultants hired by this department, and this reliance has further tilted matters in favor of executives.⁸²

Compensation Consultants

Directors have incentives and tendencies that would tend to produce outcomes favorable to executives even if the information and advice provided to the directors were done by individuals focusing solely on shareholder interests. But the providers of information and advice have had themselves incentives to favor executives. This has been the case not only with respect to firms' human resources department, which are subordinate to the CEO, but also with respect to compensation consultants. Compensation consultants have had a strong incentive to please, or at least

⁸⁰ "Best Practices Calendar for Corporate Boards and Committees," Sidley Austin Brown & Wood LLP (September 2002), p.2.

⁸¹ Patrick McGeehan, "Quick: What's the Boss Making?," New York Times, 21 September 2003, Section 3, p.1

⁸² Graef S. Crystal, *In Search of Excess* (New York: Norton, 1991).

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not to anger, the CEO. Warren Buffet recently remarked that compensation consultants "had no trouble perceiving who buttered their bread."⁸³

Typically, consultants have been hired through a firm's human resources department, and CEOs have often been involved in the selection process.⁸⁴ Even if the CEO has not been involved, the chosen consultant has understood that a recommendation that displeases the CEO may preempt future employment. Moreover, executive pay consultants have usually worked for consulting firms that derived most of their income from other services to the human resource department of firms. The consulting firms often had, or at least could expect to get in the future, other assignments with the hiring company. One compensation consultant commented: "There are two classes of clients you don't want to offend - actual and potential."⁸⁵

Finally, because their income has not been linked to shareholder value, compensation consultants have not borne any of the costs that favoring managers imposed on shareholders; consultants could have only benefited from using their discretion to favor the CEO. Two directors interviewed by *Fortune* under conditions of anonymity described the overall incentive structure of consultants in a rather blunt way:

"I would say that it is unusual to find a consultant who does not end up, at the least, being a prostitute. The consultants are hired by management. They're going to be rehired by management."

"Any other kind of consultant you can think of is brought in to try to cut costs. [However], the basic goal of compensation consultants is to justify whatever it is the CEO wants to make. After all, who's going to recommend these consultants to other CEOs?"⁸⁶

⁸³ Warren Buffett, Letter to Shareholders of Berkshire Hathaway Inc., included in the Annual Report to the Shareholders of Berkshire Hathaway Inc., February 2004.

⁸⁴ For an insider's account of the use of compensation consultants to justify executive pay, see Graef S. Crystal, *In Search of Excess: The Overcompensation of American Executives* (New York: Norton, 1991).

⁸⁵ This quote is reported in Warren Buffett, Letter to Shareholders of Berkshire Hathaway Inc., included in the Annual Report to the Shareholders of Berkshire Hathaway Inc., February 2004, at p. 8.

⁸⁶ Carol J. Loomis, "This Stuff is Wrong," *Fortune*, 25 June 2002, p.74.

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Compensation consultants' incentives are important because they have substantial discretion in performing their tasks. Consultants provide the data that underlie directors' compensation decisions, frame the issues, and put forward options. The limited time that directors have to devote to compensation decisions, and their lack of information and expertise, leads them to rely heavily on consultants' input. Thus, a tilt in favor of executives on the part of compensation consultants could produce outcomes favorable to executives even if directors themselves had no incentives and tendencies to favor executives.

Among other things, consultants can favor the CEO by generating a mass of compensation data that "objectively" justifies the desired pay plan. For example, they have tended to design surveys to focus on comparative data that help make the case for higher pay.⁸⁷ When a firm did well, consultants pushed for high compensation, arguing that pay should reflect performance, and should therefore be higher than the industry average and certainly higher than the pay of CEOs who are doing poorly. When a firm did poorly, the consultants looked not to performance but rather to peer group pay norms to argue that the salary of the CEO should be higher to reflect prevailing salaries.

In the future, compensation consultant may well be hired formally by compensation committees rather than human resources departments. The NYSE's new listing requirements require that the charter of the compensation committee provide it with the sole authority to retain the compensation consultant assisting it in evaluating executive compensation.⁸⁸ However, the human resources department might be a source of recommendations for such a consultant. And given that consultants make most of their money providing services to human resources departments, they will continue to have strong incentives to make a favorable impression on the human resources department and to avoid annoying the CEO. Thus, the reforms might reduce, even though not eliminate, the additional tilt produced by compensation consultants.

In any event, the most that the new reforms can hope to accomplish is to make consultants pay attention only to the wishes of the compensation

⁸⁷ See Stuart Gillan, "Has Pay for Performance Gone Awry: Views from a Corporate Governance Forum," *Research Dialogue* 68 (2001): 1-16.

⁸⁸ See commentary to NYSE Listed Company Manual Rule 303A(5)(b)(ii).

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committee and not to those of the executives. The compensation consultants cannot be expected to have direct incentives to focus on the interests of shareholders. Thus, to the extent that directors continue to have incentives and tendencies to favor executives, consultants can be expected to assist them in doing so.

Newly Hired CEO's

Boards approve CEO compensation both during the CEO's tenure and when the CEO is hired. In a critique of our earlier work, Kevin Murphy argued that, even if there is no arm's length bargaining between boards and continuing CEOs, such bargaining has taken place when new CEOs were hired, especially when they were hired from outside the company.⁸⁹ In our view, although negotiations with new, outside CEOs might have been closer to the arm's length model than negotiations with incumbent CEOs, they still have deviated substantially from that model.

To be sure, some of the social and psychological factors leading directors to favor incumbent executives are absent when directors negotiate compensation arrangements with prospective outside hires. The CEO candidate was not involved in appointing any of these directors to the board. Thus, the directors would not feel the sense of obligation and loyalty that they would feel to a CEO who supported their appointment to the board. In addition, the familiarity and collegiality that come with serving together on a board will not yet have developed.

It is nevertheless likely that bargaining over the candidate CEO's compensation has been far from arm's length. Given that the CEO candidate will, if the negotiations are successful, be the next CEO, a director still has considerable incentive to please the candidate. The next CEO will have influence over the likelihood of the director's re-election and over the level of director compensation. In addition, she will be in a position to reward directors she favors.

Further, some of the social and psychological factors that cause directors to favor incumbent CEOs are equally present in compensation negotiations with a new CEO. Since directors will anticipate working closely

⁸⁹ Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options," *University of Chicago Law Review* 69 (2002): 847.

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with the incoming CEO, they will naturally want to get things off to a pleasant, collegial start. The self-serving cognitive biases that lead directors who themselves are well-paid executives to be generous with CEOs will apply equally in the case of a newly hired CEO. And the financial cost to most directors of being generous to their new colleague and leader remains extremely low. Because directors typically own only a tiny fraction of the firm's stock, they bear an insignificant portion of the cost associated with compensating the CEO, whether the CEO is incoming or incumbent.

Finally, the time and information constraints that limit even the abilities of well-intentioned directors to bargain with incumbent CEOs apply equally to board negotiations with an outsider. As Rakesh Khurana documents, directors are far from thorough even when selecting a new CEO.⁹⁰ The choice of CEO is often a more important factor for the future performance of the firm than is the particular pay arrangement with which the CEO starts. If directors put little effort into choosing the new CEO, they are unlikely to put much effort into bargaining over the CEO's compensation.

Furthermore, as in the case of incoming CEOs, time constraints would force directors considering the new CEO's pay to rely on the information and advice provided by the firm's human resources department and its compensation consultant. Members of the department know that the person for whom they are designing the plan soon will be their boss. The compensation consultant knows that the CEO will influence the decision about whether to continue using that consultant. Thus, both the human resources department and the consultant have an incentive to use their discretion to favor the CEO.

Lastly, given the negative scrutiny that will be applied to the board if it fails to hire a replacement CEO in a timely fashion, it is in the directors' interest to sacrifice hard bargaining to expedience. Acceding to the candidate's compensation demands minimizes the risk of offending the candidate or creating the impression that the board will be a tough taskmaster, increasing chances that the candidate will accept the offer. The board will not want to appear to have bungled the search by "losing" the person they thought was best suited for the job. In addition, the board will

⁹⁰ Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs* (Princeton, N.J.: Princeton University Press, 2002).

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wish to complete the search process as quickly as possible. At the same time, the cost to directors of giving in to a CEO candidate's extravagant compensation demands is trivial, given their tiny stakes in the firm. Thus there is little to be gained, and much to lose, from being a tough bargainer. In contrast, the CEO candidate has every incentive to hold out for higher and less performance-sensitive pay in order to ensure that she will be well-paid even when firm performance is poor. The combination of these factors is likely to be an important reason that pay packages to newly hired CEOs are so generous.

The (Infrequent) Firing of CEO's

The incidence of board firing of CEOs in the 1990s was somewhat higher than in earlier decades. This change has been attributed to the increased role of independent directors.⁹¹ The willingness of certain boards to fire poorly performing CEO's has received a fair amount of attention and has been regarded as a sign of improved corporate governance.⁹²

Critics of our earlier work, such as *Wall Street Journal* columnist Holman Jenkins, have suggested that the increased willingness of boards to fire CEOs provides evidence that boards do in fact deal with CEOs at arm's length.⁹³ If boards are willing to go as far as firing CEOs, it is argued, surely they are capable of negotiating at arm's length over compensation. But the phenomenon of forced CEO resignations fails to demonstrate the existence

⁹¹ Michael S. Weisbach, "Outside Directors and CEO Turnover," *Journal of Financial Economics* 20 (1998): 453-454. More narrowly focused industry studies also find that the presence of inside directors reduces the likelihood that poorly-performing CEO's will be fired. For example, Warren Boeker finds that the likelihood that a poorly performing CEO of semiconductor firm will be replaced decreases as the percentage of inside directors increases. See Warren Boeker, "Power and Managerial Dismissal: Scapegoating at the Top," *Administrative Science Quarterly* 37 (1992): 400-418. Not surprisingly, firms in which the CEO is also chairman of the board are less likely to fire the CEO for poor performance. Vidhan K. Goyal and Chul W. Park, "Board Leadership Structure and CEO Turnover," *Journal of Corporate Finance* 8 (2002): 49-66.

⁹² Denis B. K. Lyons, "CEO Casualties: A Battlefield Report," *Directors & Boards* (Summer 1999): 43-45.

⁹³ Holman W. Jenkins, "Outrageous CEO Pay Revisited," *Wall Street Journal*, 2 October 2002, p. A17.

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of an arm's length relationship between managers and boards, let alone the existence of arm's length bargaining over compensation.

It is important to keep in mind that the incidence of firing is still extremely low. A study of more than one thousand companies found that between 1993 and 1999, each year fewer than 1 percent of all CEOs resigned or were forced out because of poor performance.⁹⁴ Another study of CEO turnover finds that the turnover of CEOs in subsidiaries is significantly more sensitive to performance than the turnover of CEOs of similar stand-alone public firms.⁹⁵ Managers usually have to perform dismally in order to be fired. For the board to take such a step, there must usually be substantial outside pressure of the kind produced by a highly significant and visible managerial failure.

Moreover, as we will discuss in detail in chapter seven, in the rare cases where CEOs are asked to resign, the board often provides them with gratuitous goodbye payments – payments and benefits on top of those required by the CEO's contract -- to sweeten the departure. Whether these gratuitous payments are necessary to overcome the resistance of some of the directors to do anything that would hurt the CEO, or whether they serve to alleviate the board's discomfort with forcing out the CEO, their frequent use in cases where CEOs are asked to leave suggests that directors are not dealing with the CEO at arm's length.

Even if some boards can make detached decisions to fire CEOs in "crisis" situations, this is hardly proof that boards regularly make detached decisions about "business as usual" matters, such as pay arrangements. When a corporation performs dismally, there might be substantial outside pressure on directors to solve the problem. Directors might fear that doing nothing would be such a clear and visible dereliction of their duties that it would invite embarrassing public criticism. When the personal stakes are that high, the incentives to fire management can overcome the social, collegial and psychological factors that normally make directors reluctant to

⁹⁴ Narayanan Subramanian, Atreya Chakraborty, Shahbaz Sheikh, "Performance Incentives, Performance Pressure, and Executive Turnover," working paper, Brandeis University, 2003.

⁹⁵ See Chris McNeil, Greg Niehaus, Eric Powers, "Management Turnover in Subsidiaries of Conglomerates Versus Stand-alone Firms, working paper, School of Business, Penn State Erie and Moore School of Business, University of South Carolina (2003).

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displease the CEO. There is, however, little risk of such outrage when the board is asked to approve compensation that is not obviously excessive.

Better and Worse Pay-Setting Processes

Although the pay-setting process has departed from arm's length bargaining in most widely-held public companies, this process has likely worked better in some companies than in others. The myriad factors impeding arm's length bargaining – managers' influence over director appointment, managers' ability to reward cooperative directors, the social and psychological forces leading directors to favor managers, the limited costs to directors of being cooperative, and the time and informational barriers that impede arm's length negotiation – vary from company to company. The stronger these factors are in aggregate, the larger will be the departure from arm's length bargaining. In chapter six, we present evidence that CEO pay is higher and less sensitive to performance when the CEO has relatively more influence over directors.

In the same way that the magnitude of departures might vary among companies, it might also change over time. The factors impeding arm's length contracting are in part a product of legal rules and corporate practices. With the rules and practices that we have had to date, directors have remained subject to a myriad of incentives and forces that have prevented them from bargaining at arm's length with the CEO over pay.

The future, of course, might be different from the past. Indeed, some now take the view that, even though the pay setting process has until now not been characterized by arm's length negotiation, the 2003 stock exchange listing requirement revisions regarding independent directors will move this process sufficiently close to the arm's length ideal. As we have seen, however, the modifications of stock exchange listing requirements weaken but fail to eliminate the various factors that have until now led directors to favor executives at the expense of shareholder interests.

Notwithstanding the changes in the listing requirements, independent directors will still find avoiding conflict with the CEO to be the safest strategy for being re-elected to the board and otherwise rewarded by the CEO through the various channels that still remain at her disposal. The social and psychological factors of friendship, collegiality, loyalty, team spirit, and natural deference to the firm's leader will continue to operate on

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many directors. And there will be little to counter these incentives and tendencies, given the small personal cost that favoring executives imposes on most directors.

Corporate governance experts writing in the late 1990's suggested that the increased dominance of independence of directors during the 1990s had already made boards effective in overseeing CEO performance.⁹⁶ As we have seen, however, substantial deviations from arm's length contracting have remained. Current predictions that the new stock exchange requirement will restore arm's length bargaining, we believe, will also prove unwarranted. In chapters fifteen and sixteen, we propose reforms that could considerably improve matters. For now, however, we conclude that the executive compensation landscape has been very much shaped, and for now will continue to be significantly affected, by CEO's influence over corporate directors.

⁹⁶ See, for example, Ira M. Millstein and Paul W. MacAvoy, "The Active Board of Directors and Performance of the Large Publicly-Traded Corporation," *Columbia Law Review* 98 (June 1998): 1283-1321; Mark J. Loewenstein, "The Conundrum of Executive Compensation," *Wake Forest Law Review* 35 (2000): 15.

CHAPTER 3: SHAREHOLDERS' LIMITED POWER TO INTERVENE

Having seen that boards have not been bargaining at arm's length with executives, we now turn to the question of whether other constraints nevertheless compel boards and executives to adopt the same kind of pay contracts that arm's length negotiations should theoretically produce. We discuss market forces in the subsequent chapter, and we focus on shareholder power to intervene in this chapter.

In particular, shareholders have sought to constrain executive compensation arrangements in three ways – by (i) suing the board, (ii) voting against employee stock option plans, and (iii) putting forward shareholder resolutions. As we explain below, none of these methods has imposed significant constraints on compensation practices.

Litigation

We do not believe that the problems of executive compensation can be addressed by judicial intervention. Courts are simply ill-equipped to judge the desirability of compensation packages and policies. To understand the contemporary compensation landscape, however, one must realize that courts in fact *have* avoided involvement in the design of compensation arrangements and that the option to seek protection from courts has not in practice been available to shareholders.

In theory, shareholders can challenge inefficient executive compensation packages in court as violations of the directors' and officers' fiduciary duties to the shareholders. If such a case were initiated, however, a court would be highly unlikely to review the substantive merits of the specific compensation arrangement. As a practical matter, judicial review has failed to impose any constraint on executive pay. In fact, a 1992 study found that courts in almost all cases since 1900 have refused to overturn compensation decisions made by the boards of publicly traded firms.⁹⁷

Under the well-established business judgment rule, courts defer to and refuse to review the substantive merits of board decisions as long as these satisfy certain process requirements. In the case of executive

⁹⁷ See Linda J. Barris, "The Overcompensation Problem: A Collective Approach to Controlling Executive Pay," *Indiana Law Review* 68 (1992): 82.

compensation, if nominally independent and informed directors approve the arrangement, their decision receives the protection of the business judgment rule. Furthermore, courts have not been particularly demanding when determining whether directors' decision-making in fact satisfied the process requirements. Courts have generally allowed business judgment protection whenever a package has been considered and approved by a compensation committee composed of independent directors who received some materials or presentations from inside or outside compensation experts.

As long as a decision satisfies the undemanding process requirements, then, the business judgment rule implies that courts will generally refuse to consider arguments that the approved package was unreasonable. The only argument that courts are willing to hear is that a given compensation package was so irrational that no reasonable person could approve it and it therefore constitutes "waste."⁹⁸ This standard is an "extreme test, [that is] rarely satisfied by a shareholder plaintiff."⁹⁹ Indeed, a well known judge states that cases in which it is possible to demonstrate "waste," like the Loch Ness Monster, are so rare as to be possibly non-existent.¹⁰⁰

Because arguments of some sort generally, can be made even for plans that are highly undesirable, the standard for judicial intervention is extremely difficult to meet. In fact, Professor Mark Lowenstein reports that there have been almost no appellate court decisions involving a publicly traded company that affirm an order to reduce managerial compensation on the theory of gift or waste.¹⁰¹

For the sake of completeness, we should note that shareholders who wish to challenge an executive compensation arrangement also face procedural barriers that make it extremely difficult even to get their substantive claims heard. Excessive compensation does not hurt shareholders directly; it hurts them indirectly, through their equity interests

⁹⁸ See *Brehm v Eisner*, 746 A2d 244, 259-63 (Del 2000).

⁹⁹ See *Zupnick v. Goizueta*, 698 A. 2d 384 (Del. Ch. 1997).

¹⁰⁰ See *Steyner v. Meyerson*, C.A. No. 13139, 1995 WL 441999 (Del. Ch.1995).

¹⁰¹ Mark J. Loewenstein, "Reflections on Executive Compensation and a Modest Proposal for (Further) Reform," *Southern Methodist University Law Review* 50 (1996): 201-223.

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in the firm. Under corporate law, shareholders in such cases generally must file what is called a “derivative suit” – a suit brought on behalf of the corporation. Because the board, not shareholders, generally makes decisions on behalf of the corporation—including decisions to initiate a lawsuit—the courts have severely restricted shareholders’ ability to proceed with a derivative suit.

A major procedural restriction is the “demand requirement,” which forces shareholders to demand formally that the board investigate and correct the given problem before they initiate a lawsuit. If “demand” is not made, the board can usually have the case dismissed.¹⁰²

If the shareholders demand that the board pursue the litigation, however, the board then takes control of the lawsuit and usually seeks to dismiss it. If the board appears to have acted independently and to have conducted a reasonable investigation of the allegations, the court will respect the board’s decision to terminate the litigation, thus ending the legal challenge to the board’s original compensation decision. As a result, the only way shareholders can proceed with litigation is by circumventing the demand requirement. To do this, they must convince the court that demand is “futile.”

To establish demand futility, the plaintiff must present “particularized facts” that create a reasonable doubt that the directors are disinterested and independent. This requirement is difficult to satisfy in general, and nearly impossible to satisfy in the early stages of litigation, when the plaintiff has not had the opportunity to conduct “discovery,” that is, to take depositions from the defendants and require them to hand over relevant documents.

Finally, even when shareholders satisfy the demand futility requirement, the board can still appoint a “special litigation committee” of independent directors (possibly even new independent directors appointed for this purpose) to consider whether continuation of the suit is in the “best interest” of the firm. If the committee recommends termination, the court will likely defer to this decision and dismiss the suit. All in all, there are many procedural hurdles to overcome before a court will decide claims involving executive compensation, and even then, the shareholders must

¹⁰² See Randall S. Thomas and Kenneth J. Martin, “Litigating Challenges to Executive Pay: An Exercise in Futility?” *Washington University Law Quarterly* (2001): 576-579.

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actually win on the merits, a daunting task given courts' deference to the business judgment of directors.

A 2003 decision by the Delaware Supreme Court involving the Disney company has received a great deal of attention and has been viewed by some as signaling a change in the judicial attitude to compensation arrangements.¹⁰³ The case involves Michael Ovitz, who left Disney after serving for less than a year as president. Although his performance was widely regarded as a failure, he walked out with a package valued at more than \$100 million thanks to a counter-productive no-fault termination clause. Under this clause, as long as Ovitz's behavior did not amount to "malfeasance," termination following poor performance still entitled him to receive as much compensation as if he had served his full contract.

The Delaware court approved the decision of the lower court not to hear arguments that the package was undesirable because of the perverse incentives it provided to Ovitz. But the court did give plaintiffs an opportunity to submit to the lower court an amended complaint based on flaws in the compensation process. When plaintiffs then unearthed evidence about the egregiously careless way in which the compensation committee approved the package, the lower court permitted the case to proceed to trial, and this decision was viewed as a great victory for the shareholder plaintiffs.

Although this litigation may recover some value for Disney's shareholders, it in fact highlights the considerable limits to judicial involvement in this area. The case does not signal any willingness on the part of courts to review the substantive merits of compensation arrangements. Rather, the case was permitted to proceed only because of unique circumstances that suggested egregious carelessness. In the future, boards can easily ensure that these circumstances do not arise. The Disney plaintiffs unearthed evidence suggesting that the compensation committee approved the arrangement after spending a small fraction of a one-hour meeting on it, without receiving any materials in advance or any recommendations from an expert, and without even seeing a draft of the agreement. Thus, the case suggests only that courts may be willing to hear cases against directors who lack a paper record showing even a minimal level of deliberation and seriousness. As long as the compensation committee receives relevant materials and spends some time examining

¹⁰³ *In re Walt Disney Co. Derivative Litig.*, 825 A. 2d 275 (Del. Ch. 2003).

them, however, courts have not shown any indication of abandoning their long-standing (and understandable) reluctance to constrain the discretion of the directors in shaping compensation packages.

Voting on Option Plans

In 2003, the SEC approved revisions to NASDAQ and NYSE rules that will require a shareholder vote on most stock option plans. At least in theory, then,, shareholders of firms listed on these two exchanges now have an opportunity to influence executive compensation when they vote on stock option plans.

Even before shareholder voting on option plans became mandatory, however, shareholders have voted on most stock option plans.¹⁰⁴ In many cases, shareholders had the right under state corporate law or stock exchange rules to approve or reject equity-based compensation plans. Shareholders of firms incorporated in New York, for example, have the right to vote on all stock option plans. The corporate statutes of all states require shareholder approval of the corporate charter, and the implementation of some stock option plans has required increasing the number of authorized shares. Finally, the stock exchanges had pre-existing rules requiring shareholder approval of stock option plans that were not broad-based.

In addition, even when firms were not required to put option plans to shareholder vote, they often chose to do so. Firms wishing to deduct option compensation when an executive's total annual compensation exceeds \$1 million must put the option plan to shareholder vote. Section 162(m) of the Internal Revenue Code disallows deductions of compensation exceeding \$1 million per year unless the compensation is "performance-based," and one of the requirements for a performance-based option plan is that it receive shareholder approval. Thus boards seeking to preserve the deductibility of executive compensations often have allowed shareholders to vote on option plans even though such a vote was not required by corporate statute or stock exchange rules. Even before Section 162(m) was enacted, in fact, boards often allowed shareholders to vote on option plans because such

¹⁰⁴ Telephone conversation on August 6, 2003, with Ally Monaco and Annick Dunning of IRRC. Annick Dunning conducted a study for the IRRC in which she found that only 40 percent of S&P 500 firms and 35 percent of S&P 1500 firms had stock option plans that were not approved by shareholders.

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ratification gives directors substantial protection from fiduciary duty suits relating to the firm's use of employee options.¹⁰⁵

Unfortunately, shareholder voting on option plans has not provided a strong impediment to deviations from arm's length bargaining. For starters, the plans on which shareholders vote generally do not specify the design of a particular executive's compensation. Instead, they set out general parameters for the use of stock options, such as the total number of options that can be issued under the plan. Shareholders cannot reject or approve a particular executive's pay package.

To be sure, shareholders have been able to reject an option plan to protest inappropriate CEO compensation. But they could have hardly been able to rely on such rejection to make them better off. To begin, when shareholder ratification of a plan is essential to executive retention, vetoing a plan would likely lead to a management crisis. In addition, failure to ratify might lead the board to provide executives with additional compensation in ways likely to be even more inefficient and costly for shareholders. A board can easily switch to arrangements that are similar to options but do not require the issuance of actual securities, such as share appreciation rights. These promise executives future cash payments based on the appreciation of the company's stock price. Perhaps worse, the board can offer compensation that is not equity-based at all, such as large cash bonus plans. As we will discuss in chapter ten, such plans are often highly insensitive to performance.

Furthermore, in those cases in which shareholder approval was needed primarily to enable the firm to obtain a tax deduction, shareholders would have shot themselves in the foot had they reject the option plan. The board would have been still able to grant the options, and the firm would have simply lost the tax deduction. Indeed, proxy materials distributed in connection with such votes have generally put shareholders on notice that the board may grant options without shareholder approval, and institutional investors have generally assumed that the board was prepared to do so.¹⁰⁶

¹⁰⁵ See Randall S. Thomas and Kenneth J. Martin, "The Determinants of Shareholder Voting on Stock Option Plans," *Wake Forest Law Review* 35 (2000): 46-51.

¹⁰⁶ For an example of proxy materials suggesting that the only effect of the shareholder vote will be to determine whether or not the firm can deduct executive compensation that the firm will pay in any event, see Finova Group Inc., Schedule 14A filed on April 2, 1997; Home Depot Schedule 14A filed on April 19, 2002.

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Although in the future firms will not be able to threaten to grant options anyway, shareholders will likely remain concerned about the possibility that rejection of the option plan would lead to worse compensation arrangements, such as cash-based plans that would be less sensitive to performance.

It is also worth noting that current voting processes in publicly traded companies have built-in biases toward management-sponsored proposals. Given the difficulty of collective action, it is rarely worthwhile for any given shareholder to expend significant resources to campaign against a proposed option plan. In contrast, the firm covers whatever expenses are incurred in soliciting proxies for the company's proposals.

Furthermore, managers have been able to count on certain votes beyond their own. Many firms have an employee stock option plan (ESOP), and the management-appointed trustee who controls the voting of those shares can generally be expected to vote for management-sponsored proposals. In addition, as is now widely recognized, institutional investors' votes are biased in favor of management.¹⁰⁷ Many such investors, including insurance companies, mutual funds, and banks, have or hope to have business dealings with the firm: for example, managing its employee retirement accounts. Thus, besides seeking to increase the value of the portfolios they manage, such funds have an additional interest in being on good terms with management. Indeed, there is evidence that the tighter the business ties between institutional investors and a firm, the higher its CEO's compensation is.¹⁰⁸

¹⁰⁷ Recognition of this fact led the SEC in 2003 to require mutual funds to disclose all of their votes. See Investment Advisers Act Release No. 2106 (January 31, 2003); Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies; Securities and Exchange Commission, 7 CFR Parts 239, 249, 270, and 2; Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02; RIN 3235-AI64. Because investors base their choices of funds on investment performance, not on how funds vote in corporate governance matters, we do not expect this disclosure requirement to eliminate funds' pro-management bias in voting decisions. In our view, the most effective way to eliminate bias would be to require strictly confidential shareholder voting.

¹⁰⁸ David Parthiban, Rahul Kochar, and Edward Levitas, "The Effect of Institutional Investors on the Level and Mix of CEO Compensation," *Academy of Management Journal* 41 (1998): 200-208.

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Given that a particular money manager's vote is unlikely to be pivotal, and that whatever benefits may arise from voting for efficient compensation will largely be captured by other investors, the money manager's other business interests may substantially influence voting decisions. This problem received great media attention in connection with the HP-Compaq merger in 2002. In that case, accusations arose that Deutsche Bank cast its portfolio votes in favor of management because of its business with the company.¹⁰⁹ Because executive compensation is a matter especially dear to management's heart, and voting against an option plan provides at most a limited benefit to shareholders, institutional investors are unlikely to oppose management.

Until 2003, managers could also count on broker support in votes on certain option plans – those that did not involve more than 5 percent of the firm's outstanding shares.¹¹⁰ The stock exchanges permitted brokers to vote a customer's shares in connection with such plans and other "routine" management proposals when the customer did not provide specific instructions on how to vote. As a result, brokers typically voted 10 percent to 15 percent of outstanding shares and almost uniformly voted with management.¹¹¹ Two researchers studying broker voting estimated that brokers provided the swing vote in about 12 percent of routine stock option plan proposals.¹¹² In 2003, the SEC approved amendments to the NYSE's rules on broker voting that effectively prohibit broker voting on all U.S. stock exchanges in connection with equity compensation plans. Thus, managers can still look to the ESOP trustee and institutional investors for support on management stock option proposals, but not to brokers.

Consistent with the above analysis, only 1 percent of option plans put to a vote in the past has failed to obtain shareholder approval.¹¹³ Thus,

¹⁰⁹ Pui-Wing Tam, "Hewlett Sues, Seeking to Foil Compaq Deal," *Wall Street Journal*, 29 March 2002, p. A3.

¹¹⁰ Jennifer E. Bethel and Stuart L. Gillan, "The Impact of the Institutional and Regulatory Environment on Shareholder Voting," *Financial Management* 31 (2002).

¹¹¹ See Stuart L. Gillan, "Option-Based Compensation: Panacea or Pandora's Box?" *Journal of Applied Corporate Finance* 14 (2001): 124.

¹¹² Jennifer E. Bethel and Stuart L. Gillan, "The Impact of the Institutional and Regulatory Environment on Shareholder Voting," *Financial Management* 31 (2002).

¹¹³ Randall S. Thomas and Kenneth J. Martin, "The Determinants of Shareholder Voting on Stock Option Plans," *Wake Forest Lake Review* 35 (2000): 58-59.

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shareholder voting on option plans has been a weak constraint on compensation arrangements. And although recent stock exchange requirements will strengthen this constraint somewhat, shareholder voting will still be unlikely to eliminate substantial departures from arm's length arrangements in the future.

Voting on Precatory Resolutions

In addition to voting on some option plans, shareholders have also been able to initiate and offer for shareholder vote "precatory" resolutions on corporate matters. Some of these resolutions have focused on executive compensation.¹¹⁴ However, such resolutions are not binding on the board, and most of them have not been implemented by the board.¹¹⁵

Until recently, most of the precatory resolutions on executive compensation have been offered by social or labor activists. A substantial fraction proposed drastic measures, such as low ceilings on executive pay or the elimination of options. Given that institutional investors have not favored such measures, it is not surprising that executive compensation resolutions have, on average, received little support.¹¹⁶ In recent years, more precatory resolutions have called for changes that institutional investors favor, such as expensing stock options, and such proposals have received growing support.¹¹⁷

¹¹⁴ See Brian R. Cheffins and Randall S. Thomas, "Should Shareholders Have a Greater Say over Executive Pay?: Learning from the U.S. Experience," *Journal of Corporation Law Studies* 1 (2001): 301. Cheffins and Thomas report that in the 2000 proxy season, stockholders in 83 of the 1,000 leading U.S. public companies filed a precatory proposal relating to executive compensation.

¹¹⁵ See Tom Petrino, "Activist Investors Making Inroads," *Los Angeles Times*, 18 May 2003, Part 3, p.1. According to data collected by Institutional Shareholder Services, among resolutions that received majority support, only about 10% were implemented until recently. The percentage of implementation has increased, but it still about 30%. We are grateful to Patrick McGurn, Vice-president of Institutional Shareholder services, for providing us with these figures.

¹¹⁶ See Kenneth J. Martin and Randall S. Thomas, "Should Labor Be Allowed to Make Shareholder Proposals," *Washington Law Review* 73 (1998): 41, 68, 76.

¹¹⁷ See Andrew Countryman, Board Term Battle Heats Up: Shareholder Activists Pushing for Switch to Annual Elections, *Chicago Tribune*, 16 June 2003, p.1.

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As we will discuss in the next chapter, shareholder resolutions, even when unsuccessful in attracting a majority of votes, have put some pressure on boards by focusing shareholder and media attention on companies' executive compensation. These proposals strengthen the "outrage constraint" that may limit departures from efficient arm's length arrangements. Resolutions with strong shareholder backing have naturally put more pressure on boards.

But voting on such resolutions, as well as on option plans, could not have effectively prevented departures from arm's length contracting. The basic problem is that such resolutions can provide only a limited constraint on board discretion as long as they are merely advisory. They would become more meaningful if shareholders could adopt resolutions that are binding on the board, a reform that we advocate in chapter sixteen.

Chapter 4: The Limits of Market Forces

Having seen that boards have not been bargaining at arm's length, and that shareholders have lacked the power to compel arm's length outcomes, it remains to examine whether market forces compel such outcomes. An important school of thought maintains that markets – for managerial labor, corporate control, capital, and products – effectively align the interests of managers and shareholders. This “Chicago School” view is associated with the work of legal academics such as Frank Easterbrook and Daniel Fischel and financial economists such as Eugene Fama.¹¹⁸ We agree that market forces place some constraints on compensation. These constraints, however, are far from tight enough to ensure that compensation arrangements do not substantially deviate from that arm's contracting would produce.

In earlier work, one of us has shown that market forces can correct agency problems with respect to some but not all types of managerial decisions. In particular, market mechanisms cannot deter managers from exploiting opportunities to take “significantly redistributive” actions -- actions that transfer to managers value that is substantial relative to the resulting loss to shareholders.¹¹⁹ In such cases, the benefit a manager reaps by taking the action is likely to exceed the penalty that markets might impose on him or her for the resulting share price decline.

¹¹⁸ Frank H. Easterbrook, “Managers’ Discretion and Investors’ Welfare: Theories and Evidence,” *Delaware Journal of Corporate Law* 9 (1984): 540-571; Daniel R. Fischel, “The ‘Race to the Bottom Revisited: Reflections on Recent Developments in Delaware’s Corporation Law,” *Northwestern University Law Review* 76 (1982): 916-920; Eugene F. Fama, “Agency Problems and the Theory of the Firm,” *Journal of Political Economy* 88 (1980): 289.

¹¹⁹ See Lucian A. Bebchuk, “Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law,” *Harvard Law Review* 105 (1992): 1461-1467; Lucian A. Bebchuk, “Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments,” *Harvard Law Review* 102 (1989): 1840-1846; Lucian A. Bebchuk and Mark J. Roe, “A Theory of Path Dependence in Corporate Ownership and Governance,” *Stanford Law Review* 52 (1999): 142-153. These works explain why market forces cannot ensure that insiders’ reincorporation decisions, charter amendment decisions, and ownership structure decisions are those that are best for shareholders.

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Extracting higher executive compensation is a prime example of a significantly redistributive action. The personal gains to the executive are direct and can be quite large. Obtaining favorable compensation arrangements is the type of action that market forces cannot be expected to eliminate. Below we briefly review the market forces that bear on such managerial behavior and explain why they are unlikely to impose tight constraints on compensation practices.

Managerial Labor Markets

The behavior of employees -- senior executives are, after all, employees -- is usually affected by the labor market. Good performance may be rewarded by promotion within the firm or by an attractive offer to join another firm. Poor performance may lead to dismissal.

For the CEO, however, internal promotion is impossible. There is always a chance of external promotion—becoming the head of a larger or more prestigious firm—but most CEO positions are filled internally.¹²⁰ The overwhelming majority of CEOs do not become CEOs of other firms.¹²¹

In any event, the likelihood of outside promotion depends on a CEO's overall performance, not on the amount of rents received. The possibility of being hired elsewhere is unlikely to deter a CEO from seeking these rents. Indeed, when CEOs do get new jobs, the initial hiring grants from their new firms are highly correlated with the value of the unvested options and restricted stock the CEOs leave behind.¹²² If anything, the prospect of being hired by another firm exacerbates rather than dampens distortions in CEO compensation.

Nor will fear of dismissal deter CEOs from seeking favorable pay arrangements. As noted in chapter two, CEO dismissal is extremely rare and

¹²⁰ See C. Edward Fee and Charles J. Hadlock, "Raids, Rewards, and Reputations in the Market for CEO Talent," *Review of Financial Studies* 16 (2003): 1327. The authors report that in a sample of 1,200 CEO hires during the period 1990-98, only 26.5 percent were outside hires.

¹²¹ See Melvin A. Eisenberg, "The Structure of Corporation Law," *Columbia Law Review* 89 (1989): 1495.

¹²² See C. Edward Fee and Charles J. Hadlock, "Raids, Rewards, and Reputations in the Market for CEO Talent," *Review of Financial Studies* 16 (2003): 1352.

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the risk of being fired depends mostly on overall firm performance, not on the type of pay package sought by the CEO.

Finally, executive compensation itself is thought to provide executives with incentives to enhance shareholder value. Failure to increase the stock price decreases the value of shares and options granted to the CEO; so, equity compensation might indeed discourage managers from taking actions where personal gains would be small relative to corporate losses. In reality, however, the direct benefits managers reap from favorable pay arrangements are typically much too large to be outweighed by any resulting reduction in the value of their shares.

According to a number of studies, the shares and options owned by the average CEO have increased his or her personal wealth by approximately 1 percent of any increase in corporate value.¹²³ Consider an "average" CEO who is contemplating whether to seek an extra \$10 million in compensation which, because of the poor incentives generated by the arrangement, will reduce firm value by \$100 million. The arrangement would provide an extra \$10 million in compensation while reducing the value of the CEO's existing shares and options by \$1 million, leaving a net gain of \$9 million. As this example illustrates, managers' holdings of shares and options have been unlikely to dissuade CEOs from seeking higher - and potentially inefficient -- compensation arrangements.

¹²³ Perry and Zenner report that in 1997 the median S&P 1500 CEO stood to gain or lose \$11.50 per \$1000 of shareholder gain or loss. See Tod Perry and Marc Zenner, "CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?" *Wake Forest Law Review* 35 (2000): 149. Similarly, Hall and Liebman have estimated that 1998 CEO-wealth-to-shareholder-value sensitivity was approximately \$11 per \$1000, based on a firm with \$1 billion market capitalization. See Brian J. Hall and Jeffrey B. Liebman, "The Taxation of Executive Compensation," *Tax Policy and the Economy*. Edited by James Poterba. Vol. 14. Cambridge, Mass.: MIT Press, 2000, fig. 1. CEO-wealth-to-shareholder-value sensitivity was even lower in the past. Using 1974-1986 data, Jensen and Murphy calculated a median CEO-wealth-to-shareholder-value sensitivity of \$3.25 per \$1000, a figure that included a \$0.30 per \$1000 adjustment for risk of dismissal. See Michael Jensen and Kevin J. Murphy, "Performance Pay and Top-Management Incentives," *Journal of Political Economy* 98 (1990): 261.

Market for Corporate Control

The market for corporate control is often viewed as an important mechanism for aligning the interests of managers and shareholders.¹²⁴ In theory, a company whose share price sags should become more vulnerable to a hostile takeover, which might lead to the replacement of the CEO and the entire board. Alternatively, the incumbents could be ousted through a proxy contest. The fear of a hostile takeover or proxy contest, runs the argument, should compel executives and directors to craft pay arrangements that maximize shareholder value.

In fact, the fear of a control contest has been unlikely to discourage managers from seeking greater compensation, because existing rules and arrangements have provided incumbents with substantial protection. As already noted, outsider challenges via proxy contests have been extremely rare. Hostile takeover bids have occurred, but they confronted strong defenses.

The most significant of these defenses is the staggered board, an arrangement that prevents a hostile acquirer from gaining control for at least a year. According to a study by John Coates, Guhan Subramanian, and one of us, staggered boards are in place in a majority of publicly traded companies, and they often enable incumbent managers to completely block hostile bids that shareholders find attractive.¹²⁵ The study finds that, during the second half of the 1990s, only about 1 percent of publicly traded companies received a hostile bid. Most of them remained independent or were acquired by a friendly bidder. Furthermore, to overcome incumbent opposition, hostile bidders had to pay an average premium of 40 percent. The market for corporate control has thus left managers with considerable autonomy.

In the rare event of a successful hostile bid, ousted incumbents do not fare too badly. As will be discussed in chapter seven, successful bids often trigger generous golden parachutes and other benefits for the target's

¹²⁴ The importance of the market for corporate control as a source of discipline was first emphasized by Henry G. Manne, "Mergers and the Market for Corporate Control," *Journal of Political Economy* 73 (April 1965): 110-120.

¹²⁵ Lucian Bebchuk, John Coates IV, and Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy," *Stanford Law Review* 54 (2002): 887-951.

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executives.¹²⁶ Such cushioned landings have further weakened the disciplinary force of takeovers.

Furthermore, even if a takeover is a real and very costly possibility, the benefits to a CEO from favorable pay arrangements may well exceed the cost of any resulting increased likelihood of a control challenge. Consider an attempt by executives of a \$10 billion company to increase their compensation by an amount with a present value of \$100 million in such a way that firm value is reduced by \$250 million. Obviously, the direct benefit to the executives is very large. In contrast, the increase in takeover risk resulting from a 2.5 percent reduction in firm value is likely quite limited. Indeed, a study by Anup Agrawal and Ralph Walking reports that firms whose executives are relatively overpaid compared with their peers in the industry are not more likely to become takeover targets.¹²⁷

To be sure, the market for control may impose some costs on managers who are especially aggressive rent-seekers. At a certain point, shareholders may become sufficiently outraged to support outside challengers in a control contest. Indeed, as we will discuss in chapter six, CEOs of firms with weaker takeover protection get pay packages that are both smaller and more performance-sensitive than those received by CEOs of firms with stronger protection. Thus the threat of a takeover can have some effect on executive compensation. The important point, however, is that the market for corporate control has failed to impose stringent constraints on executive compensation and permitted substantial deviations from arm's length contracting.

¹²⁶ See Marcel Kahan and Ed Rock, "How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law," *University of Chicago Law Review* 69 (summer 2002): 871-915.

¹²⁷ See Anup Agrawal and Ralph A. Walking, "Executive Careers and Compensation Surrounding Takeover Bids," *Journal of Finance* 49 (1994): 986. Their study examined Forbes 800 firms in the 1980s. They determined that takeover bids were more common in industries in which CEOs were overpaid, but found no significant difference between CEO compensation in firms that were takeover targets within these industries and CEO compensation in firms that were not.

Market for Additional Capital

Another potential source of discipline arises from the possibility that the firm will need to raise additional capital in the equity market. The prospect of selling additional shares to the public should force boards and managers to exercise self-discipline and to adopt compensation arrangements that do not depart significantly from what arm's length contracting would yield.

Most firms, however, return to the equity markets to raise capital very rarely, if at all. The chief source of capital for publicly traded firms is retained earnings; debt comes second, and equity is a distant third.¹²⁸

Even if a situation arose in which equity markets were the only available source of financing, the absence of arm's length contracting between the board and management would not limit a firm's access to those markets. Excessive and behavior-distorting executive compensation does not make equity unavailable, it only raises the cost of equity financing: inefficient compensation arrangements reduce firm value and thus cause investors to pay less for the firm's shares in a secondary offering than they would otherwise. Firms must issue more shares to raise a given amount of capital, but are not denied capital altogether.

Admittedly, the excessive executive compensation would result in a reduction in share value for all existing shareholders, including executives. But as we have noted, executives typically hold only a small fraction of the firm's shares and thus bear only a small fraction of the reduction in value. This cost is too trivial to discourage them from seeking the direct benefits of a favorable compensation arrangement.¹²⁹

¹²⁸ See Lynn Stout, "The Unimportance of Being Efficient," *Michigan Law Review* 87 (1988): 645-647, for a discussion of the sources of capital for publicly traded firms.

¹²⁹ Note that to the extent the firm uses debt financing, executive compensation arrangements that encourage excessive risk-taking might increase the cost of debt. However, as in the case of equity financing, the increase in the cost of the debt would not prevent debt-financed expansion but would only reduce the value of existing shareholders' equity in the firm. Furthermore, managers would bear only a small fraction of this cost.

Product Markets

Finally, let us consider whether product market competition places an effective constraint on executive compensation. In a competitive product market, one could argue, excessive pay and managerial slack would produce competitive disadvantage. Such inefficiencies could cause shrinking profits, business contraction, and even failure.¹³⁰

In fact, the redistribution of firm profits from shareholders to executives may have no significant effect on the operational efficiency of a company. The diversion of profits to managers is unlikely to alter the cost and quality of a company's products, and is therefore unlikely to interfere with the firm's ability to compete in product markets. To the extent that executive compensation arrangements distort managers' business decisions, they may reduce operational efficiency, but product markets are not usually perfectly competitive: large companies often operate in markets characterized by oligopolistic or monopolistic competition.¹³¹ Because these firms have market power, they are able to generate considerable profits that provide additional resiliency. In such markets, distorted pay arrangements are unlikely to threaten firm survival.

Even if distorted pay arrangements do seriously harm firm performance, the increased likelihood of failure will not deter managers from seeking these arrangements. The direct benefit of higher compensation to executives is substantial, while its effect on the likelihood of business failure is probably small. Furthermore, as we will explain in chapters seven and ten, the "golden goodbye" payments given departing managers -- including those who have performed quite poorly -- commonly cushion executives from the effects of their own failure.

Take, for example, a bank with an overpaid CEO who fails to cut back vigilantly on unprofitable operations. The return to equity will suffer, shareholder value will be adversely affected, but the bank is unlikely to fail completely. Even if the situation becomes sufficiently serious for the bank to be forced to seek an acquirer, that transaction may not happen until after the

¹³⁰ See Frank H. Easterbrook, "Managers' Discretion and Investors' Welfare: Theories and Evidence," *Delaware Journal of Corporate Law* 9 (1984): 540-571.

¹³¹ See Jean Tirole, "The Theory of Industrial Organization," (Cambridge, Mass.: MIT Press, 1988): 277-303.

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CEO's retirement. And if it happens before, the incompetent CEO may well profit handsomely, despite having performed poorly, given the practice of rewarding executives when their firms are acquired (a practice we discuss in chapter seven).

Overall Force

Even in the aggregate, then, market forces are unlikely to impose tight constraints on executive compensation. They may impose some constraints and deter managers from deviating extremely far from arm's length contracting arrangements, but overall they permit substantial departures from that benchmark.

The conclusion that market forces do not impose stringent constraints on executive compensation is supported by the studies we will discuss in chapter six. These studies examine the extent to which non-market factors, including the CEO's power vis-à-vis the board, the firm's shareholders, and potential acquirers, affect CEO pay. The evidence indicates that such power is in fact an important determinant of CEO compensation. That these non-market factors make a difference implies that market forces are not sufficiently powerful to dictate outcomes.