

## Positive Corporate Governance and its Implications for Executive Compensation

*By James McConvill\**

### **Abstract:**

As a result of a series of high-profile corporate collapses worldwide, along with regular reporting of shareholder money being spent on corporate jets, executive golf days and increasingly excessive executive compensation arrangements, the common perception is that the executives of our largest corporations are driven by self-interest with little regard for what is best for the corporation. Due to this negative perception, there has been an exponential increase in the amount of laws, rules and guidelines setting in place a heightened standard of corporate governance best practice. Without such regulation, it is believed, another collapse or scandal is inevitable. In this article, I dispute this reasoning. In my view if we embrace "positive corporate governance", in which the positive strengths and virtues of company executives are emphasised, we can move towards an environment in which heavy regulation is replaced by positive corporate norms inside the corporation. I then apply my approach of positive corporate governance to address one of the most significant issues confronting corporate regulation at present- how to deal with the rapid increase in executive compensation in our largest corporations. I suggest that the dominant methodology of pay for performance is ultimately flawed.

### **A. Introduction**

There is a growing perception that company directors and executives are self-interested actors, using their position in the company to pursue their own ends rather than being focused on pursuing what is best for the company and its stakeholders. This perception is aided by recent news of the record 25-year jail sentence handed down to former World.Com boss Bernard Ebbers for his part in

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the fraud that caused the \$11 billion collapse of that company,<sup>1</sup> and reports of overly-exuberant compensation arrangements at US insurance company Fannie Mae, in which large rewards were provided to company executives even if the company failed or their own performance was not up to standard.<sup>2</sup> Indeed, according to Harvard professor Robert C. Clark in a recently-released paper, the media frenzy following the collapse of Enron and a host of other corporate scandals, resulted in a "social facilitation" (a term derived from social psychology) of the idea that the "bursting of the corporate bubble" was due to bad corporate behaviour, rather than normal economic forces.<sup>3</sup>

The growing distrust of, and scepticism towards, company executives and directors across the developed world has resulted in an panoply of new corporate governance requirements enshrined in legislation (in particular, the Sarbanes-Oxley Act in the US) or through other regulatory mechanisms (eg, the NYSE rules and the requirements of corporate governance ratings agencies);<sup>4</sup> the assumption

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<sup>1</sup> See James McConvill and Mirko Bagaric, *Give The Corporate Crooks A Break*, LAWYERS WEEKLY (Australia), 19 August 2005.

<sup>2</sup> See Lucian Bebchuk and Jesse Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Non-Performance Pay, and Camouflage*, John M. Olin Center for Law, Economics & Business Working Paper, Harvard Law School, January 2005.

<sup>3</sup> See Robert C. Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale to Policymakers Too*, John M. Olin Center for Law, Economics & Business Working Paper, Harvard Law School, September 2005 (forthcoming in 2006 in THE CORPORATE GOVERNANCE LAW REVIEW). Clark believes that because of this, "major legal reform to stop corporate fraud was [seen as a] needed response (at 2). See also Larry Ribstein, *Sarbanes Oxley After Three Years*, Illinois Law and Economics Working Paper Series, Working Paper No. LE05-016, June 2005.

<sup>4</sup> The most significant changes made by the *Public Company Accounting Reform and Investor Protection Act 2002* ("Sarbanes-Oxley Act") included:

1. prohibiting registered public accounting firms from performing specified non-audit services contemporaneously with a mandatory audit, with firms only allowed to perform such services if they are approved by the client's audit committee, or the fees for non-audit services amount to no more than 5% of total revenues paid to the auditor by the company.
2. requiring that the lead audit partner and the review partner for each audit client be replaced every five years.
3. prohibiting a registered public accounting firm from performing statutorily mandated audit services for a company if the audit client's senior management officials had been employed by the audit firm and participated in the client's audit during the one-year period preceding the audit initiation date.
4. requiring that a company's audit committee have the responsibility for the appointment, compensation and oversight of a registered public accounting firm, that is required to

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perform the audit. Members of the audit committee must be members of the board of directors of the company, and be independent.

5. the establishment of a Public Company Accounting Oversight Board with the following mandate:
  - a. overseeing the audit of public companies that are subject to the securities laws;
  - b. establishing audit reporting standards and rules; and
  - c. investigating, inspecting, and enforcing compliance relating to registered public accounting firms, associated persons, and the obligations and liabilities of accountants.

As to the New York Stock Exchange Rules on corporate governance, which were approved by the SEC in November 2003 (with amendments made in 2004), see section 303A of the NYSE *Listed Company Manual*. The main corporate governance rules introduced by the NYSE were that:

- Listed companies must have a majority of independent directors and 'independence' is defined in detail.
- To empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management.
- Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.
- Listed companies must have a compensation committee, with a minimum of 3 members, composed entirely of independent directors (as defined in section 303A.02).
- Each listed company must have an internal audit function.
- Listed companies must adopt and disclose corporate governance guidelines
- Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.
- Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.
- Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards, qualifying the certification to the extent necessary.
- Each listed company CEO must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of this Section 303A.

See further Jean J du Plessis, James McConvill and Mirko Bagaric, *PRINCIPLES OF CONTEMPORARY CORPORATE GOVERNANCE* Ch 12 (2005). Also Mark J Roe, *The Inevitable Instability of American Corporate Governance*, 1 *THE CORPORATE GOVERNANCE LAW REVIEW* 1 (2005).

underlying such initiatives being that top-down external regulatory mechanisms are needed to “encourage” those in positions of power to put the interests of the company above their own when wearing their corporate hat. Without such regulation, shirking and rent-seeking is inevitable, or so the argument goes.

A counter-argument that has been circling for some time now in the press and academic resources is that such “quack”<sup>5</sup> regulatory initiatives are undesirable, and at least an over-reaction. The initiatives are targeting the very small group of “bad eggs”, but the main effect is to punish the much larger group of good eggs in the boardroom and managerial offices who perform very successfully; have the company’s best interests at heart; and want to get on with growing the company and providing returns to stakeholders, rather than having to resort to box-ticking. Implied in this argument is that the great majority of company directors and executives are decent citizens with commendable virtues and objectives, rather than being untrustworthy, grubby animals with their snouts in the trough. Further, regulating- through external legislation and “soft law” initiatives- to achieve good corporate governance initiatives is inefficient and simply not necessary, because the same objective can- and indeed is- being achieved inside the corporation through fostering a successful corporate culture which aligns itself with contemporary corporate governance objectives.

I have certainly been a supporter of this view, and indeed have taken this argument a step further by utilising research and ideas that have been percolating outside corporate law and governance.<sup>6</sup> Rather than focusing on the bad eggs and obsessing over the very slight chance that things will go wrong in the corporation, which has certainly characterised mainstream commentary as well as regulatory initiatives in recent times, I believe it is time for commentators, legislators and regulators to embrace what I term ‘positive corporate governance’, and start from the base point that the overwhelming majority of company executives are inherently decent people, who desire (like we all do) to be happy, and do good.

If corporate governance changed its orientation to focus upon, and work to develop and enhance, the positive virtues of those involved in the corporation, I strongly believe that not only would there be less need for externally-imposed rules which place a burden on corporations (one such example being rules dealing with

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<sup>5</sup> Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521 (2005). According to Professor Romano, there is no justification for prescriptive rules (with the principal focus of the paper being on the federal *Sarbanes-Oxley Act*) mandating corporate governance practices.

<sup>6</sup> James McConvill, *Reflections on the Regulation of Contemporary Corporate Governance* (2006, forthcoming).

executive compensation, which I will explore in detail in Part E of this article), but the corporation would also be more capable of aligning the interests of shareholders and other stakeholders- which is again a major objective in contemporary corporate governance.<sup>7</sup>

The concept of “positive corporate governance” draws largely upon literature in the positive psychology movement developed recently by University of Pennsylvania psychology professor Martin Seligman- both in terms of what it is trying to achieve, and also in terms of how individuals are perceived and the faith placed in individuals to develop. Accordingly, before providing an account of ‘positive corporate governance’, I begin with an explanation of ‘positive psychology’.

### **B. Martin Seligman’s “Positive Psychology”**

Positive psychology recognises positive human strengths and virtues (so-called ‘signature strengths’), rather than focusing on negative human traits. In his book *Authentic Happiness*, Martin Seligman explains the underlying rationale for positive psychology:

For the last half century, psychology has been consumed with a single topic only - mental illness - and has done fairly well with it. ... But this progress has come at a cost. Relieving the states that make life miserable, it seems, has made building the states that make life worth living less of a priority. But people want more than just to correct their weaknesses. They want lives imbued with meaning, and not just to fidget until they die.<sup>8</sup>

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<sup>7</sup> See James McConvill, *Directors’ Duties to Stakeholders: A Reform Proposal Based on Three False Assumptions*, 15 AUSTRALIAN JOURNAL OF CORPORATE LAW 88 (2005); Richard Alock & Caspar Conde, *Socially and Environmentally Responsible Business Practices: An Australian Perspective*, 1 THE CORPORATE GOVERNANCE LAW REVIEW 329 (2005).

<sup>8</sup> MARTIN SELIGMAN, *AUTHENTIC HAPPINESS* 1 (2002). Seligman provides an even more succinct explanation in saying positive psychology ‘... seeks to cultivate human strengths, rather than focus on human weaknesses’: see Martin Seligman, Paul R Verkuil & Terry H Kang, *Why Lawyers are Unhappy*, 23 CARDOZO L. REV. 33, 35 (2001); 10 DEAKIN L. REV. 49 (2005) See also Martin E P Seligman & Mihaly Csikszentmihalyi, *Positive Psychology: An Introduction*, 55 AMERICAN PSYCHOLOGIST 5, 13 (2000):

The prevailing social sciences tend to view the authentic forces governing human behavior to be self-interest, aggressiveness, territoriality, class conflict, and the like. Such a science, even at its best, is by necessity incomplete. Even if utopianly successful, it would then have to proceed to ask how humanity can achieve what is best in life.

On the nature and utility of positive psychology, see also C R SNYDER & SHANE J LOPEZ, *POSITIVE PSYCHOLOGY* (2005); the March 22, 2005 edition of the *JOURNAL OF POSITIVE BEHAVIOR INTERVENTIONS*;

Seligman envisages that the approach underpinning positive psychology could be extended to the social sciences more generally, that is 'positive social science'.

How has it happened that the social sciences view the human strengths and virtues - altruism, courage, honesty, duty, joy, health, responsibility and good character - as derivative, defensive or downright illusions, while weaknesses and negative motivations ... are viewed as authentic.

My vision is that social science will finally see beyond the remedial and escape from the muckraking that has claimed it, that social science will become a positive force for understanding and promoting the highest qualities of civil and personal life.<sup>9</sup>

As noted in *Character Strengths and Virtues: A Handbook and Classification* (2004) (by Christopher Peterson and Martin Seligman), positive psychology has the effect of reclaiming the study of character as a legitimate topic of psychological inquiry and informed societal discourse. As discussed below, this re-emphasise on studying character is important and provides a useful basis for a similar enlightened approach in corporate governance. The focus in corporate governance - at least recently - has been on control and compliance, emphasising the negatives and weaknesses in human beings, which need to be addressed by external incentives (executive pay being the most common, see discussion below).<sup>10</sup> But if we were to also focus on character in corporate governance, appreciating and promoting the view that positive character is something that is important to the corporation and can be fostered in the managers of the corporation; that positive character is inherent and can be utilised and developed in a corporate setting, and that the importance of character can be taught, then it could be considered that there is less need for control, with implications in terms of the manner of corporate regulation.

### C. An Outline of Positive Corporate Governance

While positive corporate governance is not just positive psychology inside a corporate setting but with a different label, it draws heavily on thinking and

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and *FLOURISHING: POSITIVE PSYCHOLOGY AND THE LIFE WELL-LIVED* (Corey L.M. Keyes & Jonathan Haidt, ed., 2002).

<sup>9</sup> See Martin Seligman, *Positive Social Science*, *APA MONITOR*, Volume 29, No 4- April 1998.

<sup>10</sup> See LUCIAN BEBCHUK AND JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

practices in relation to positive psychology (in particular the use of education in recognising and promoting the “signature strengths” which contribute to happiness, and the development of “infrastructure” to emphasise human virtues and strengths).

Positive corporate governance represents a movement that views the behaviour and motivations of corporate participants (particularly executives) in a positive light (and is thus a significant departure from the ‘anti-management’ approach which presently maintains support in law faculties and management schools), to recognise their personal strengths and virtues, and to promote the tangible implications that this positive perspective has for corporate governance (in particular the regulation of internal governance arrangements and the performance of companies).

Positive corporate governance, by adopting a positive view of executives and their role in the corporation, is a useful umbrella term to unify under the one label emerging literature on real human behaviour (behavioralism), trust and altruism, as well as happiness studies and stewardship theory - which has, to date, had relatively little impact in legal and corporate governance literature.<sup>11</sup> These areas of study all question, and indeed reject, the mainstream views of agency theorists regarding the strict motivating factor for corporate executives of wealth maximization, and the approach to regulating corporate governance based on assumptions about the behaviour and motivations of corporate executives. This is far from revolutionary, but requires a concerted effort - particularly as (discussed by Daniel Nettle in *Happiness: The Science Behind Your Smile* (2005)), there are evolutionary reasons why negative thoughts tend to have a more powerful force with human beings than positive thoughts.

Positive corporate governance recognises the dominance of the corporation in modern society and places enormous faith in the corporation as a facilitator of positive outcomes in society (strong employment, sustainable environment, healthy relationships on a professional and personal level). It does this by emphasising and promoting the positive traits in corporate participants, how these traits can be materialised through the corporation (as well as how these traits can be brought to the corporation), and the important implications of this positive emphasis on the corporation and its performance and sustainability. This provides positive corporate governance with a solid normative grounding.<sup>12</sup>

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<sup>11</sup> For a review of this literature, see JAMES McCONVILL, *THE FALSE PROMISE OF PAY FOR PERFORMANCE: EMBRACING A POSITIVE MODEL OF THE COMPANY EXECUTIVE* Ch 5 & 6 (2005).

<sup>12</sup> On the importance of developing a normative theory of the corporation for contemporary corporate governance, see STEPHEN M BAINBRIDGE, *COMPETING CONCEPTS OF THE CORPORATION* (‘A.K.A. CRITERIA?’

In this respect, it could be said that there are close parallels between positive corporate governance and “virtue ethics”, first advocated by Aristotle in *The Nicomachean Ethics*, and which has since been applied in contemporary management literature and thinking to infuse management with moral accountability and autonomy. Virtue ethics is fundamentally concerned with the character or attributes of a person that allow that person to “best” perform their role [as director, executive or otherwise]. There is a focus on character and how it can be enhanced, rather than emphasising the utility of rules. Education is considered to have an important role to play in this systematic development.<sup>13</sup>

Because of the concentration on human weaknesses inside the corporation rather than recognising and fostering strengths, what we have seen in recent years is a change in the dynamics of regulation in relation to corporate governance - from adherence to internal ‘norms’ to the emergence of external regulatory mechanisms (i.e., formal legal rules) designed to perform a reward or punishment function in an effort to control the behaviour of managers. Under this approach, the corporation, and the individuals within the corporation, cannot be trusted to regulate their own internal arrangements without some external oversight and imposition of external rules.

But the important question is what would happen if we were to change our perception of top executives in the corporation? Rather than devoting our energy to endeavouring to control their weaknesses, what if we instead devote our energy to recognising and promoting their positive traits - what positive psychologists refer to as ‘signature strengths’?

This simple change in perception and approach, one which has already commenced through recent work of some leading scholars but until now has not had a unifying label, raises some important - indeed fundamental questions. Many perceived inevitabilities in corporate governance may indeed become no longer inevitable. For example, if we are to emphasise and promote an alternative, ‘positive’ perspective of the motivations and behaviour of executives, what are the implications in terms of the framework of corporate governance (regarding the operation of the board, meetings, the role of auditors, executive compensation, shareholder participation etc)? What would and should be the nature of corporate

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JUST SAY NO’), UCLA SCHOOL OF LAW, LAW- ECON RESEARCH PAPER, NO 05-01. Available on-line at: <[www.ssrn.com](http://www.ssrn.com)>.

<sup>13</sup> See, for example, Ian E Thompson and Bryan A Howieson, *ETHICS* 92 (1997); Barbara Mescher & Bryan Howieson, *Beyond Compliance: Promoting Ethical Conduct by Directors and Corporations*, 1 *THE CORPORATE GOVERNANCE LAW REVIEW* 93 (2005).

governance regulation- could and should we rely more on 'positive norms' that develop inside the corporation? Another, and broader, issue is the impact of this change of perception about the motivations and behaviour of executives in terms of our understanding of the corporation.

If we accept that the rational self-interested model (*homo economicus*) does not paint a complete picture of the typical corporate executive, and that the typical executive would not be drawn to a short-term, profit-orientated view of the corporation, what would be the implications? It may be said, intuitively, that if we are to emphasise and promote a positive model of the company executive, with importance placed on positive relationships between corporate participants and stakeholders and the genuine fulfilment of what is in the best interests of the corporation, we would naturally witness a change in attitude and approach directed towards the long-term best interests of the corporation. Sustainability rather than selfish pursuit would come to be appreciated as the overriding company objective.

#### **D. Positive Corporate Governance and Regulation**

Positive corporate governance has some significant implications for the regulation of corporate governance. This is because the negative 'agency problem' is considered the underlying and ultimate justifying force for external regulation of corporate governance.

In their text, *Understanding Company Law* (2003), Lipton and Herzberg make it quite clear that regulation of corporate governance is based entirely on the presumption that directors and managers of modern public corporations need to be kept accountable:

Corporate governance best practice seeks to provide the mechanisms which align the interests of management with those of shareholders. The development of increased interest in corporate governance reflects higher expectations by the public and investment community that greater efforts be made by listed public companies to develop structures and procedures so as to ensure management is effective and acts in the interests of shareholders and adopts appropriate standards of corporate behaviour.<sup>14</sup>

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<sup>14</sup> See PHILLIP LIPTON & ABE HERZBERG, *UNDERSTANDING COMPANY LAW* 295 (11<sup>th</sup> ed, 2003).

Similarly, in their article, 'Toward a Management Theory of Management',<sup>15</sup> Davis, Schoorman and Donaldson discuss how 'governance structures', along with executive compensation, are the two mechanisms which 'protect shareholder interests, minimize agency costs and ensure agent-principal interest alignment'.

The authors continue:

Controlling governance mechanisms are prescribed, because agency theorists assume that agent-principal interests may diverge and that given the opportunity the agent will maximize his or her individual utility at the expense of the principal's utility ... the model of the agent remains as inherently opportunistic, in that there is an ever-present possibility of opportunism, unless it is curbed through controls.<sup>16</sup>

This view on the significance of the agency problem to corporate regulation is commonly attributed to F L Easterbrook and D R Fischel's classic treatise on the law and economics of corporate law, titled *The Economic Structure of Corporate Law* (1991). It was argued by Easterbrook and Fischel in this work that corporate law (at least in the United States) is designed to limit agency costs by providing a menu of default rules that parties can alter by contract if they so choose.

If we are to embrace a positive model of the company executive, what would be the implications for corporate regulation? Existing rules - indeed the entire formal regulation of corporate governance arrangements - would need to be re-examined. If we can be confident that executives are naturally inclined to pursue what is best for the company, and doing so is an incentive in itself, external regulation can be dispensed with (at least to a significant extent).

One of the areas of corporate governance where positive corporate governance has significant implications is executive compensation. Positive corporate governance may just be the answer to the problematic "decoupling" of executive pay from company performance that we have recently witnessed.

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<sup>15</sup> See James H Davis, F David Schoorman & Lex Donaldson, *Towards a Stewardship Theory of Management*, 22 *ACADEMY OF MANAGEMENT REVIEW* 20, 22 (1997).

<sup>16</sup> *Id.* at 23.

## E. Positive Corporate Governance and an Appropriate Methodology for Executive Compensation

### I. Overview

In 2004, prominent law professors Lucian Bebchuk and Jesse Fried released a controversial new work, *Pay without Performance: The Unfulfilled Promise of Executive Compensation*,<sup>17</sup> which has become one of the best-selling books on corporate governance internationally.

In *Pay without Performance*, Bebchuk and Fried highlight that in recent times there has been a decoupling of pay and performance in the United States, and articulate a “managerial power” thesis to explain this trend. According to Bebchuk and Fried’s managerial power thesis, many contemporary features of executive compensation can best be explained as the result of the CEO (and perhaps other top-level executives) wielding enormous influence over the board of directors- who are ultimately responsible for determining executive pay. Due to this influence, the boards structure compensation arrangements with the interests of the CEO as the primary concern, with shareholder interests relegated to a secondary consideration.<sup>18</sup>

Perhaps the best summary of the points and intricacies of the managerial power thesis is contained in an article in the *University of Chicago Law Review*,<sup>19</sup> published prior to *Pay without Performance*. In that article, Bebchuk, Fried (and Walker) outline their thesis as follows:

The dominant approach to the study of executive compensation among academics has for some time been what we call the “optimal contracting approach”. Under this approach, executive compensation practices in large, publicly traded companies are viewed as designed to minimize the agency costs that exist between senior executives (the agents) and shareholders (the principals). The board is viewed as seeking to maximize shareholder value, with the compensation scheme being designed to serve this objective. ...

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<sup>17</sup> Published in 2004 by Harvard University Press.

<sup>18</sup> For a critique of the Bebchuk-Fried thesis, see for example, William W. Bratton, *The Academic Tournament Over Executive Compensation*, 93 CAL. L. REV. (2005, forthcoming); Stephen Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005).

<sup>19</sup> See Lucian Bebchuk, Jesse M Fried & David I Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

We seek to contrast this optimal contracting approach to the study of executive compensation with an approach that we label “the managerial power approach”. Analysis from this perspective focuses on the ability of executives to influence their own compensation schemes. According to the considered approach, compensation arrangements approved by boards often deviate from optimal contracting because directors are captured or subject to influence by management, sympathetic to management, or simply ineffectual in overseeing compensation. As a result of such deviations from optimal contracting, executives can receive pay in excess of the level that would be optimal for shareholders; this excess pay constitutes rents. More importantly, to camouflage or facilitate the extraction of rents, managerial power can lead to the use of inefficient pay structures that weaken or distort incentives and that thus, in turn, further reduce shareholder value. ...<sup>20</sup>

Due to executive compensation being influenced by managerial power rather than determined at arm’s length by directors acting as stewards for the company, the cost- according to Bebchuk and Fried - is weak incentives to reduce managerial slack (“shirking”), and perverse incentives for directors to implement compensation arrangements which do not tightly link pay and performance (“rent-seeking”).

While managerial power has attracted significant attention, I believe that Bebchuk and Fried’s thesis becomes questionable at best when we apply the literature which underpins my positive corporate governance. Managerial power is perceived to be a problem due to the rather negative portrait of the typical CEO of a large public company painted by Bebchuk and Fried. According to Bebchuk and Fried, top executives in the modern company cannot be trusted- and in the absence of external incentives are naturally inclined to pursue their own self-interest (by way of shirking and rent-seeking), rather than uphold and defend the interests of the company and its shareholders. That is, executives are best described as agents in the sense understood by financial economists, rather than as ordinary individuals that may have some faults (like we all do) but otherwise are enriched with positive virtues and objectives.

Bebchuk and Fried do not in any way question the emphasis placed upon money by agency theorists, or the “pay for performance” methodology for determining executive compensation. Indeed, even though the gap between pay and performance continues to expand (especially in the United States) due to sophisticated arrangements that have resulted in total remuneration for executives

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<sup>20</sup> *Id.* at 753-5.

escalating significantly, Bebchuk and Fried contend that “pay for performance” (discussed below) is a “promise”, albeit “unfulfilled”.

Positive corporate governance demonstrates, however, that pay for performance is not an “unfulfilled” promise, but rather is no promise at all. Agency theory, and pay for performance which is based upon agency theory, derives from a narrow, and ultimately false understanding of human motivation and behaviour.<sup>21</sup> The literature underpinning positive corporate governance makes it very clear that executives are not solely motivated by money in terms of their relationship with the company, nor is money the best mechanism to appeal to the interests of executives. Wealth maximisation and utility maximisation are not interchangeable concepts.

For the significant majority of executives, money is at most, a means to an end, with that end being personal happiness and doing what is best by the corporation(s) to which they are employed. On this basis, corporations are best served by recognising and promoting the fact that their interests, and the interests of their various stakeholders, can be fulfilled by fostering the positive virtues and objectives that executives bring to their role, rather than assuming that executives are guided purely by their self-interest, and feeling the need to throw money at the perceived “problem”.

## II. Pay For Performance: An Unfulfilled Promise

As alluded to above, the dominant methodology used in designing executive compensation in developed economies is pay for performance. As to the predominance of pay for performance, the comments of Michael Quinn are useful:

[Performed linked remuneration] has been the fastest emerging issue in the composition of director remuneration. It has been viewed as a tool for aligning the interests of directors and shareholders. ... In the United States, performance linked remuneration is actively encouraged by institutional investors, the Securities and Exchange Commission (SEC) and taxation laws. A more common occurrence in Australia is the granting of share options and share participation by directors.<sup>22</sup>

In Chapter 1, ‘The Official Story’, of Bebchuk and Fried’s book, the authors explain why the methodology of pay for performance has emerged from agency theory:

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<sup>21</sup> See, for example, Christine Jollis, Cass R Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998)

<sup>22</sup> Michael Quinn, *The Unchangeables- Director and Executive Remuneration Disclosure in Australia*, 10 AUSTRALIAN JOURNAL OF CORPORATE LAW 2, 4 (1999).

Economists have long believed that efficient compensation contracts should link pay with performance to provide executives with desirable incentives. Indeed, according to the standard view, the compensation arrangement is an important mechanism for reducing agency costs. And the significance of the agency problem makes it crucial to use this instrument effectively.

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 therefore important. The board can influence the CEO to behave in this manner by designing a compensation arrangement that provides the CEO with an incentive to increase shareholder value. Thus, it is argued, a well-designed compensation scheme can make up for the fact that directors cannot directly monitor or evaluate many of their top executives' decisions.<sup>23</sup>

Notwithstanding the (sometimes extensive) negative sentiment towards executives that agency theory articulates, Bebchuk and Fried implicitly endorse the theory. Indeed, the managerial power thesis put forward in *Pay without Performance* derives from an acceptance that an 'agency problem' exists in the modern corporation.<sup>24</sup>

Given the attention that is paid among agency theorists to remuneration as an incentive to align the interests of managers and shareholders,<sup>25</sup> what needs to be made clear and emphasised is that it is assumed that what motivates executives most is money, and that the interests of executives are best served by appealing to the hip pocket of executives.<sup>26</sup> On this latter point, it can therefore be taken that

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<sup>23</sup> BEBCHUK & FRIED, *supra* note 10, at 19.

<sup>24</sup> *Id.*, at 15-16.

The principals (the shareholders) cannot directly ensure that the agents (the managers) will always act in the principals' best interests. As a result, the manager-agents, whose interests do not fully overlap those of the shareholder-principals, may deviate from the best course of action for shareholders. This is called the "agency problem". 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 company value caused by such deviations are called "agency costs".

<sup>25</sup> See, for example, Ian M Ramsay, *Directors and Officers' Remuneration: The Role of the Law*, JOURNAL OF BUSINESS LAW 351 [1992]; Ruth Bender, *Why Do Companies Use Performance-Related Pay for their Executive Directors?*, 12 CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW 521 (2004).

<sup>26</sup> A good source discussing in detail various 'models' of human behaviour (and the importance of these models in understanding how organisations function), including the economic model of agency theory,

agency theorists equate utility maximisation with wealth maximisation. That 'utility' can be determined by one's level of material wealth- money is an end (utility) rather than a means to an end. Again, positive corporate governance questions this assertion.

### III. Bebchuk and Fried's Managerial Power Thesis

What is important to understand is that the managerial power thesis does not debase the potential of pay for performance as a pay-setting methodology, or the foundational assumptions upon which it is built (namely agency theory). Indeed, the Bebchuk-Fried thesis is very much in line with traditional agency theory regarding how to perceive and respond to governance problems arising in the modern corporation.

In *Pay without Performance*, once outlining the managerial power thesis that forms the foundation for their book, Bebchuk and Fried set out their views of why directors who are ultimately responsible for setting executive pay, are influenced by 'managerial power'- being the executives whose pay they are setting. According to Bebchuk and Fried:

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 1,000 companies. There are often additional perks and indirect benefits; for example, directors of UAL Corp. (which owns United Airlines) can fly United free of charge, and directors of Starwood Hotels get complimentary nights in company hotels. Moreover, a board seat often provides directors with prestige and with valuable business and social connections. The financial and nonfinancial benefits of holding a board seat give directors a strong interest in keeping their positions....

In reality ... candidates placed on the company's slate by the board have been virtually assured of being reelected. Dissident shareholders contemplating putting forward their own director slate have confronted substantial obstacles. As a result, the director slate proposed by the company has almost always been the only one on the ballot. ...

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. ...<sup>27</sup>

Later on in the book, Bebchuk and Fried recognise that there are social and psychological factors (namely friendship and loyalty, collegiality and team spirit, authority and cognitive dissonance) which encourage directors to go along with compensation arrangements that favour the company's CEO and other senior executives. They state:

These social and psychological factors reinforce the economic incentives to favour executives and can also affect directors who are not significantly influenced by such economic incentives.<sup>28</sup>

In the following two sections of Part 5 of this article, I outline the case for why the managerial power thesis is flawed. I contend that two of the key assumptions underlying Bebchuk and Fried's thesis, that executives are principally motivated by money and that the best way to please executives is via the hip pocket, are incorrect. I use a broad range of literature, which collectively paint a positive picture of company executives, to support my contention.

If this literature is given serious attention by commentators and regulators we may just about resolve for good the pay for performance dilemma- by being less caught up about the "pay" side of things.

#### **IV. Naturally Motivated Executives**

As has been discussed, agency theorists contend that there is a necessary divergence between the interests of executives and the company, and that some form of external incentive is needed to achieve a divergence of interests. In venturing outside the terrains of agency theory, there is a rich source of "positive literature", from diverse range of disciplines, which suggests the opposite.

This section draws upon this literature to paint a more favourable- indeed positive- picture of executives in terms of their relationship with the corporation.. This, of course, departs somewhat significantly from the gloomy picture which agency theory presents, a theory that has justified the continued- yet fundamentally

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<sup>27</sup> BEBCHUK & FRIED, *supra* note 10, at 25-7.

<sup>28</sup> *Id.* at 31.

flawed- existence of the pay for performance methodology for executive compensation.

### *1. Job Satisfaction and 'Calling'*

In *Authentic Happiness*, Martin Seligman notes that there has been a progressive change from money to job satisfaction as the predominant motivator at work.<sup>29</sup> Professor Seligman refers to big New York law firms as an example- where there is now a much greater focus on retaining, rather than recruiting, young associates, despite the mega bucks offered at these firms.

Seligman refers to management literature on work orientation and 'callings' to dispel the commonly held view that employees- particularly high-level employees like top executives- are motivated predominantly by their level of income. According to Seligman, as a person becomes more senior in the company, money becomes less of an emphasis. According to Seligman:

Scholars distinguish three kinds of "work orientation": a job, a career and a calling. You do a job for a paycheck at the end of the week. You do not seek other rewards from it. It is just a means to another end. ... A career entails a deeper personal investment in work. You mark your achievement through money, but also through achievement. Each promotion brings you higher prestige and more power ... as well as a raise. ... A calling (or vocation) is a passionate commitment to work for its own sake. Individuals with a calling see their work as contributing to the greater good, to something larger than they are. ...<sup>30</sup>

No doubt due to the time and effort spent climbing the corporate ladder to get to the 'top' executive positions in the organisation (particularly in large companies), and the money and security which has accrued along the way by having the top of the ladder as one's goal, most individuals in these top executive positions would consider their job to be a 'calling'. This would mean that money is not the primary motivating factor in performing the position.

Indeed, getting to the top of the corporate tree requires a certain personality- one that is to not only willing to put in the time and effort to get there, but also to be chosen by the board as someone capable and desired to perform the role. A person driven entirely by financial objectives, without this deeper sense of capability and

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<sup>29</sup> SELIGMAN, *supra* note 8, at 10.

<sup>30</sup> *Id.*, at 168.

willingness, would very really get to the top position in contemporary times- merit seems to be more highly valued than pedigree and 'old school ties'.

## *2. Motivations Other Than Money and Pure Self-interest*

Contrary to the central argument of agency theorists that remuneration is needed as an incentive to motivate executives and align executive and company interests, an extensive amount of literature refers to other factors that work to motivate company executives. For example, in his recent Wall Street Journal article 'Nice Work If You Can Get It', Tyler Cowen suggests that:

...[A]djusting pay may not be the way out of this problem. Our best portrait of the CEO type suggests that ego is its primary driving force, with money playing a secondary role (except as a measure of status). In any case there is little evidence, as the economist Kevin Murphy has noted, that CEO's perform better even when their pay is closely tied to earnings or other corporate-performance measures.<sup>31</sup>

According to Deci, there are in fact two kinds of motivation- extrinsic and intrinsic. Extrinsic motivation relates to what is done by others to motivate employees- for example, paying them a performance-related bonus. Intrinsic motivations, on the other hand, relate not only to outside influences but also to the individual employee- derived from an individual's satisfaction in doing the job.<sup>32</sup> More specifically, Gavin J Nicholson and Geoffrey C Kiel refer to two forms of motivations operating in a corporate context: self-interested decisions and company-regarding decisions.<sup>33</sup>

In fact, this categorization of motives is not new. In a classic paper, 'A Theory of Human Motivation',<sup>34</sup> Maslow explains that motivation can be discussed in terms of a hierarchy of needs. Maslow suggests that we first need to satisfy our physiological needs then, in order, love needs, esteem needs (self-esteem and the esteem of others), and self-actualisation. As Bender has written:

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<sup>31</sup> THE WALL STREET JOURNAL, 23 December 2004, D8.

<sup>32</sup> See E Deci, *The Effects of Contingent and Non-contingent Rewards and Controls on Intrinsic Motivation*, 8 ORGANIZATIONAL BEHAVIOR AND HUMAN PERFORMANCE 217-229 (1972).

<sup>33</sup> See GAVIN J NICHOLSON & GEOFFREY C KIEL, *MOTIVATED ACTORS: AGENCY COSTS AND BURKEAN ACTS*, Paper to be presented at the Annual Meeting of the Academy of Management: Creating Actionable Knowledge, New Orleans, August 6-11. 2004. Available on-line at: <<http://www.competitivedynamics.com.au/Papers&Publications/P&P.htm>>

<sup>34</sup> A H Maslow, *A THEORY OF HUMAN MOTIVATION*, IN *MANAGEMENT AND MOTIVATION* 27-41 (V H Vroom & E L Deci, eds., 1970).

[According to Maslow] a satisfied need is not a motivator of behaviour. For senior executives it seems unlikely that the sums of money being paid are necessary to meet the lower level needs, and there must be a supposition that a main function of the reward is to meet the executive's needs for self esteem and recognition.<sup>35</sup>

Further, in *Intrinsic Motivation at Work: Building Energy and Commitment* (2002), Kenneth W Thomas discusses the concept of "new work"- the importance of introducing a feeling of purpose and self-management in the workplace, rather than work being considered in the strict scientific sense of being a means to an end-that end being wealth. According to Thomas, there are four "intrinsic rewards" that make work compelling, and thus motivates employees: (1) a sense of meaningfulness; (2) a sense of choice; (3) a sense of competence or quality; and (4) a sense of progress. Money does not rate a mention.

Agency theory has been a cornerstone principle in the so-called 'law and economics' movement- applying economic literature and thinking to understand and develop the law.<sup>36</sup> While the economic analysis of law dominated legal scholarship in the United States for many years, it was obvious that there were some limitations with the 'rational actor model' (ie, that individuals are principally motivated by self-interest, with wealth maximization encapsulating that self-interest) of human behaviour that provided the basis for strict law and economics analysis. Even though human beings cannot accurately be described as irrational creatures, nor are we machines— programmed to pursue the most efficient outcome in every possible situation.<sup>37</sup>

In the second half of the 1990's a trend slowly emerged of legal scholars seeking information from outside neo-classical economics to better understand how human beings truly behave.<sup>38</sup> Studies in other fields, primarily behavioural economics, had shown that rather than being rational self-actors at all times, people are frequently unselfish. So began the 'behavioural law and economics movement', or what is

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<sup>35</sup> Bender, *supra* note 25, at, 523.

<sup>36</sup> See, for example, RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* (6<sup>th</sup> ed, 2002); THE ORIGINS OF LAW AND ECONOMICS (Charles Rowley and Francesco Parisi eds., 2005); STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* (2004); A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* (2003).

<sup>37</sup> See for example the collection of papers in *CHOICES, VALUES AND FRAMES* (Daniel Kahneman & Amos Tversky, eds., 2000).

<sup>38</sup> See Christine Jollis, Cass R Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 *STAN. L. REV.* 1471, 1471 (1998)

often referred as the 'second synthesis' of law and economics.<sup>39</sup> Behavioural law and economics also emphasises that corporate participants, and especially directors and top executives, are motivated by factors other than pure wealth maximization.

Professor Lynn Stout, together with Margaret Blair, have been prominent in exploring the implications of research into trust and trustworthiness for corporate law and governance. Both have explored and analysed important empirical evidence derived from social dilemma games including the prisoner's dilemma<sup>40</sup> (based in game theory<sup>41</sup>) that lend support to the proposition that there are many ways in which we- as homo sapiens- act as though we care about the costs borne and the benefits enjoyed by others, as opposed to being driven purely by economic self-interest (homo economicus).<sup>42</sup>

The existence of other-regarding preferences, as well as the importance of the phenomenon of 'trust' and 'trustworthiness' (and the related concept of 'altruism')

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<sup>39</sup> See generally BEHAVIORAL LAW & ECONOMICS (Cass R Sunstein, ed., 2000).

<sup>40</sup> The prisoner's dilemma is defined as a 'situation in which the noncooperative pursuit of self-interest by two parties makes them both worse off' (see <<http://www.wwnorton.com/college/econ/stiglitz/glossp.htm>>). In the prisoner's dilemma, in each game the prisoner has to decide whether to 'cooperate' with an opponent, or otherwise defect. The prisoner and the opponent must make a choice, and then their decisions are revealed. The prisoner's dilemma demonstrates that the 'rational' choice in each instance is not the one which maximises personal self-interest as neo-classical economists suggest, but rather the one that maximises the collective good of the two or more persons who are each making the decision. In other words, the most rational decision or strategy is the one that promotes cooperation between the participants in the game. Thus, the prisoner's dilemma is studied in a range of different contexts to try and find, and understand, strategies that promote cooperation.

This example demonstrates that it is best to cooperate and confess, instead of choosing to defect by not confessing based on the hope that you won't get caught and will not personally serve time in prison (which would of course be in one's self-interest).

For an explanation of the prisoner's dilemma, see A W TUCKER, CONTRIBUTIONS TO THE THEORIES OF GAMES (2001); WILLIAM POUNDSTONE, PRISONER'S DILEMMA (1993).

<sup>41</sup> Game theory encompasses an interdisciplinary approach (covering, for example, mathematics, economics, sociology and information technology) to the study of the behaviour of humans. A 'game' in this context is a scientific metaphor for a wide range of human interactions between two, or more than two, persons, such persons possessing opposing (or at least mixed) motives. In constructing these games, game theorists contend that the rational choice of game participants involves maximizing the rewards of the group of decision-makers involved in the game. See MORTON DAVIS, GAME THEORY: A NON-TECHNICAL INTRODUCTION (1997), OSKAR MORGENSTERN & JOHN VON NEUMANN, THE THEORY OF GAMES AND ECONOMIC BEHAVIOR (1944).

<sup>42</sup> See Lynn A Stout, *Other-Regarding Preferences and Social Norms*, Georgetown Law and Economics Research Paper No. 265902. Available on-line at: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=265902](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265902)>

to corporate law and governance have been emphasised by Stout and Blair in a number of articles.<sup>43</sup> For example, in a collaborative piece, Stout and Blair noted:

[P]eople often behave as if they care about costs and benefits to others. In support of this claim, we review the extensive empirical evidence that has been developed on human behaviour in social dilemma experiments. This evidence demonstrates that most people shift readily from purely self-interested to other-regarding modes of behaviour depending on past experience and social context.<sup>44</sup>

### V. Happy Executives?

We know that under agency theory, remuneration (principally money) is considered an important 'control mechanism' to align the interests of executives and the company. In other words, money is the best avenue for enhancing the

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<sup>43</sup> In fact, these concepts (trust in particular) are integrated into Stout and Blair's widely-disseminated and accepted 'team production' theory of the corporation: see Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); also more recently, Margaret Blair & Lynn Stout, *Specific Investment: Explaining Anomalies in Corporate Law* (J. CORP. L., forthcoming, 2006) (available via: <<http://www.ssrn.com>>). Blair and Stout's team production theory has generated a great deal of interest in academic circles as it challenges the dominant view of shareholder primacy by suggesting that the role of the corporation is not limited to maximising economic returns for shareholders, but rather is intended to resolve team production problems. As a result, neither shareholders nor other stakeholders are the primary concern, rather the corporation and the legal rules regulating corporations treat shareholders and stakeholders as a 'team', each contributing to the corporation in different ways.

Team production, and in particular the problems arising from team production, has been a popular area of research in economic literature for years, and this literature was the source of Blair and Stout's theory of the corporation. According to Blair and Stout, team production problems arise in situations where a productive activity requires the combined investment and coordinated effort of two or more individuals or groups. The problems arise because if the investment of members of this 'team' is firm-specific (meaning difficult to recover once committed to the project), and if output from the enterprise is non-separable (meaning that it is difficult to attribute any particular portion of the joint output to any particular member's output), it becomes very difficult to determine how any 'surpluses' generated by this production should be divided. This is because surpluses invite both 'shirking' (which essentially means free-riding off the efforts of others) and 'rent-seeking' (whereby individuals waste time and money competing for a share of a fixed amount of wealth). Blair and Stout suggest that as trying to prevent these team production problems through the mechanism of explicit contracts is next to impossible, this function can be achieved by the corporation as an 'institutional substitute' for explicit contracts. The structure of the corporation, along with the legal rules regulating the corporation, act as a 'mediating hierarchy' by which team members give up important rights (including property rights over the team's joint input) to the corporation as a separate legal entity. At the top of this hierarchy is the board of directors, whose authority over the use of corporate assets is virtually absolute. For more information on team production theory, one good source is the website: <[www.teamproduction.us](http://www.teamproduction.us)>

<sup>44</sup> See Margaret Blair & Lynn Stout, *Trust, Trustworthiness and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1807 (2001).

'utility' (that is, happiness) of executives. Utility maximisation is equated with wealth maximisation.

Recent empirical studies into happiness, that have gathered pace alongside a growing positive psychology movement, demonstrate that happiness may indeed now be a definable concept, and as human beings we are remarkably similar when it comes to the things that make us happy- and the things that do not. Happiness as a self-contained concept up until recently failed to have any significance influence in the development of policy or regulation as it was considered too subjective to have any real legitimacy. This is, however, unsound given that happiness is our most fundamental objective as human beings.<sup>45</sup>

Recently, Paul Martin has written in *Making Happy People: The Nature of Happiness and its Origins in Childhood* that: 'With the sole exception of happiness, everything we humans desire can be regarded as a means to an end- and that end is usually happiness.'<sup>46</sup> Similarly, in *Happiness: Lessons from a New Science*, Layard speaks of happiness as our 'overall motivational device'.<sup>47</sup>

Because of the traditional perception of happiness as incapable of being defined, the concept of 'utility' has continued to adhere to the traditional textbook perspective of what is in the interests of a rational, selfish actor (*homo economicus*), rather than embracing scientific evidence directly concerned with human happiness. But recent work into happiness shows that the contention of agency theorists that money (through remuneration) is the best means of enhancing the 'utility' of executives is misguided. Instead, the happiness of executives can be fostered purely through positive means.

### *1. The New Happiness*

In the past few decades, there has been an explosion in the amount of studies conducted into human happiness. Most recently, this has included conducting brain scans of individuals (using MRI technology) to record how certain events or sensations impact upon those parts of the brain that generate feelings of happiness, or sorrow. While noting the diversity in the range of activities through which

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<sup>45</sup> According to John Stuart Mill in his classic work *UTILITARIANISM*, we ought to pursue happiness because we do pursue happiness.

<sup>46</sup> PAUL MARTIN, *MAKING HAPPY PEOPLE: THE NATURE OF HAPPINESS AND ITS ORIGINS IN CHILDHOOD* 2 (2005).

<sup>47</sup> RICHARD LAYARD, *HAPPINESS: LESSONS FROM A NEW SCIENCE* 24 (2005).

people choose to express themselves, what the happiness research to date has shown is that at the base we are not that different after all.

We can now confidently identify the things that make us happy. These include a high degree of liberty, so that we are free to pursue our individual goals, a sense of participation and control in the activities we engage in, close personal relationships, good health and the pursuit of challenging projects and activities. We also know some things that do not make us happy. One of these, generally speaking, is money. In reflecting on the emerging science of happiness, Professor Layard comments that: 'Happiness is an objective dimension of all our experience. And it can be measured. ... [W]e can trace the ups and downs of someone's experience, and we can also compare the happiness of different people. ...so happiness is a real, objective phenomenon.'<sup>48</sup>

This development is very significant, particularly when the practical application and pursuit of happiness has never really taken off as a serious area of research or application in professional disciplines. Now that empirical studies have highlighted that happiness is capable of being defined, the implications— in terms of influencing public policy and the development of the law— are potentially enormous.

Given that happiness is for various reasons our ultimate objective, we can now have an informed debate as to whether executive compensation arrangements (and indeed other aspects of corporate governance) truly are effective in appealing to the utility maximising needs of executives, or whether an alternative approach is warranted. What is particularly interesting, and of special relevance to the study of executive compensation, are quite recent studies and commentary on the link between the accumulation of money and levels of personal happiness.

## *2. Money and Happiness*

### *a) Short History of Findings*

Contrary to the view of wealth maximisation relied upon by agency theorists, empirical studies that have been conducted on the link between levels of wealth and happiness have generally shown that there is only a weak correlation between wealth creation and happiness.<sup>49</sup> Indeed, based on comprehensive studies

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<sup>48</sup> *Id.*, at 224 (emphasis added).

<sup>49</sup> It is important to note, however, that some recent economic studies of well-being (using so-called 'regression equations') have shown that one's level of income, and the nation's level of GDP (gross domestic product) were factors that contributed to the happiness levels of the individuals that were

conducted by Ronald Inglehart, there is a much stronger connection between democracy and happiness than between wealth and happiness. From representative samples of around 170,000 people from a number of different countries, Inglehart concluded that there were rather significant national differences in the levels of happiness experienced by people.<sup>50</sup> For example, year after year, the Danes, Irish and Dutch were happier and more satisfied with life than the French, Greeks and Italians. From these studies, one point made by Inglehart was that a nation's well-being correlated only modestly with national affluence. In interpreting these results in his ground-breaking book *The Pursuit of Happiness*, David Myers stated that:

Moreover, the surveyed nations differ in ways other than affluence, making it hard to disentangle cause and effect. For one thing, the most prosperous nations have enjoyed stable democratic governments, and there is a striking link between a history of stable democracy and national well-being. The thirteen nations that have maintained democratic institutions continuously since 1920 all enjoy higher life satisfaction levels than do the nations whose democracies developed after World War II or have not yet fully emerged.<sup>51</sup>

Thus, across countries there is not a strong link between happiness and wealth. Similar results emerge within countries. It is not the case that within any country that people are happier simply because they are rich. Again in his book Myers, citing a University of Michigan survey, notes that what matters more than absolute wealth is perceived/relative wealth.

Myers also refers to a wide-ranging survey of the happiness levels of Americans from 1955 to 1990 during which time wealth (measured as purchasing power) doubled, the study noting that there was no increase in the happiness levels of

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studied. See, for example, Rafael Di Tella, Robert J MacCulloch & Andrew J Oswald, *The Macroeconomics of Happiness*, 85 *REVIEW OF ECONOMICS AND STATISTICS* 809 (2003); Andrew J Oswald, *How Much Do External Factors Affect Well-Being? A Way to Use 'Happiness Economics' to Decide*, 16 *THE PSYCHOLOGIST* 140 (2003); Andrew E Clark & Andrew J Oswald, *A Simple Statistical Method for Measuring How Life Events Affect Happiness*, 31 *INTERNATIONAL JOURNAL OF EPIDEMIOLOGY* 1139 (2002). What these empirical studies do not show, however, is whether so-called 'psychological needs' of individuals contribute more or less to happiness than money and wealth. Further, similar to the findings discussed in this article by the author, what these economic studies generally show is that beyond satisfaction of basic needs, money contributes little to happiness. The results from happiness regression equations used in studies by economists show that higher income is associated with higher happiness for poorer countries, but the evidence is less strong within richer countries.

<sup>50</sup> RONALD INGELHART, *CULTURE SHIFT IN ADVANCED INDUSTRIAL SOCIETY* (1990).

<sup>51</sup> DAVID MYERS, *THE PURSUIT OF HAPPINESS* 36 (1992).

respondents.<sup>52</sup> It seems that 'if not wracked by hunger or hurt, people at all income levels can enjoy one another and experience comparable joy'.<sup>53</sup>

The benefit of wealth continues to be overestimated

Further, people continue to overestimate the effect that having more money has on happiness levels.<sup>54</sup> Once the basic necessities of life are satisfied, further increases in income and material gains produce very little benefit in happiness terms. Indeed, as Paul Martin recently commented in *Making Happy People*:

...[i]ncreases in personal wealth produce comparable increases in personal happiness only up to a point where basic human needs such as food, shelter, clean water and health care have been catered for. Beyond this basic level, further rises in wealth make proportionally smaller differences to happiness.<sup>55</sup>

Indeed, in a US Time magazine poll conducted in December 2004, money was not one of the top eight answers to the question 'What are your major sources of happiness?'. In fact, money ranked fourteenth. Nor was money or high material status one of the four top answers to the question 'what one thing in your life has brought you the greatest happiness?' From the surveys, it was found that Americans are overwhelmingly happy and optimistic people, regardless of income. According to the Time poll, happiness tended to increase as income rose to \$50,000 a year (with the mean annual household income in the US being around \$43,000). But after that money did not have any dramatic effect on one's level of happiness.<sup>56</sup>

#### b) Relative wealth impacts on happiness

As noted above, another interesting finding recorded by Myers in *The Pursuit of Happiness* is that happiness is largely determined according to the attainment of others: we feel good or bad depending on whom we compare ourselves to (so-called 'relative wealth').<sup>57</sup> Professor Layard discussed the significance of relative wealth to one's level of happiness in detail. According to Layard, money per se is

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<sup>52</sup> *Id.* at 43-44

<sup>53</sup> *Id.* at 39.

<sup>54</sup> *Id.* at 53.

<sup>55</sup> MARTIN, *supra* note 46, at 147.

<sup>56</sup> See Claudia Wallis, *The New Science of Happiness*, TIME MAGAZINE, 17 January 2005.

<sup>57</sup> MYERS, *supra* note 51, at 56.

not the cause of unhappiness, but rather happiness comes from consistently comparing our income/wealth with others.<sup>58</sup>

Layard also suggests that the phenomenon of 'social comparison' (ie, comparing ourselves to our neighbours or colleagues), which makes relative wealth is so important, explains why happiness has dropped while incomes have increased.

When people become richer compared with other people, they become happier. But when whole societies have become richer, they have not become happier- at least in the West.<sup>59</sup>

In his book, Layard refers to a study of Harvard University School of Public Health students to demonstrate his point that what makes people happy is their relative income (having more than others), rather than their absolute income. The group of students were asked to choose between living in two imaginary worlds (in which prices were the same):

In the first world, you get \$50 thousand a year, while other people get \$25 thousand (average).

In the second world, you get \$100 thousand per year, while other people get \$250 thousand (average).

A majority of the Harvard students who were surveyed preferred the first imaginary world.

This quest for greater relative income, because it catches so many in its trap, results in an overall deterioration in happiness in our society. Layard explains:

... the struggle for relative income is totally self-defeating at the level of society as a whole. If my income rises relative to yours, your income falls relative to mine by exactly the same amount. The whole process produces no net social gain, but may involve a massive sacrifice of private life and time with family and friends. It should be discouraged.<sup>60</sup>

Indeed, the force of relative wealth is an important factor explaining the otherwise irrational practices and trends in executive compensation. If we accept that society

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<sup>58</sup> LAYARD, *supra* note 47, at 7.

<sup>59</sup> *Id.* at 31.

<sup>60</sup> *Id.* at 151.

places itself on a continuing treadmill of social comparison, then it becomes easier to accept that the pay for performance pay-setting methodology is fundamentally flawed. Executives are never going to be completely satisfied with their lot, even if they are earning several dozen times more than the average worker in the company: there will nearly always be someone else in a similar position somewhere who is earning more. Pay for performance is flawed in the sense that it accentuates, and to a large extent depends upon, the continuation of the social comparison treadmill- with executives always keeping their eyes and ears alert to who is earning more than them (for the purpose of working towards getting paid a higher amount, and ostensibly achieving greater status), rather than using their energies to pursue what is in the company's best interests.

Receiving 50 times rather than 40 times average pay is most unlikely to be a life changing experience for an executive who already would have all their material needs satisfied. The best way to make executives happy is not to appeal to their hip pocket, but rather to recognise and foster those factors that make executives genuinely motivated to do best by the corporation. Accordingly, embracing positive corporate governance is our best hope to deal with probably the number one governance issue across the globe at present.

## **F. Conclusion**

Positive corporate governance contends that for the overwhelming majority of corporate executives, happiness comes not from money per se, but rather one's relative position. In embracing positive corporate governance, the task becomes directing this natural competitive instinct (with the help of education both in and outside of the corporation) to promote more productive endeavours - as opposed to relying on conventional methodologies, such as 'pay for performance' to achieve the same objectives.

Such a change in emphasis is likely to attract a person to the position of executive in a company for the long-term, and with a genuine interest in what they are doing. This is best for both the executive and the corporation.

In applying positive corporate governance to the specific issue of executive compensation, this article has highlighted that the link between pay and performance is at best questionable. Given that the very reason for external regulation of executive compensation in the form of express disclosure requirements is to improve the link between pay and performance, once this link is no longer supportable, which appears to be the outcome of embracing a positive approach to corporate governance, there is really no need for regulation of executive remuneration outside of the corporation. This is particularly the case

when the need for disclosure has traditionally been based on a mistrust of directors and executives to defray from self-dealing.

By doing away with the mistrust and other nasties, and devoting our energies to embracing the positive traits of executives, the level and structure of executive compensation could be controlled through the operation and influence of 'positive norms' inside the corporation, overcoming the need for burdensome regulation. This would be, well, a 'positive' development!