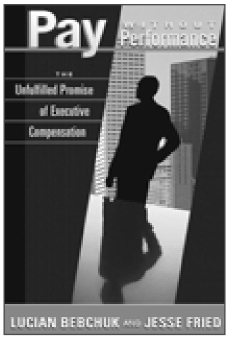

Pay without Performance

By Lucian Bebchuk and Jesse Fried

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REVIEWED BY STEPHEN F. O'BYRNE

PAY WITHOUT PERFORMANCE, subtitled *The Unfulfilled Promise of Executive Compensation*, is a fascinating and complex book. It draws on a wide range of research and makes a compelling brief that pay is unrelated to performance, corporate directors have strong incentives to favor management at the expense of shareholders, and significant corporate governance reforms are needed to make directors pursue shareholder interests when they conflict with management interests.

Lucian Bebchuk and Jesse Fried, law professors at Harvard and the University of California, Berkeley, respectively, argue that strong social and economic pressures discourage directors from aggressive pay bargaining with the CEO. Directors will be deferential to a CEO who invited them to join the board. Directors will also be deferential to the CEO because they have little hope of reelection if they raise the CEO's ire by insisting on pay that reflects poor performance. The authors cite academic studies showing that CEO compensation is higher when the outside directors are appointed by the CEO, the compensation committee chair is named after the CEO takes office, and the compensation committee members are highly paid in their primary employment.

Bebchuk and Fried argue that director independence, even with the new stock exchange rules, and public pressure are not sufficient to improve executive compensation. Directors who are completely independent of the CEO will not necessarily pursue the shareholders' interest; they are just as likely to pursue their own agenda by, for example, promoting pet projects, raising director pay, or hiring or promoting favored executives.

The authors offer several proposals to improve pay for performance and corporate governance. They recommend giving shareholders a much stronger role in director elections. Shareholder groups that have owned 5 percent of the company for at least a year should be able to nominate a full slate of directors (staggered boards would be eliminated) and have their costs paid by the company if they gain substantial support. As an alternative, albeit a less desirable one, they propose limiting director discretion by requiring shareholder approval for "bad pay," e.g., options that are not indexed to eliminate market or industry price changes or do not require a substantial holding period after vesting.

The book does not make a completely convincing argument that managerial influence is the *primary* cause of pay without performance, and hence leaves some doubt that its remedies are right. One cited study shows that CEO pay is higher when the directors have been appointed by the CEO, but the difference is less than 1 percent. Global Crossing, Qwest Communications, JDS Uniphase, and AOL Time Warner are cited as the egregious examples of pay without performance, but the telecom/Internet bubble and founder stock may have played bigger roles in these cases than bad executive compensation practices. Bebchuk and Fried use professional sports pay as an example of arm's-length bargaining, but they don't show that there is more pay for performance in sports than in business. Managers, like athletes, may demand too large a risk premium for incentive compensation to make high levels of pay for performance cost-efficient.

The authors argue that equity-based compensation is largely pay for market performance, since 70 percent of stock price changes are due to overall market performance (citing a 1998 newspaper report of a consulting firm study) and option exercise prices are rarely adjusted for market performance. But data from Ibbotson Associates, a leading source of investment data, show that the market has a much smaller impact, explaining only 25 percent of share price movement for larger companies and less than 10 percent for small companies. This and the common use of annual grants (which provide exercise price averaging) may explain the limited use of indexed options more than managerial power.

While we can raise some questions about their argument, Bebchuk and Fried's compelling book clearly shifts the burden of proof to the opponents of corporate governance reform. Well worth reading! ■

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