Pay without Performance

The Unfulfilled Promise of Executive Compensation

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Preface

A WAVE OF corporate scandals that began in late 2001 shook confidence in the performance of public company boards and drew attention to potential flaws in their executive compensation practices. There is now recognition that many boards have employed compensation arrangements that do not serve shareholders' interests. But there is still substantial disagreement about the scope and source of such problems and, not surprisingly, about how to address them.

Many take the view that concerns about executive compensation have been exaggerated. Some of these observers believe that flawed compensation arrangements have been limited to a small number of firms and that most boards have carried out effectively their role of setting executive pay. Others concede that flaws in compensation arrangements have been widespread, but maintain that these flaws have resulted from honest mistakes and misperceptions on the part of boards seeking to serve shareholders. In this view, now that the problems have been recognized, corporate boards can be expected to fix them on their own.

Our aim in this book is to persuade readers that such complacency is hardly warranted. Flawed compensation arrangements have been widespread, persistent, and systemic, and they have stemmed from defects in the underlying governance structure that enable executives to exert considerable influence over their boards. Given executives' power, directors could not have been expected to engage in arm's-length bargaining with executives over their compensation. The absence of effective arm's-length dealing under today's system of corporate governance—not temporary mistakes or lapses of judgment—has been the primary source of problematic compensation arrangements.

Another, broader aim of this book is to contribute to a better understanding of some basic problems of the corporate governance system. Our

study of executive compensation opens a window through which we can examine our current reliance on boards to act as guardians of shareholders' interests. Our corporate governance system gives boards substantial power and counts on them to monitor and supervise the company's managers. As long as it is believed that corporate directors carry out their tasks for the benefit of shareholders, current governance arrangements—which insulate boards from intervention by shareholders—appear acceptable. Our work casts doubt on the validity of this belief and on the wisdom of insulating boards from shareholders.

By providing a full account of how and why boards have failed to serve their critical role in the executive compensation area, we hope to contribute to efforts to improve compensation practices and corporate governance more generally. Understanding the source of existing problems is essential for assessing reforms. Some observers now concede that boards have not been sufficiently attentive to shareholders' interests, but argue that an increase in the role of independent directors—facilitated by recently adopted stock exchange requirements—will make such problems a matter of the past. But this is not the case. Our analysis indicates that, to address the identified problems, directors must be made not only more independent of insiders but also more dependent on shareholders. We therefore put forward reforms that would reduce boards' insulation from shareholders. Such reforms may well offer the most promising route for improving executive compensation and corporate governance.

This book builds on our 2001 study with David Walker, "Executive Compensation in America: Managerial Power or Extraction of Rents?" which was published in 2002 in the *University of Chicago Law Review* under the title "Managerial Power and Rent Extraction in the Design of Executive Compensation." It also draws on another piece by the two of us, "Executive Compensation as an Agency Problem," which was published in the *Journal of Economic Perspectives* in the summer of 2003. As we indicate at various points throughout the book, we also build on other work that we have done on corporate governance.

In the course of writing this book, we have incurred considerable debts that we wish to acknowledge. Special thanks go to David Walker, our coauthor on the 2001 study. David worked on the first stage of this study and made an important contribution to its development. In the fall of 2000, he entered legal practice for two years, and the demands of this

practice prevented him from continuing to work with us. His sound judgment and insights contributed much to our 2001 study, and we very much missed them after he left.

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June 2004

In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging.

Warren Buffett, letter to shareholders of
Berkshire Hathaway, Inc., February 2004

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—companies whose shares are traded on stock exchanges—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 ninefold during this period.[2] The growth of executive compensation far outstripped that of compensation for other employees. In 1991, the average large-company CEO received approximately 140 times the pay of an average worker; in 2003, the ratio was about 500:1.[3]

Executive pay has long attracted much attention from investors, financial economists, regulators, the media, and the public at large. The higher CEO compensation has 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 the increase in the volume of research papers on the subject.[4]

Executive compensation has also long been a topic of heated debate. The rise in pay has been the subject of much public criticism, which further intensified following the corporate governance scandals that began erupting in late 2001. But the evolution of executive compensation during the past two decades has also had powerful defenders. In their view, despite some lapses, imperfections, and cases of abuse, executive arrangements have largely been shaped by market forces and boards loyal to shareholders.

Our main 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 financial economists' study of executive compensation has assumed that pay arrangements are the product of arm's-length bargaining—bargaining between executives attempting to get the possible deal for themselves and boards seeking to get the best possible deal for shareholders. This assumption has also been the basis for the corporate law rules governing the subject. We aim to show, however, that the pay-setting process in publicly traded companies has strayed far from the arm's-length model.

Our analysis indicates that managerial power has played a key role in shaping managers' pay arrangements. 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 studying executive compensation.

We seek to contribute to a better understanding of the flaws in current compensation arrangements and in the corporate governance processes generating them. Such an understanding is necessary for addressing these problems. We show that recent corporate governance reforms, which seek to increase board independence, would likely improve matters but that much more needs 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 discusses the shortcomings of the "official" view of executive compensation. According to this view, which underlies existing corporate governance arrangements, corporate boards operate at arm's length from the executives whose pay arrangements they decide. Seeking to serve shareholders, directors design cost-effective compensation arrangements that provide executives with incentives to increase shareholder value.

Recognition of managers' influence over their own pay has been at the heart of the criticism of executive compensation in the media and by shareholder activists.[5] However, the premise that boards negotiate pay arrangements at arm's length from executives has long been and remains a central tenet in the corporate world and in most 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 that, 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 portrayed as being made largely with shareholders' interests at heart and therefore deserving of deference.

The official view's premise of arm's-length bargaining has also been shared by most of the research on executive compensation. Managers' influence over directors has been recognized by those writing on the subject from a legal, organizational, or sociological perspective.[6] But most of the research on executive pay (especially empirical research) has been done by financial economists, and the premise of arm's-length bargaining has guided most of their work. Some financial economists, whose studies we discuss later, have reported findings they viewed as inconsistent with arm's-length contracting.[7] However, the majority of work in the field has assumed arm's-length bargaining between boards and executives.

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 from executives and seeking to maximize shareholder value. Rational parties transacting at arm's length have powerful incentives to avoid inefficient provisions that shrink the pie produced by their contractual arrangements. The arm's-length contracting approach has thus led researchers to believe that executive compensation arrangements will tend to increase value, which is why we have used the terms "efficient contracting" or "optimal contracting" to label this approach in some of our earlier work.[8]

Financial economists, both theorists and empiricists, have largely worked within the arm's-length model in attempting to explain common compensation arrangements as well as 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 how 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 will ultimately either 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, 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 the company's top executives. Various social and psychological factors—collegiality, team spirit, a natural desire to avoid conflict within the board team, and sometimes friendship and loyalty—have also pulled board members in that direction. Although many directors own shares in their firms, their financial incentives to avoid arrangements favorable to executives have been too weak to induce them to take the personally costly, or at the very least unpleasant, route of haggling with their CEOs. Finally, limitations on time and resources have made it difficult for even well-intentioned directors to do their pay-setting job properly.

Some writers have argued that even if directors are subject to considerable influence from corporate executives, market forces can be relied on to force boards and executives to adopt the compensation arrangements that arm's-length bargaining would produce. Our analysis, however, finds that market forces are neither sufficiently finely tuned nor sufficiently powerful to compel such outcomes. The markets for capital, corporate control, and managerial labor do impose *some* constraints on executive compensation. These constraints are hardly stringent, however, and they permit substantial deviations from arm's-length contracting.

A realistic picture of the incentives and circumstances of board members, then, reveals myriad incentives and tendencies that lead directors to behave very differently than expected under the arm's-length model. Recent reforms, such as the new stock exchange listing requirements that seek to limit CEOs' ability to financially reward independent directors, may weaken some of these factors but will not eliminate them. Without additional reforms, the pay-setting process will continue to deviate substantially from the arm's-length model.

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 influenced by management, sympathetic to executives, insufficiently motivated to bargain over compensation, or simply ineffectual in overseeing compensation. Execu-

tives' influence over directors has enabled them to obtain "rents"—benefits greater than those obtainable under true arm's-length bargaining.

Although top executives generally have some degree of influence over their board, the extent of their influence depends on various features of the firm's governance structure. The managerial power approach predicts that executives who have more power vis-à-vis their boards should receive higher pay—or pay that is less sensitive to performance—than their less powerful counterparts. A substantial body of evidence does indeed indicate that pay has been higher, and less sensitive to performance, when executives have more power.

There are, of course, limits to the arrangements that directors will approve and executives will seek. Markets, such as the market for corporate control, might penalize boards that allow pay arrangements that appear egregious. Directors and executives might in such a case also bear social costs. The constraints imposed by markets and by social forces are far from tight, however, and they permit substantial deviations from arm's-length outcomes. The adoption of arrangements favoring executives is unlikely to impose substantial economic or social costs if the arrangements are not patently abusive or indefensible.

One important building block of the managerial power approach is that of "outrage" costs. When a board approves a compensation arrangement favorable to managers, the extent to which directors and executives bear economic and social costs will depend on how the arrangement is perceived by outsiders whose views matter to the directors and executives. An arrangement that is perceived as outrageous might reduce shareholders' willingness to support incumbents in proxy contests or takeover bids. Outrage might also lead to shareholder pressure on managers and directors, as well as possibly 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.

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 try to obscure and legitimize—or, more generally, to camouflage—both the level and performance-insensitivity of executive compensation. Camouflage thus allows executives to reap benefits at the

expense of shareholders. More importantly, attempts to camouflage can lead to the adoption of inefficient compensation structures that harm managers' incentives and, in turn, company performance, imposing even greater costs on shareholders.

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 compensation and the extent to which it is decoupled from managers' own performance. Managers' interest in reduced transparency has been served by the design of numerous compensation practices, such as postretirement 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.

Performance Pay and the Unfulfilled Promise of Executive Pay

Those applauding the rise in executive compensation have stressed the benefits to shareholders from strengthening managers' incentives to increase shareholder value. Indeed, in the beginning of the 1990s, prominent financial economists such as Michael Jensen and Kevin Murphy urged shareholders to be more accepting of large pay packages that would 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 executive pay as the price of improving managers' incentives. Higher compensation has been presented as essential for improving managers' incentives and therefore worth the additional cost. Unfortunately, however, much of the additional value provided to executives has not actually been tied to their own performance. Shareholders have not received as much bang for their buck as possible.

As we describe in part III, managers have used their influence to obtain higher compensation through arrangements that have substantially decoupled pay from performance. Firms could have generated the same increase in incentives at a much lower cost, or they could have used the amount spent to obtain more powerful incentives. Executive pay is much less sensitive to performance than has commonly been recognized.

Although equity-based compensation has recently drawn the most

attention, much executive pay comes in forms other than equity, such as salary and bonus. The evidence indicates that cash compensation—including bonuses—has been at best weakly correlated with firms' industry-adjusted performance. Such compensation has been generously awarded even to managers whose performance was 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 frequently receive, such as favorable loans, pensions and deferred compensation, and various perks. These less-noticed forms of compensation, which can be substantial, have tended 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—that is, compensation based on the value of the company's stock. Most equity-based compensation has taken the form of stock options—options to buy a certain number of company shares for a specified price (the "exercise" or "strike" price). We strongly support equity-based compensation, which in principle can provide managers with desirable incentives. Unfortunately, however, managers have been able to use their influence to obtain option arrangements 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 was 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 are unrelated to 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 cling to conventional option plans under which most of the equity-based compensation paid to managers is not tied 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. Unfortunately, most of the boards now changing their equity-based compensation plans in response to outside pressure are still choosing to avoid plans that would effectively eliminate such windfalls. Rather, they are moving to plans, such as those based on restricted stock, that fail to eliminate, and sometimes even increase, these windfalls.

Alternative Critiques of Executive Compensation

Criticism of executive compensation practices can come from a variety of methodological and ideological perspectives. It is important to make clear at the outset how our take on the subject differs from other types of criticism. Indeed, in some respects, our positions are closer to those of supporters of current pay arrangements than to those of other critics of these arrangements.

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

Our own criticism does not come from this perspective. Our approach is completely pragmatic and consequentialist, focusing on shareholder value and the performance of corporations (and, in turn, the economy as a whole). We would accept compensation at current or even higher levels as long as such compensation, through its incentive effects, actually serves shareholders. We are concerned, however, that the compensation arrangements that have been in place do not meet this standard.

It is also important to distinguish our position from the view that financial incentives are not very important in motivating top executives and that enhancing shareholder value therefore does not call for large pay packages. At least since the first half of the past century, some industrial psychologists have maintained that corporate executives, who are all materially well off anyway, are primarily moved by such factors as the need for esteem, self-actualization, and so forth.[11] In this view, “The 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, does not affect performance and is simply a waste of shareholder money.

In contrast to this view, we share the assumption of defenders of current pay arrangements that executives are influenced by financial incentives. We agree that paying generously to provide desirable incentives can be a good compensation strategy for shareholders. Indeed, the fact that executives (as well as directors) are influenced by financial incentives and have an interest in increasing their own pay actually plays an important role in our analysis. Our concern is simply that executives have partly taken over the compensation machine, leading to arrangements that fail to provide managers with desirable incentives.

Finally, it is worth emphasizing that our criticism of executive pay arrangements does not focus on the amount of compensation received by executives. In our view, high absolute levels of pay do not by themselves imply that compensation arrangements deviate from arm's-length contracting. Our conclusion that such deviations have been common is based primarily on an analysis of the processes by which pay is set, as well as on examining the inefficient, distorted, and nontransparent structure of pay arrangements. For us, the "smoking gun" of managerial influence on pay is not high pay but rather such things as evidence linking the relationship between power and pay, the systematic use of compensation practices that obscure the amount and performance insensitivity of pay, and the showering of gratuitous benefits on departing executives.

The Stakes

How important is the subject of executive pay? Why should one read a whole 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, do not substantially affect shareholders' bottom line and are thus mainly symbolic.

Even if symbolism were unimportant, however, the subject of executive compensation is of substantial practical importance for shareholders and policymakers. Flaws in compensation arrangements impose substantial costs on shareholders. To begin with, there is the excess pay that managers receive as a result of their power, that is, the difference between what managers' influence enables them to obtain and what they would get under arm's-length contracting. As a current study by Yaniv Grinstein and one of us seeks to document in detail,[13] the amounts involved are hardly pocket change for shareholders.

During the five-year period 1998–2002, the compensation paid to the top five executives at each company in the widely used ExecuComp database, aggregated over the 1500 companies in the database, totaled about $100 billion (in 2002 dollars). And the capitalized present value of aggregate top-5 compensation in publicly traded U.S. companies is rather substantial. During the past ten years, the growth rate of aggregate executive compensation has kept pace with that of total stock market capitalization. Assuming that aggregate executive compensation continues to grow in tandem with market capitalization or that managers' share of