REVIEW ARTICLE

Pay Without Performance. The Unfulfilled Promise of Executive Pay. Lucian Bebchuk and Jesse Fried. Boston, MA: Harvard University Press, 2004. xii + 450 pp + 8 pp index. Hardback £16.95.

This is an important book. *Pay Without Performance* contains a devastating, highly readable and frequently breathtaking critique of the current executive pay excesses which are dominating the corporate governance debate. It sets out a new and compelling framework, with far-reaching implications for the received wisdom that the board acts as guardian of shareholders' interests, for how to think about the burgeoning executive pay problem. The authors also propose a "shareholder power" based model for managing agency conflicts in the dispersed ownership company more generally, given the evidence, of which executive pay provides the paradigm example, of defective board monitoring of management. The book is a landmark in corporate governance scholarship. Although it is concerned with US law, policy and pay practices, it contains a number of important lessons for the EU, not least given the EU Commission's 2004 reforms to the governance of executive pay decisions which form part of the Commission's important 2003 Company Law Action Plan.

At the core of the book is the authors' thesis that wildly spiralling US executive pay is no longer effectively linked to performance because pay has become an expression of management power and influence over the board. The widely held conviction, which has dominated academic opinion, that soaring levels of executive pay are justifiable as pay is set by boards which act on behalf of shareholders and link pay to executive performance is relentlessly exposed as a fiction. Bebchuk and Fried test their model of executive pay as an expression of managerial influence over the board against the full range of executive pay practices from retirement packages to management perks, options and cash bonuses. The managerial power model emerges as explaining current executive pay practices much more convincingly than the dominant model of executive pay as a function of arm's length contracting between the board, acting on behalf of shareholders and management. The approach throughout, however, is deeply scholarly and always balanced: this is no polemic against one of the more unattractive and popularly demonised features of capitalism. The authors describe their approach as "pragmatic and consequentialist". Their quarrel is not with high levels of pay *per se*, but with the decoupling of the pay–performance link and the consequent costs to shareholders in terms of flawed and perverse management incentives. The reduction in shareholder value caused by inefficiencies in pay arrangements is isolated as the biggest cost of management influence over pay. Throughout, the analysis is anchored to persuasive empirical evidence, drawn from scholarly studies, surveys and anecdotal data.

The book opens with a comprehensive deconstruction in section I of what the authors term "the official view" or the "arm's length bargaining" theory that currently dominates the executive pay debate and particularly the financial economics literature which has led executive pay research. Under this model, executive pay remedies the agency costs generated by the misalignment of management and shareholder interests in the dispersed ownership company. Shareholders in dispersed ownership systems have only a fractional interest in firm profits and are not fully incentivised to discipline, and have limited opportunities to monitor, management. Management's unobserved actions can prejudice shareholder wealth and give rise to agency costs. Agency theory suggests that the performance-based, or incentive, pay contract, which links pay to shareholder wealth via performance indicators such as share prices or accounting-based targets, is a powerful way of attracting, retaining and motivating managers to pursue the shareholders' agenda. The incentive pay contract is negotiated by the board, seeking to maximise shareholder value.

This "official view", and the reality of efficient contracting by the board on behalf of shareholders' interests, is subject to a searing criticism. At the heart of the tightly argued critique, which is supported by numerous examples and studies, is the authors' analysis of director incentives: they make the telling but often overlooked point that, given that management does not instinctively seek to maximise shareholder value (the reality at the core of the dominant agency analysis of executive pay), there is no reason to expect that directors will also act in this way: "directors' own incentives and preferences matter". Problematic incentives include: directors' desire to be re-elected to the board; the desire to placate CEOs, given their power to benefit directors; directors' natural tendencies to support awards which benefit their own remuneration; and incentives driven by social and psychological factors such as friendship and loyalty to the CEO and senior executives. Insufficient time and information to digest pay contract information exacerbates the core incentive problem, as does the influence of remuneration consultants on the pay information provided to directors. The likelihood of disinterested board action over pay, and the arm's length model working, is shown to be almost infinitesimal under these conditions. Allied to weaknesses in board incentives is the difficulty of effective shareholder intervention. Bebchuk and Fried argue that backstop shareholder power, whether in the form of litigation against directors for breach of directors' duties, votes against employee shareholder plans, or shareholder resolutions, is ineffective given collective action difficulties and more discrete weaknesses in shareholder voice mechanisms. The correcting influence of market forces (labour, corporate control, capital and products) as an additional bulwark against flawed bargaining is also considered but shown to be insufficient to prevent pay from deviating from what arm's length bargaining should produce. Multiple failures therefore combine to exacerbate the essential incentive problem faced by boards in bargaining for executive pay at arm's length.

Section II presents the authors' alternative managerial power model. Given the conditions described in section I, if there is evidence of managerial influence, it will combine with weak board incentives to act on behalf of shareholders to produce an environment conducive to flawed pay-setting. Managerial power, in effect, allows management to extract rents in the form of pay in excess of what is optimal for shareholders and of what would be obtained under arm's length bargaining. It is not, however, simply a question of higher pay being extracted: much greater risk to shareholders lies in management's incentives to bear less risk and less pressure to generate shareholder value. The real danger lies in the strong management incentive to break the performance link, a key point which is compellingly illustrated. Bebchuk and Fried also present two key building blocks of this alternative model: the "outrage constraint" and the "camouflage" response. Given the limited controls on the board and its flawed incentives, the extent to which the board is restrained in setting executive pay becomes a function of negative outside reaction and the consequent costs to the board and management. Where negative reaction, or "outrage" costs, are likely to be high, boards should be more reluctant to approve, and management more hesitant in proposing, defective pay schemes. A key tenet of the Bebchuk and Fried analysis, however, is that outrage does not resolve, but rather exacerbates, the pay problem. The likely response of a board subject to management influence is to "camouflage" pay structures, and particularly weak performance links, to minimise outrage. The camouflage response, in particular, provides a powerful narrative for explaining current opaque executive pay practices and is a recurring theme of the rest of the book's examination of particular pay practices. The authors also show in this section how particular conditions are more likely to lead to management power and influence over boards: power is positively related to relatively weak boards, the absence of outside shareholders, fewer institutional shareholders and aggressive anti-takeover protections for management. Compelling examples of management power and influence, beyond the remuneration packages which are considered in section IV, which cannot be explained under the arm's length model, include the gratuitous payments to departing CEOs whether on dismissal, retirement, or when the company is acquired. Similarly, the authors show how retirement benefits, given their scale and their related ability to camouflage large, non-performance-linked payments to executives, can only be explained under the management power model. The evidence of how executive loans are granted also shows that they are similarly unworkable as effective pay under the arm's length model.

Section III is a *tour de force*. Using the management power model, it exposes the extent to which pay has not only become higher than what is optimum for shareholders, but also, and much more importantly, how it has been decoupled from performance. All aspects of the remuneration contract (equity and non-equity elements) are examined under the management power model and shown to be inexplicable under the arm's length model. This section reads as a severe indictment of pay practices over the last 20 years and of the corrosive influence of the arm's length model as a justification for what emerges as endemic and entirely unjustifiable board failures to set pay to reflect shareholder interests. In particular, the failure of equity and non-equity pay to provide appropriate incentives, which is the real cost to shareholders, is examined at length.

Four chapters are devoted to equity-based pay, which continues to generate most controversy on both sides of the Atlantic. Equity-based pay arrangements, and particularly share options, have seen the greatest removal of incentives and generation of perverse incentives. Paradoxically, equity-based pay also remains, for the most part, the darling of policy makers, institutional investors and financial economists. This is all the more concerning as the authors reveal how cash-based bonus plans, and particularly acquisitions bonuses, golden hellos and severance packages, do not reward performance. Although the authors support equity-based pay in principle as an effective interest-alignment mechanism, they also show that it has not lived up to its promise:

> "managers have been able to use their influence to grab the reins of the options bandwagon and steer it in a direction that serves their interests . . . options plans . . . have delivered a considerable amount of pay without performance and packaged that pay so that it seems defensible and legitimate."

Structural weaknesses in option arrangements, allied to weak board governance and strong management influence, has allowed management to use options to generate massive windfall gains, destroy the pay–performance link and distort the incentives built into option pay, using the opaque structure of option pay as camouflage. The failure of options to reduce windfall gains, or gains linked to share price increases which occur independently of corporate performance, is at the core of their critique. Bebchuk and Fried show how a wide range of techniques, chief among them indexing, are available to filter out windfall gains and sharpen performance incentives, but that there is "an almost complete absence of reduced windfall options". They conclude that this can only be explained under the managerial power model and reject the range of conventional excuses (chief among them options accounting rules) usually offered to characterise windfalls as an outcome of rational and optimum arm's length contracting. A similar analysis is applied to other anomalies such as the grant of "at-the-money" options, which are issued at an exercise price equal to the company's share price at the time of grant (when greater incentives are delivered when options are issued at out-of-the money share prices) and the practice of re-pricing options when the share price drops. Perhaps most convincing in support of the managerial power model is the extensive evidence of the complete failure of option programmes to prevent managers from unwinding incentives by selling the option immediately or hedging away the risk it represents. Unloading of options "either weakens managers' incentives or forces the firm to provide additional options or shares to restore incentives".

Flawed pay arrangements not only weaken managerial incentives to increase shareholder value. The equity-based incentive contract may also deepen conflicts of interest between shareholders and management by generating perverse management incentives to manipulate financial disclosure, particularly earnings, and to distort share prices, which can lead to catastrophic corporate failures. Bebchuk and Fried present a powerful analysis of this risk, showing how the failure to manage unwinding by managers also incentivises them to manipulate disclosure, or follow short-term, opaque policies, to generate short term price increases prior to unloading options: "the costs to shareholders of such distortions might exceed, possibly by a large margin, whatever liquidity or risk-bearing benefits executives obtain from being able to unload their options and shares at will".

In their concluding section IV, on the implications of the management power model for executive pay, and for corporate governance more generally, the authors take a twin track approach. First, they isolate particular pay structures which robustly promote performance and which should be supported by shareholders, particularly institutional shareholders (such as schemes which filter out windfall gains and which restrict the unwinding of incentives and unloading equity-based pay). Secondly, they address governance structures and the board as guardian of shareholder interests. In contrast with the EU position, outlined below, and the current trend of US reforms post-Sarbanes–Oxley, Bebchuk and Fried are sceptical as to the value of board independence-based reforms, given the continuing vulnerability of boards to management influence and the core incentive weakness in the board. Instead, they propose a restructuring of board incentives to act on behalf of shareholders, by increasing board dependence on shareholders. In particular, they suggest that US arrangements which insulate directors from removal by shareholders should be reduced or eliminated. They also argue that board power to veto changes over governance arrangements in a company's constitutional documents should be removed. Ultimately, they locate the executive pay decision in a properly incentivised board. While they view the shareholder voice mechanism as important, albeit still flawed (they propose a shareholder vote on suspect pay structures such as options which do not address windfalls, and pay packages which do not prevent the unwinding of incentives), they argue that it cannot substitute close director consideration of the many and complex choices involved in effective executive pay decisions. Their conclusion is ultimately a hopeful one.

The Bebchuk–Fried analysis is particularly timely for the EU debate given that executive remuneration practices have recently come under close review with the EU's 2004 Recommendation on Executive Remuneration and 2004 Recommendation on Non-Executive Directors. Executive remuneration operates in a sharply different context in the EU, however, which calls for some care when considering the Bebchuk–Fried analysis in the EU environment. Remuneration levels, and particularly option grants, have not reached the stratospheric levels of US practice. More fundamentally, however, the agency problem at the core of the management power model changes characterisation as the EU executive pay contract arises under dispersed and block-holding conditions, and in relation to different agency problems and managerial incentives. In particular, continental European relationship-based corporate governance, characterised by concentrated shareholdings and long-term shareholder commitment, changes incentives and conflicts. The agency costs of the dispersed ownership company are reduced as block-holding shareholders have enhanced incentives and resources to monitor managers more directly and effectively, and without high-powered incentive contracts. There is, therefore, less need for an incentive contract to control agency costs arising from a conflict between management and shareholder interests. There is also less probability of related agency costs, deriving from executive pay becoming an expression of management power, arising. EU practice bears this analysis out. The sophistication of regulatory intervention on pay, and the extent to which high-powered, equity-based incentive contracts are adopted, reflects governance systems across the EU. Member States with predominantly dispersed ownership see the heaviest reliance on equity-based, incentive-driven pay contracts. Monitoring by controlling shareholders seems to have limited the degree of reliance on high-powered equity-based contracts in continental Europe, although option pay is on the rise across the EU (see generally G Ferrarini and N Moloney (2005) 21 *Oxford Review of Economic Policy* 304 and G Ferrarini *et al* (2004) 4 *Journal of Corporate Law Studies* 243).

Nonetheless, the pan-EU evidence from the last few years of inexorable increases in pay, and particularly opaque option grants (the UK remains the only Member State to rely heavily on long-term, share-based incentive plans), suggests that a Bebchuk–Fried analysis of incentives, governance, and consequences for pay–performance links is essential. This is particularly the case for dispersed ownership regimes, where the board may be an unreliable guardian of shareholder interests, but also for block-holding governance. Where the shareholder/owner manages the company, there is an alignment of interests, and the need for an incentive contract, in principle, recedes. Where a professional/outside manager manages for the owner-shareholder, who may also be a director, the owner monitors the manager's performance, reducing the need for an incentive contract. Where ownership is concentrated, however, and management is carried out by inside managers or professional/outside managers, monitoring of management is carried out by the block-holders, but the incentive contract can align managerial interests in the interests of the company as a whole, protecting minority shareholders. Intervention may, however, be appropriate to prevent collusion between block-holders and management. Where management and block-holders collude on pay-bargaining, a conflict arises between their interests and those of minority shareholders, triggering a potential misalignment of interests, albeit across a different conflict line.

The EU has moved to consider executive remuneration as an aspect of board governance and conflict of interest management. Its approach reflects the Bebchuk–Fried concern with faulty incentives and poor governance. The 2004 reforms are based on the assumption that, while design is for individual company policy, the executive pay contract should provide proper incentive alignment, monitored by shareholders and market forces, and that EU intervention, to promote convergence in best practices, is necessary to achieve this. Unlike the Bebchuk–Fried approach, however, the EU reforms are essentially based on improving board governance through director independence and remuneration committee mechanisms. The non-executive director mechanism is employed to protect the interests of weak shareholders over management in dispersed ownership and to ensure that the interests of minority shareholders are considered in block-holding systems. Although the effectiveness of a Recommendation remains questionable, the recommendations as to remuneration committee composition, independence, skills and competence of non-executive directors should at least enhance board incentives to link pay to performance. A relentless focus on board incentives may, however, be less important, given the existence of shareholder vote mechanisms on pay, as well as direct director removal powers, in the UK (the classic EU dispersed ownership system): effective disclosure is, however, critical.

Problems remain, however, for minority shareholders with potential block-holder–management collusion on pay, which are unlikely to be fully addressed by the board reforms given the close connection between the board and the block-holders. Notwithstanding the weakness of collective shareholder action, which are cogently assessed by Bebchuk and Fried, the EU reforms also heavily reflect backstop shareholder control in the disclosure reforms and in specific shareholder voice mechanisms. These include: the remuneration policy being a specific item on the agenda of the annual general meeting; the remuneration policy statement being submitted to the general meeting for an advisory vote; and approval of the grant and terms of equity pay schemes (including repricing provisions). This uncompromising commitment to traditional shareholder governance as an additional control on faulty board incentives sits uneasily, however, with the control dynamics of block-holding governance. The best approach here may be to maximise the opportunities for Bebchuk–Fried wider market "outrage" as a protection for minority shareholders and, therefore, extensive disclosure and wider market transparency—both of which are included in the EU reforms and which should also minimise the opportunity for consequent "camouflage" strategies.

The EU faces considerable difficulties in tackling what may, given recent evidence, be an emerging executive pay problem. While incentive problems reflecting the Bebchuk–Fried model undoubtedly exist, they cross a wider range of relationships than US corporate governance. In addition, any reform must grapple with the desirability of harmonisation of corporate governance practices. Disclosure, particularly to promote "outrage" and, where practical, to support shareholder voice, is central to the adoption of effective incentive contracts in the EU. Any other interventions in the pay process carry the risk of distorting competition and interfering with the dynamics of different ownership structures and economic contexts.

Executive pay has been described as "One of the great, as-yet-unsolved problems in [the US]" (SEC Chairman Donaldson, 2003, cited in *Pay Without Performance*). The problem is now one common to all EU Member States as well. Bebchuk and Fried are too modest in their hopes for their analysis and in their primary objective of "improv[ing] understanding of the problems that have plagued executive compensation". Their outstanding analysis will not only change the contours of the executive pay debate but also shape thinking on the power dynamics of the board/shareholder relationship for some time to come.

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