Book Review

BEBCHUK, Lucian, AND Jesse M. FRIED [2004], *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, Harvard University Press: Cambridge, MA, and London. 292 pp. $24.95 (hardcover). ISBN 0-674-01665-3.

In this book Bebchuk and Fried, professors of law at Harvard and Berkeley, respectively, analyze the three interrelated questions: Can the spectacular increase of executive compensation in the last 10 to 20 years be justified as an outcome of efficient contracting? Can the structure of executive compensation be justified in this way? And, finally, do academic researchers have the right model to analyze executive compensation? After a thorough review of the academic literature on the subject, their answer is "no" to all three questions.

The book comprises 16 chapters organized into four parts. Part I critiques what the authors label the "official view," which is nothing other than the standard textbook model of agency relationships in a public corporation. Shareholders entrust a board of directors with their interests. The board then bargains with senior executives over their remuneration. Thus, executive pay is set in a labor market just like any other compensation contract and results from arm's-length bargaining. Then the level of pay and structure of compensation contracts reflects the scarcity of managerial talent and the marginal productivity of executives, and must be understood as a second-best solution to the agency relationship between shareholders and executives.

The authors then review the empirical evidence for the United States and conclude that this "official view" is a seriously distorted picture of reality. The cornerstone of their criticism is the role of the board of directors. In their view, the board lacks affirmative incentives (directors normally own little if any stock in their companies), information (for this they rely on executives), and the necessary independence to look effectively after shareholders' interests. In fact, they enjoy a close and collegial relationship with the CEO and devote little time and resources to their work. In addition, their judgment is compromised in that CEOs have the power to buy off their consent by influencing directors' pay or donating company funds to directors' favorite charities, and directors sometimes even depend on the CEO through interlocking directorships (where A sits on the board of company B and B sits on the board of company A). Shareholders have little leverage over the board of directors. Legal rules in the U.S. make shareholder resolutions at annual general meetings nonbinding (most resolutions passed with a majority are not implemented), and litigation has to pass too many procedural hurdles to provide an effective check on managerial power. They also dismiss market forces (product markets, reputation in the market for managerial labor, the mar-

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ket for corporate control) as too weak to curtail executives' ability to award themselves excessively generous pay packages.

In Part II the authors then formulate an alternative view of the pay-setting process that relies on two key assumptions. Firstly, all the power in the pay-setting process rests with management and in particular with the CEO. While self-dealing cannot be prevented given current institutions, executives do encounter resistance from something that Bebchuk and Fried baptize the "outrage constraint." This constraint reflects the social costs executives have to bear when their pay arrangements fall foul of the standards of relevant outsiders. Interestingly, these outrage costs sanction executives precisely through those channels that are dismissed in part I as ineffectual. Secondly, executives engage in "camouflage." The perception of the outsiders who impose outrage costs is selective and focuses on some components and some aspects of executive pay packages more than on others. Executives respond by designing compensation packages in such a way as to avoid outrage by choosing forms of compensation that attract little public attention. Examples are generous pension schemes, changes of technical details of stock-option grants, taking out loans from their companies that are forgiven later, or gratuitous grants upon leaving the company. Based on these two assumptions, the authors formulate two hypotheses: Managers are paid more if they are more powerful, and they structure their compensation in a way that attracts the least amount of public resistance. After establishing this framework the book then reviews the empirical evidence on severance pay, retirement benefits, and executive loans in great detail and concludes that none of these arrangements can plausibly be explained as a result of arm's-length bargaining. However, all of the findings follow naturally from a framework that emphasizes managerial power and the desire to camouflage excessively generous pay.

Part III confronts the main competing hypothesis of rising executive pay: CEOs were paid more because boards want to increase the pay-for-performance sensitivity of their pay. Linking pay to performance exposes executives to additional risks, and the increased pay is simply an additional premium managers demand for risktaking. The authors first work through the evidence on non-equity-based compensation and argue that bonus schemes, sign-up bonuses ("golden hellos"), and life insurance policies are designed to shield managers from the risks of the company rather than exposing them to these risks. However, most of this part is devoted to the discussion of the well-known fact that companies make very little use of benchmarking and do not reward their executives for firm-specific performance. Instead, managers are allowed to benefit generously from market-wide movements and are rewarded for luck rather than for value creation that could reasonably be attributed to their own efforts. Here the authors take issue not only with current practice, but also with the academic literature. They list no less than eight different approaches developed by academics – financial economists in particular – to rationalize observed practice as the outcome of rational, arm's-length bargaining between managers and directors. Bebchuk and Fried dismiss all of these as "excuses." From their perspective, the virtual absence of indexed option plans and managers' lobbying efforts to prevent the expensing of stock options provide strong support for their analysis. While the expensing of stock options does not affect companies' cash flows and is therefore costless to shareholders, it does make the costs of stock options more visible and simply removes one opportunity to "camouflage" an important component of executive pay. Also, an outcome of arm's-length bargaining should reflect firm-specific (and possibly also CEO-specific) characteristics, but strike prices are set in the same way in almost all companies – at the lowest level consistent with tax-saving objectives, resulting in the highest possible value for managers. Finally, managers have substantial abilities to reduce the performance sensitivity built into their equity-based incentive schemes – from the perspective of the authors an obvious conflict with the alleged objectives of these schemes.

The book concludes with two chapters (part IV) where the authors suggest improvements of current practice. They advocate the removal of all pay practices that reduce performance sensitivity and that are merely strategies to camouflage the true size of executive pay. Interestingly, and in contrast to much of the public discussion, they do not take issue with the size of pay packages as such. In the final conclusion, they see the main obstacles to improvements in executive pay in those rules that insulate directors from the influence of shareholders.

The main result of the analysis of this book is plausible and important. The authors challenge current practice as much as the leading academic paradigm. The book provides an up-to-date and readable survey of the evidence on executive compensation. The authors review a rather voluminous literature that comprises contributions from accounting, financial economics, and law and tie it into one coherent narrative. Thus, this contribution is more ambitious than previous survey articles and provides a convincing critique of executive-compensation practice and research.

The authors are less convincing when it comes to formulating an alternative theory. If compensation arrangements are inefficient, then it still remains unclear how managerial power could explain this. Inefficiency reduces the size of the pie that is split between directors and the CEO when they bargain over compensation, and even in the extreme case where CEOs have all the bargaining power (and directors have none) it would still be optimal for CEOs to seek efficient arrangements (maximize the size of the pie) and then make sure that they get the most generous package still acceptable to directors. Managerial power can explain the arguably overgenerous size of executive pay packages, but does nothing to help us understand why we observe inefficient contracts. A similar point holds with respect to the spectacular increase of executive pay in the 1990s: if managerial power is the main reason, then managerial power must have increased in the 1990s, but there is no empirical evidence for the claim that it did, an argument formulated by HALL AND MURPHY [2003]. Bebchuk and Fried argue that the enthusiasm for equity-based pay in the 1990s loosened the "outrage constraint" as outsiders came to accept pay increases as rewards necessary for executive risktaking, but it is not convincing to assume that moderate increases in performance sensitivity could be accompanied by incomparably larger risk premia without anybody taking notice. The concept of "camouflage" is intriguing and convincing when it comes to explaining some design features of stock options, the use of pension plans and corporate loans, or resistance against stock-option expensing. Therefore, this concept deserves further development. As it stands, the authors seem to connect camouflage with the belief that more transparency leads to lower pay, apparently because the outrage constraint becomes more stringent when outsiders are better informed (p. 72). However, other mechanisms do exist. In fact, the authors describe on the page before that executives often try to be in the upper half (*e.g.*, at the 75th percentile) of the distribution (*ratcheting:* everybody wants to be above average). If ratcheting indeed is a dominant force, then increased transparency allows CEOs to establish where they stand in relation to the distribution more easily, so that increased transparency would generate larger pay increases. CRYSTAL [1991] pointed out the details of this mechanism and lamented the "overcompensation" of executives already before the spectacular increases of pay in the 1990s. In retrospect, the increased transparency of pay after the 1992 reforms may have done more to increase pay than the "camouflage" theory suggests.

Overall I rate this as an important book that should help to get the academic profession thinking in a new direction. The supporters of the conventional model of compensation clearly have a case to answer, and this book makes it plain what the challenges to developing a better understanding of executive compensation are. Thus, it will surely generate a productive debate (for a thorough critique of this book and another view, see the review by CORE, GUAY, AND THOMAS [2005]).

European observers – not least, executives who point out how much they are underpaid in relation to "international" standards – often look to the U.S. as a model. The book should also be seen as a welcome contribution to the corporate-governance debate in Europe, as it provides a sobering perspective on what many regard as a role model. Everybody who wants to participate in the debate on executive compensation should read this book.

References

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Ernst Maug, University of Mannheim